

4

The Income Statement

Overview

To some, the income statement is the most important financial statement. To virtually all users, it remains one of the two most important, along with the balance sheet. Hence, understanding what goes into it, and how, is of vital importance not only in your understanding of this chapter but for later chapters as well.

Revenue (and expense) recognition is a significant concept both in this chapter and in practice these days. A number of accounting scandals have included improper recognition. (This topic is covered in more detail in Chapter 6.) Comprehending how, and why, recognition should occur when it does, according to GAAP, will help in enabling you to decide proper accounting treatment for the wide variety of possible transactions that can occur in the real world.

Income statements are not as simple as revenues minus expenses. There are specific components that break up the various revenues and expenses into certain classifications to provide additional information to users for easier analysis. Those components include not only the separate classification of cost of goods sold from operating expenses but also the separately stated, or below-the-line, items known as discontinued operations and extraordinary items.

The details of these matters were probably not gone over (at least in any degree of detail) in your introductory financial accounting course. Comprehensive income is another topic that may also be totally, or mostly, new to you.

Learning Objectives

Refer to the Review of Learning Objectives at the end of the chapter. It is crucial that this section of the chapter is second nature to you before you attempt the homework, a quiz, or exam. This important piece of the chapter serves as your CliffsNotes or “cheat sheet” to the basic concepts and principles that must be mastered.

If after reading this section of this chapter you still don't feel comfortable with all of the Learning Objectives covered, you will need to spend additional time and effort reviewing those concepts you are struggling with.

The following "Tips, Hints, and Things to Remember" are organized according to the Learning Objectives (LOs) in the chapter and should be gone over after reading each of the LOs in the textbook.

Tips, Hints, and Things to Remember

LO1 – Define the concept of income.

How? What is the difference between financial and physical capital maintenance? First of all, it is easy to remember the system in use since it is the same word as the term usually used to describe accounting for external users—*financial* or financial accounting. The difference between financial and physical is primarily related to the use of historical or current cost. If you remember back to LO5 in Chapter 1, you'll know that financial accounting uses various measurements of costs/values. For many companies, the primary measurement is historical cost (since things like inventory, and property, plant, and equipment can frequently make up the bulk of the assets on a balance sheet).

Under a physical capital maintenance system, assets would be valued at current cost. Although such a system would provide useful, perhaps more useful, information, it would also be difficult and costly to implement. Appraisals, or revaluations, would be required every time financial statements were to be issued. If the appraisals or revaluations were being done by management, then skeptics could claim that balance sheet numbers were inflated. If the appraisals or revaluations were being done by independent third parties, then companies would face even higher costs to come into compliance with accounting rules and requirements.

LO2 – Explain why an income measure is important.

LO3 – Explain how income is measured, including the revenue recognition and expense-matching concepts.

Why? Review the **Why?** sections beginning on page 1-3 for LO5 in Chapter 1.

How? Revenue is generally recognized when products are delivered or when services are performed. There are some exceptions as discussed in this chapter and as will be discussed in detail in later chapters. One of the key things to keep in mind is that collection of cash does not always, or even usually, result in revenue recognition. Cash is usually received, for most companies, before or after revenue recognition takes place.

Why? Revenue recognition has been an area of (potential) abuse. Investors and creditors are concerned not only with the bottom line but also with steady revenue growth. (In addition, the bottom line is affected by revenue.) Without firm rules in place, companies could potentially accelerate or defer revenues to more desirable accounting periods. (More will be said on this in Chapter 6). In the meantime, understand that it is important to recognize revenue in the correct period for comparability purposes (the company vs. others in the industry and the company's current revenue vs. past and projected revenues) and other reasons.

How? Expense recognition is similar to revenue recognition with some exceptions. Generally, expenses should be matched with the revenues they help generate in accordance with the matching process, or principle, that basically defines accrual-basis accounting. In some cases, this is not entirely possible, or feasible, so a rational allocation of costs should take place over a number of accounting periods (depreciation expense being the prime example for this method of expense recognition). Some other kinds of expenses are recognized immediately, for conservative reasons and/or because future revenues associated with the costs are not certain.

LO4 – Understand the format of an income statement.

How? There are two basic forms of an income statement—single-step and multiple-step. Don't worry too much about the single-step format. You won't see it much in practice or textbooks after your introductory course.

The multiple-step form is very common. The major difference from the single-step form is that items are classified into categories for easier analysis on the multiple-step form. It is important to know what goes into each of the categories (described in more detail in LO5 but highly summarized below).

- Separately stated items (discontinued operations and extraordinary items) are their own, below-the-line category. They don't show up elsewhere. They are the only items that show up net of income taxes.
- Interest revenue/expense (for most companies) shows up as "other."
- Cost of goods sold is the only expense that goes into the gross profit calculation.
- All other expenses (except income taxes and restructuring) usually get put in the operating expenses category.

LO5 – Describe the specific components of an income statement.

How? Restructuring charges may, at first glance, sound like discontinued operations. Don't be confused. They are not the same thing and do not appear in the same section of the income statement (although companies, in practice, sometimes announce earnings with and without restructuring as if it were a below-the-line item). Restructuring charges appear as an other expense (along with interest, losses, and a few other items)—*not* as an operating expense or as a below-the-line item shown net of income taxes.

How? Performing an intraperiod income tax allocation can prove to be tricky for some students. It shouldn't be. Think of it this way. All of your revenues/gains and expenses/losses that figure into "income before income taxes" have tax effects placed upon them in a single-line item, known as income tax expense and immediately following income before income taxes. Therefore, anything showing up after this (actually below this) point on the income statement will need to have the tax effects shown separately since they didn't show up above and wouldn't have had tax effects represented.

Where students sometimes become confused is with the direction in which the tax allocation moves income. After all, an extraordinary gain is going to have the opposite effect as an extraordinary loss on taxes. Don't bother memorizing which way everything should go. You'll likely forget the directions quickly and/or get them backwards come test time. Rather, remember this one thing: *Intraperiod income tax allocation will always move the gain or the loss closer to zero.*

How? There are two, and only two, below-the-line items. Know them. When you are taking a test or doing homework for this chapter specifically, identify them immediately so that you don't accidentally include them as an above-the-line kind of item. They are discontinued operations (including both the gain or loss on the sale/disposal of the operation's assets and the current year income or loss from the operation) and extraordinary items (must be *both* unusual and infrequent). Also, remember that they are presented in that order.

LO6 – Compute comprehensive income and prepare a statement of stockholders' equity.

Why? Comprehensive income is a measurement that is sometimes more exhaustive than net income. For many companies, net income and comprehensive income will be the same. However, if a company has foreign operations in another currency (more on this in your advanced accounting course), investments classified as available-for-sale (more on this in Chapter 14), or a number of other (infrequently occurring for many companies) transactions that FASB has specifically stated should be included in comprehensive income, then there are positive or negative adjustments to net income to arrive at comprehensive income.

Comprehensive income basically captures items that change equity (other than owner-related transactions such as selling stock or paying dividends) that don't already go into net income (and, hence, retained earnings after the books are closed).

LO7 – Construct simple forecasts of income for future periods.

The following sections, featuring various multiple choice questions, matching exercises, and problems, along with solutions and approaches to arriving at the solutions, is intended to develop your problem-solving and critical-thinking abilities. While learning through trial and error can be effective for improving your quiz and exam scores, and it can be a more interesting way to study than merely re-reading a chapter, that is only a secondary objective in presenting this information in this format.

The main goal of the following sections is to get you thinking, “How can I best approach this problem to arrive at the correct solution—even if I don't know enough at this point to easily arrive at the proper results?” There is not one simple approach that can be applied to all questions to arrive at the right answer. Think of the following approaches as possibilities, as tools that you can place in your problem-solving toolkit—a toolkit that should be consistently added to. Some of the tools have yet to even be created or thought of. Through practice, creative thinking, and an ever-expanding knowledge base, you will be the creator of the additional tools.

Multiple Choice

MC4-1 (LO1) Which of the following concepts relates to a system in which productive assets are revalued to current cost on the balance sheet?

- a. historical cost principle
- b. physical capital maintenance
- c. financial capital maintenance
- d. matching

MC4-2 (LO2) The amount of income reported for tax purposes

- a. is always less than the net income reported to stockholders.
- b. must be computed according to GAAP.
- c. is used to compute earnings per share.
- d. may differ from the amount of income determined for financial reporting purposes.

MC4-3 (LO3) Costs that can be reasonably associated with specific revenues but not always with specific products should be

- always charged to expense in the period paid.
- allocated to specific products based on the best estimate of the production processing time.
- capitalized and then amortized over a period not to exceed 60 months.
- expensed in the period in which the related revenue is recognized.

MC4-4 (LO3) Under the general rule of revenue recognition, revenue is recognized when

- marketability and market price are assured.
- a contractual agreement exists, and cash collection is assured.
- the company has provided the goods or services promised, and payment or a valid promise of payment has been received.
- all related expenses have been incurred.

The following information is for **MC4-5** through **MC4-7**.

The following amounts are from Case's Cards 2011 income statement:

Sales	\$340,000
Cost of goods sold	132,000
Utilities expense	66,000
Interest revenue	1,000
Income tax on operations	28,000
Extraordinary loss due to earthquake, net of tax	5,000
Interest expense	4,000
Salaries expense	46,000
Loss on sale of investments	3,000

MC4-5 (LO4) What amount would Case's Cards show for income from continuing operations on a multiple-step format income statement?

- \$208,000
- \$62,000
- \$57,000
- \$96,000

MC4-6 (LO4) What amount would Case's Cards show for gross profit on a multiple-step format income statement?

- \$208,000
- \$62,000
- \$57,000
- \$96,000

MC4-7 (LO4) What amount would Case's Cards show for net income on a multiple-step format income statement?

- a. \$208,000
- b. \$62,000
- c. \$57,000
- d. \$96,000

MC4-8 (LO4) On a multiple-step income statement, gains or losses on the sale of a building (not a separately identifiable component of the business for discontinued operations classification purposes) for a company not in the business of selling buildings would be shown

- a. after income before extraordinary items but before net income.
- b. after income from continuing operations but before income from extraordinary items.
- c. after gross profit on sales but before income from continuing operations.
- d. before gross profit on sales.

MC4-9 (LO5) The normal ordering of items in the income statement would be best illustrated by which of the following?

- a. extraordinary items, income from continuing operations, discontinued operations, net income
- b. income from continuing operations, discontinued operations, extraordinary items, net income
- c. income from continuing operations, extraordinary items, gross profit, net income
- d. discontinued operations, income from continuing operations, extraordinary items, net income

MC4-10 (LO5) Which of the following is NOT true regarding restructuring charges?

- a. Restructuring charges reflect a loss in asset values of assets no longer consistent with a company's strategic plan.
- b. Restructuring charges are reported as extraordinary items.
- c. Companies that are already faced with the prospect of poor reported performance for a year may intentionally overstate the cost of a restructuring.
- d. In 2002, the FASB issued a clarifying standard to reduce the flexibility companies have to strategically estimate and recognize big-bath restructuring charges.

MC4-11 (LO5) On June 30, 2011, Carla Company's operating facilities in Texas were destroyed by an earthquake, considered both infrequent and unusual. The loss of \$700,000 was not covered by insurance. Carla's tax rate for 2011 is 30 percent. In Carla's income statement for the year ended December 31, 2011, this event should be reported as an extraordinary loss of

- a. \$0.
- b. \$210,000.
- c. \$490,000.
- d. \$910,000.

MC4-12 (LO5) Assume that a change in accounting principle takes place for Stamper Company. By requiring Stamper Company to restate their financial statements for all prior years presented and adjust retained earnings (if needed) for the first year presented, which of the following items from the conceptual framework is being adhered to?

- a. Comparability
- b. Conservatism
- c. Representational faithfulness
- d. Verifiability

Matching

Matching 4-1 (LO1, LO2, LO3, LO4) Listed below are the terms and associated definitions from the chapter for LO1 through LO4. Match the correct definition letter with each term number.

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| ___ 1. consolidated financial statements | a. the process of determining the period in which expenses are to be recorded; possibilities for doing so include these categories: (1) direct matching, (2) systematic and rational allocation, and (3) immediate recognition |
| ___ 2. expense recognition | b. a format of the income statement that lists operating revenues and expenses first, resulting in operating income; gains and losses are then added or subtracted to arrive at income from continuing operations; irregular and extraordinary items are then added or subtracted to arrive at net income |
| ___ 3. financial capital maintenance | c. the amount that an entity could return to its investors and still be as well-off at the end of the period as it was at the beginning |
| ___ 4. income | d. inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations |
| ___ 5. losses | e. income is defined as the excess of physical productive capacity at the end of an accounting period over the physical productive capacity at the beginning of the period, excluding the effects of transactions with owners |
| ___ 6. matching | f. combines revenues and gains and subtracts from them expenses and losses, resulting in income from continuing operations; irregular and extraordinary items are then added or subtracted to arrive at net income |
| ___ 7. multiple-step form | g. combine the financial results of a parent company and its subsidiaries |
| ___ 8. physical capital maintenance | h. basic accounting concept that is applied to determine when expenses are recognized (recorded); expenses for a period are determined by associating them with specific revenues over a particular time period |
| ___ 9. revenues | i. the amount by which the proceeds from disposing of a non-inventory asset are less than the book value of the asset |
| ___ 10. single-step form | j. income is defined as the excess of net assets at the end of an accounting period over the net assets at the beginning of the period, excluding effects of transactions with owners |

Matching 4-2 (LO5) Listed below are the terms and associated definitions from the chapter for LO5 and LO6. Match the correct definition letter with each term number.

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| ___ 1. comprehensive income | a. a measure of the profitability of sales in relation to the cost of goods sold |
| ___ 2. discontinued operations | b. a measure of the relationship between the market price of a company's stock and its profitability |
| ___ 3. earnings per share (EPS) | c. revenue from net sales minus cost of goods sold |
| ___ 4. extraordinary items | d. a concept of income measurement and reporting that includes all changes in owners' equity except investments by and distributions to owners |
| ___ 5. gross profit | e. a measure of the profitability of a company that relates net income to the sales of the company—net income divided by net sales |
| ___ 6. gross profit percentage | f. a calculation required by generally accepted accounting principles to be presented on the income statement for income from continuing operations and for each irregular or extraordinary component of reported income |
| ___ 7. income from continuing operations | g. revenues minus cost of goods sold and operating expenses; also called earnings before interest and taxes |
| ___ 8. intraperiod income tax allocation | h. a number that is obtained by subtracting expenses and losses from revenues and gains and is always disclosed after taxes have been subtracted |
| ___ 9. operating income | i. changes made directly to the Retained Earnings account to correct errors made in previous periods |
| ___ 10. price-earnings ratio (P/E ratio) | j. a method of income statement presentation of irregular or extraordinary items in which the tax effect of each of these special items is reported with the individual item rather than in the income tax expense related to current operations |
| ___ 11. prior-period adjustments | k. disposal of a separately identifiable component of a business either through sale or abandonment; operations and cash flows of the component must be clearly distinguishable, both physically and operationally, from other activities of the company |
| ___ 12. return on sales | l. gains or losses resulting from events and transactions that are both unusual in nature and infrequent in occurrence or otherwise defined as such per accounting standards |

Problems

Problem 4-1 (LO3) The changes in the account balances and the following additional information are taken from the accounts of the Mays Corporation. Retained Earnings is the only balance sheet account not shown.

	Increase (Decrease)
Cash	\$ 140,000
Accounts Receivable	(30,000)
Inventory	200,000
Buildings and Equipment (net of Accumulated Depreciation)	630,000
Accounts Payable	(170,000)
Bonds Payable	375,000
Capital Stock	300,000
Additional Paid-In Capital	45,000

Dividends for 2011 were \$80,000. There were no transactions in 2011 affecting Retained Earnings other than the dividends and net income. Calculate the 2011 net income.

Problem 4-2 (LO5) The following pretax amounts pertain to the Kanako Corporation for the year ended December 31, 2011:

Sales	\$400,000
Operating expenses	84,000
Extraordinary gain	30,000
Interest expense	4,000
Cost of goods sold	280,000
Gain on sale of equipment	10,000
Loss on disposal of separately identifiable business segment	40,000
Dividends declared	12,000

The effective corporate tax rate is 35 percent. Assume there were 15,000 shares of common stock outstanding throughout the year.

Prepare a multiple-step income statement in good form for the year ended December 31, 2011.

Problem 4-3 (LO5) Pigs, Moons, & Wishes Corporation purchased a patent on January 1, 2006, for \$100,000. The original life of the patent was estimated to be 20 years, and it is being amortized over its life using the straight-line method. In December 2011, the company received information that the patent would be obsolete within four years. Accordingly, the company decided to write off the unamortized portion of the patent cost over five years beginning in 2011.

Is this a correct treatment, or should the company make retroactive adjustments to the comparative financial statements they will be presenting?

How would the change in useful life be reflected in the accounts for 2011, prior years, and subsequent years?

Problem 4-4 (LO5) JG Company has two divisions, J and G. The operations and cash flows of these two divisions are clearly distinguishable. On August 1, 2011, the company decided to dispose of the assets and liabilities of Division G. It is probable that the disposal will be completed later this year. The revenues and expenses of JG Company for 2006 and for the preceding two years are as follows:

	2011	2010	2009
Sales—Division J	\$18,000	\$17,000	\$16,000
Sales—Division G	15,000	16,000	19,000
Total nontax expenses—Division J	14,000	16,000	14,000
Total nontax expenses—Division G	16,000	15,000	17,000

During the latter part of 2011, JG disposed of Division G and recognized a pretax loss of \$10,000 on the disposal. The income tax rate for JG Company is 35 percent.

Prepare the comparative income statements for JG Company for the years 2009, 2010, and 2011.

Solutions, Approaches, and Explanations

MC4-1

Answer: b

Approach and explanation: Historical cost is the opposite of the current cost approach, so choice *a* certainly can't be correct. Under the financial capital maintenance concept (which is the system used for U.S. GAAP purposes for financial accounting), a variety of valuation methods are used including historical cost, current cost, present value, etc. (See LO5 in Chapter 1 and the **How?** on page 4-2.)

The hardest choice for most students will, therefore, be between choices *b* and *d*. Let's look at *d* first. Matching, in the accounting sense, does not mean that we match assets with their current costs. Instead, it is an income statement-related concept (and more specifically an expense-related principle) dealing with matching expenses to the revenues, which the expense went toward producing.

By a process of elimination, then, we have come up with choice *b* as the correct answer even if we didn't know what it was to begin with. Physical capital refers to the productive assets and maintenance refers to maintaining the balance sheet cost at current, rather than historical, values.

MC4-2

Answer: d

Approach and explanation: Income for financial statement purposes must be computed according to GAAP. As LO2 states, however, taxable income is usually different than GAAP income.

Note that choices *a* and *d* are similar. However, if choice *a* were correct, choice *d* would also have to be correct. The opposite isn't the case. Choice *d* can be correct without choice *a* also being correct. Since two choices can't be correct, that rules out choice *a*.

Earnings per share (EPS) (covered in later LOs in the chapter and then in much more detail in Chapter 18) is based on GAAP numbers. EPS is not a tax concept; nor is it in any way associated with taxable income.

MC4-3

Answer: d

Approach and explanation: It may help to think of an example of a cost that can be reasonably associated with specific revenues but not always with specific products.

For instance, a company may have shipped 10,000 units during the year at a cost of \$5 per unit. The units consisted of a wide variety of products and, hence, wouldn't always be easy to track on a product-by-product basis. If the company paid \$40,000 during the year to the shipping company during the year and the remaining \$10,000 in the subsequent year, when should these expenses be recognized?

The best method, and first method that should be used if possible, is the matching process. In this case, if things wouldn't change and should we be talking about expenses allocable to specific products (for instance, cost of goods sold), we can match the expenses with the revenues so the full \$50,000 should be recognized as a shipping expense in the current year even though the full amount hasn't been paid. Choice *a* doesn't very often work when we are dealing with accrual-basis accounting.

Choice *b* doesn't make sense because the question states that we can't always associate these expenses with specific products.

Choice *c* sounds like something you may do for organizational costs for tax purposes or for an intangible asset that isn't going to be useful for more than five years. It certainly isn't the norm for these kinds of shipping expenses, which businesses likely encounter far more frequently.

MC4-4

Answer: c

Approach and explanation: For revenue to be recognized (recorded on the books), two things must happen:

1. The revenue must be realized or realizable.
2. The revenue must be earned through substantial completion of the activities involved in the earnings process.

“Realized” means that cash has been received. “Realizable” means that a valid promise of payment has been received. Completion of the activities involved means that the product has been delivered or (in the case of a service-based business) that the services have been rendered.

Choices *a* and *b* would allow companies to book revenue (much) earlier than they currently can. Choice *a*, in particular, would allow companies to recognize revenue perhaps even years before they actually sold (delivered) the product.

Choice *b* could also go to that extreme. Imagine a life insurance company selling a policy (contract) to a 20-year-old who is going to pay \$1,000 a month for the next (perhaps) 60+ years or so for a million dollars upon their death. Recognizing hundreds of thousands of dollars in revenue now just because a contract exists and the cash will be coming in (far down the road for the most part) makes no conceptual sense.

Choice *d* could go either way. If a company bought inventory and that was their only cost, then they could prematurely recognize revenue before ever selling the inventory. Alternatively, they may have bought inventory on account. If they had to pay off their account before they could recognize revenue for the sale of the product, then revenue recognition would be erroneously deferred.

MC4-5

Answer: b

Approach and explanation: Since you are required to use the information for three different questions, you should prepare one multiple-step income statement for the data given and use your income statement to answer the three questions. This method and approach will save you time and assure that you haven’t forgotten any components to the income statement. If, instead, you tried to solve each problem independently, you are going to have to run three calculations instead of one, increasing the amount of time spent and increasing the odds of an error entering one of your calculations.

So what should your income statement look like? A helpful way to determine what your income statement should look like is to draw out a “13-piece income statement skeleton,” like the following:

1. Revenue
2. – Cost of goods sold
3. = Gross profit
4. – Operating expenses
5. = Operating income
6. ± Other revenue/gains/expenses/losses
7. = Income from operating operations before income taxes
8. – Income taxes
9. = Income from continuing operations
10. ± Discontinued operations
11. = Income before extraordinary items
12. ± Extraordinary items (net of taxes)
13. = Net income

Commit the above to memory as you're bound to see it tested in some way, shape, or form at least once on any quiz or exam that includes Chapter 4. If you have the above written out on a piece of scratch paper, then once you see the choices, no matter which components are included, you're sure to get the answer correct.

Likewise, if you are given an open-ended problem in which you are to create a multiple-step income statement with (or without) separately stated items, you will already have a skeleton statement to go off of so that you are sure to not miss any of the components. Remember that lucky number 13 is the number of pieces in a multiple-step income statement.

Now plug in the numbers in each row:

1. \$340,000
2. – \$132,000
3. = \$208,000
4. – \$112,000 (\$66,000 + \$46,000)
5. = \$ 96,000
6. – \$ 6,000 (\$1,000 – \$4,000 – \$3,000)
7. = \$ 90,000
8. – \$ 28,000
9. = \$ 62,000
10. ± \$ 0
11. = \$ 62,000
12. – \$ 5,000
13. = \$ 57,000

With the above in hand, you could now answer 13 questions about this income statement.

MC4-6

Answer: a

Approach and explanation: Just look at row 3 from your income statement skeleton calculation in **MC4-5**.

MC4-7

Answer: c

Approach and explanation: Just look at row 13 from your income statement skeleton calculation in **MC4-5**.

Notice that choice *d* is also a part of the income statement skeleton (row 5). Therefore, you need to know not only where everything goes on the income statement but also what everything is called. Operating income is usually not the same thing as net income, income from continuing operations, or gross profit.

When would they all be the same? When the only expense was cost of goods sold, there are no other revenue/gain/expense/loss items, and there are no separately stated items, all of these titles would yield the same number.

A more likely situation would be for just income from continuing operations and net income to be the same. When would that situation be the case? When there are no discontinued operations or extraordinary items, these titles would produce the same number.

MC4-8

Answer: c

Approach and explanation: This answer could be one of several of the choices depending on how the question is worded. Let's look at the correct answer first and then see how tweaking the question will make the correct answer incorrect and some of the other choices correct.

Before ever looking at the choices, you should know that there are three places where gains or losses on the sale of a building could possibly show up: (1) as part of gross profit for companies in the business of selling buildings, (2) as part of continuing operations—but not part of gross profit—for most companies, (3) and as a separately stated item if the building was sold as part of a discontinued operation. As you read the question, highlight the fact that this is *not* part of a discontinued operation and the fact that the company is *not* in the business of selling buildings. This will zero you in on the only correct possibility of choice *c*.

How could the question be changed so that choice *a* is correct? Here is a reworded question that would yield such an answer:

On a multiple-step income statement, gains or losses on the insurance proceeds for a building destroyed in a fire, an event considered both unusual and infrequent, would be shown...

What if the question was reworded to say the following?

On a multiple-step income statement, gains or losses on the insurance proceeds for a building on a flood plain destroyed in a flood, an event considered unusual but not infrequent (or vice versa), would be shown...

Then we wouldn't have an extraordinary item, and the correct answer would still be choice *c*.

How could the question be changed so that choice *b* is correct? Here is a reworded question that would yield such an answer:

On a multiple-step income statement, gains or losses on the sale of a building (a separately identifiable component of the business for discontinued operations classification purposes) for a company not in the business of selling buildings would be shown...

You may not have even noticed the difference. Just one word was dropped—"not." By dropping the word "not" and making it a discontinued operation, the correct answer changes from choice *c* to choice *b*.

How could the question be changed so that choice *d* is correct? Here is a reworded question that would yield such an answer:

On a multiple-step income statement, gains or losses on the sale of a building (not a separately identifiable component of the business for discontinued operations classification purposes) for a company in the business of selling buildings would be shown...

Again, you may not have even noticed the difference. Just one word was dropped this time as well—the second "not." By dropping the second "not" and making the selling of buildings this company's normal business activity, the correct answer changes from choice *c* to choice *d*.

Hopefully, this demonstration has impressed upon you a couple of things:

1. Read each word in a question very carefully because changing, dropping, or adding even a single word can change the correct answer.
2. When going through questions in preparation for a quiz or an exam, ask yourself how the question can be changed to make the other choices correct. Professors frequently tweak homework or practice questions when they turn them into exam questions to make sure that you fully understand the material and haven't merely memorized correct choices from practice questions.

MC4-9

Answer: b

Approach and explanation: Once again, before ever looking at the choices, it is a good idea to write out what you know and then try to match the correct answer to what you have already written. Otherwise, seeing the choices may scramble things in your brain or cause you to second guess yourself. While covering the choices with a scratch piece of paper, write out an income statement skeleton:

1. Revenue
2. – Cost of goods sold
3. = Gross profit
4. – Operating expenses
5. = Operating income
6. ± Other revenue/gains/expenses/losses
7. = Income from operating operations before income taxes
8. – Income taxes
9. = Income from continuing operations
10. ± Discontinued operations
11. = Income before extraordinary items
12. ± Extraordinary items (net of taxes)
13. = Net income

MC4-10

Answer: b

Approach and explanation: If this answer wasn't easy for you, then review the first **How?** for LO5 on page 4-4.

Restructuring charges are not separately stated (below-the-line) items. They are not to be considered discontinued operations or extraordinary items.

That having been said, you may still be scratching your head and saying, "But choice c just doesn't sound true; why on earth would a company overstate the cost of a restructuring when their year was bad already?" For the answer to this, you may want to flip ahead to Chapter 6's discussion on the big bath. In a nutshell, if a company wants future profits to look better (and for investment purposes the future is always more important than the past), one way to accomplish such an objective is to over expense things now so that when the expenses are later reversed, future profits are artificially inflated.

MC4-11

Answer: c

Approach and explanation:

Step 1: Determine whether this is an extraordinary item. Is the event both infrequent and unusual? If yes, then it is an extraordinary item. If no, then the correct choice would be a.

Step 2: If the answer to step 1 is yes, then the amount of the extraordinary item, net of taxes, needs to be computed. If the item was covered by insurance, then the difference between the insurance proceeds and the carrying value of the asset would result in the amount of gain or loss before taxes. In this case, that number has been provided as \$700,000.

Multiply this number by one minus the tax rate to come up with the correct after-tax gain or loss in this intraperiod income tax allocation. Remember (from the second **How?** for LO5 on page 4-4) that the number should always move closer to zero regardless of whether it is a gain or a loss. ($\$700,000 \times 0.7 = \$490,000$)

Alternatively, you can multiply $\$700,000 \times 30$ percent and come up with the tax benefit of \$210,000. Be careful what you do with the \$210,000 though. It isn't the correct answer (incorrect choice *b*), nor should you add it to the \$700,000 or you will come up with the incorrect choice *d*. Since losses reduce income for tax purposes as well, there is a tax savings by having this extraordinary loss. That is why the number moves closer to zero and not further away. The amount of the loss, after tax, is less than the original loss amount.

MC4-12

Answer: a

Approach and explanation: If companies were allowed to change accounting methods and not restate prior results, they could suddenly recognize a (potentially huge) gain or loss in the current year that was due not to how the company actually performed but solely to an accounting difference (some would say accounting trick!).

Therefore, to maintain comparability and consistency, companies must restate prior earnings so that a user of the financial statement information can see how the company has been doing over time assuming they always used the new accounting method.

Conservatism, on the other hand, would probably say something like "recognize losses due to accounting changes but not the gains." Representational faithfulness and verifiability deal with reliability. The numbers could still be sound (reliable) if we presented them as gains or losses in differing years, but the comparability in terms of how the company has performed over time goes out the window if the financial statements are not restated to reflect the new accounting principle in use.

Matching 4-1

1. g
2. a
3. j
4. c
5. i
6. h
7. b
8. e
9. d
10. f

Complete these terminology matching exercises without looking back to the textbook or on to the glossary. After all, you probably won't have those as a reference at test time. Learning through trial and error causes the item to be learned better and to stick in your memory than if you just look to the textbook, glossary, or a dictionary and "cook book" the answers. Sure you may get the answer correct on your first attempt, but missing something is sometimes best for retention. Don't be afraid of failure while studying and practicing.

Matching 4-2

1. d
2. k
3. f
4. l
5. c
6. a
7. h
8. j
9. g
10. b
11. i
12. e

Problem 4-1

The first thing to note is that you will never be given such a problem in real life. What this problem, and others like it, is testing is your problem-solving abilities when given new parameters, or facts rearranged in a nontraditional format (which is what will frequently happen to you during your professional career). So what do you need to know, and what do you do to solve such a thing?

1. You need to know how the balance sheet and income statement work/fit together. After all, this problem asks for income statement information, but only balance sheet information is provided.
2. You need to remember back to Chapter 3 that, on a balance sheet, assets always equal the sum of liabilities and equity.

3. Recall that the only account on the balance sheet that directly relates to net income is Retained Earnings.

With those things in mind, we can begin to solve this problem. Let's treat the changes in account balances as if they were single entries into an accounting system using the standard debit and credit format (reviewed in Chapter 2).

Debit changes in accounts during 2011, other than Retained Earnings, are as follows:

Cash	\$ 140,000
Inventory	200,000
Buildings and Equipment (net)	630,000
Accounts Payable	<u>170,000</u>
Total debits	<u>\$1,140,000</u>

Credit changes in accounts during 2011, other than Retained Earnings, are as follows:

Accounts Receivable	\$ 30,000
Bonds Payable	375,000
Capital Stock	300,000
Additional Paid-In Capital	<u>45,000</u>
Total credits	<u>\$750,000</u>

Difference between debits and credits (\$1,140,000 – \$750,000) \$390,000

Since Retained Earnings is the only account for which a balance change was not obtained, we know that retained earnings must have received 390,000 in net credits for the year.

2011 change in Retained Earnings	\$390,000
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Dividends always reduce Retained Earnings, so we need to add dividends to the Retained Earnings change to determine the amount of the change due to Net Income being closed out to Retained Earnings.

2011 change in Retained Earnings	\$390,000
Add dividends	<u>80,000</u>
Net Income	<u>\$470,000</u>

There are other ways to approach the problem. For instance, you can create a comparative balance sheet and put in fake numbers (for instance, \$100,000 as your beginning cash and \$240,000 (\$100,000 + \$140,000 increase) as ending cash, etc.). Ultimately, whatever approach you take, you will be figuring out the change in Retained Earnings and using that number to back into Net Income after adding back in dividends.

Problem 4-2

Kanakano Corporation
Income Statement
For the Year Ended December 31, 2011

Sales	\$400,000
Cost of goods sold	<u>280,000</u>
Gross profit	\$120,000
Operating expenses	<u>84,000</u>
Operating income	\$ 36,000
Other revenues and gains:	
Gain on sale of equipment	10,000
Other expenses and losses:	
Interest expense	<u>(4,000)</u>
Income from continuing operations before income taxes	\$ 42,000
Income taxes	<u>14,700</u>
Income from continuing operations	\$ 27,300
Discontinued operations:	
Loss on disposal of separately identifiable business segment (net of income tax benefit of \$14,000)	<u>(26,000)</u>
Income before extraordinary item	1,300
Extraordinary gain (net of income taxes of \$10,500)	<u>19,500</u>
Net income	<u><u>\$ 20,800</u></u>
Earnings per common share:	
Income from continuing operations	\$ 1.82
Discontinued operations	(1.73)
Extraordinary gain	<u>1.30</u>
Net income	\$ 1.39

Some items to note regarding the solution:

- When a problem asks you to prepare an income statement (especially when it specifically says something to the affect of “in good form”), make sure to include a proper header. You may lose points if you don’t include a header or score bonus points by including one. The header should include the name of the company, the name of the statement, and the time period covered. For an income statement, make sure that it is for a period of time and not just dated 12/31/11. The date of 12/31/11 doesn’t tell you if the income statement is for the month of December, the quarter ending in December, or the year ending in December.
- Label every number. Don’t assume that the reader knows that revenue minus cost of goods sold is called gross profit. Include a title for each line in which a number is given.

- The \$14,700 is computed as $\$42,000 \times 35$ percent. For computations of the intraperiod income tax allocation, see the explanation given in Step 2 of the solution to **MC4-11** on page 4-19.
- Total income tax expense for this company is \$11,200 even though it shows up on the statement as a line item of \$14,700. Why is this? The \$14,700 does not include amounts for the below-the-line items. When those items are considered ($14,700 - 14,000 + 10,500$), the actual expense drops to \$11,200.
- Don't forget earnings per share (EPS)! Although EPS doesn't always show up in textbook illustrations (since textbook examples may not be teaching EPS at that point in the book), they are required on the face of income statements if the income statement is being presented in accordance with GAAP. EPS should be shown separately for all below-the-line items as well as for "net income" and for "income from continuing operations."

Problem 4-3

This is the correct treatment with respect to a change in estimate. Change in estimates are accounting for currently and prospectively, not retroactively.

Original cost of patent	\$100,000
Amortization for 5 years (\$5,000* per year 2006–2011)	<u>25,000</u>
Remaining unamortized balance	\$ 75,000
New estimated life beginning in 2011	<u>÷ 5 years</u>
Amortization expense for each year (2011–2015)	\$ 15,000*

* $100,000/20$

Prior years will not be affected. Amortization expense will go up in the current year and in the next four years by \$10,000 ($\$15,000 - \$5,000$) each year compared to what it would have been had the useful life not changed.

The key calculation to make in these change-of-estimate type problems is the computation of unamortized or undepreciated balance. Once you have that number, you use it as your new basis to be amortized or depreciated over the new (not total) remaining life.

Problem 4-4

JG Company
Income Statement
For the Years Ended December 31

	2011	2010	2009
Sales	\$ 18,000	\$17,000	\$16,000
Expenses	<u>14,000</u>	<u>16,000</u>	<u>14,000</u>
Income before taxes	\$ 4,000	\$ 1,000	\$ 2,000
Income tax expense (35 percent)	<u>1,400</u>	<u>350</u>	<u>700</u>
Income from continuing operations	\$ 2,600	\$ 650	\$ 1,300
Discontinued operations:			
Income (loss) from discontinued operations (including loss on disposal in 2011 of \$10,000)	\$(11,000)	\$ 1,000	\$ 2,000
Income tax expense (benefit) (35 percent)	<u>(3,850)</u>	<u>350</u>	<u>700</u>
Income (loss) on discontinued operations	<u>\$ (7,150)</u>	<u>\$ 650</u>	<u>\$ 1,300</u>
Net income (loss)	<u><u>\$ (4,550)</u></u>	<u><u>\$ 1,300</u></u>	<u><u>\$ 2,600</u></u>

Note that this problem was given pretty much the same way as a similar one was given in the textbook. However it could have been provided in a different format. For instance, the original income statements could have been provided for the company as a whole. After all, in 2010 and 2009, no discontinued operations were known about, so when those financial statements were created, there was no “discontinued operations” section of the income statement. Those statements would have looked like the following:

JG Company
Income Statement
For the Years Ended December 31

	2010	2009
Sales	\$33,000	\$35,000
Expenses	<u>31,000</u>	<u>31,000</u>
Income before taxes	\$ 2,000	\$ 4,000
Income tax expense (35 percent)	<u>700</u>	<u>1,400</u>
Net income	<u><u>\$ 1,300</u></u>	<u><u>\$ 2,600</u></u>

Notice that net income doesn't change, but the presentation still changes rather dramatically. You could have been given the above comparative income statement and then the Division G information and been asked to do the same thing. In that case, you'd simply need to pull the Division G numbers out of the above numbers to come up with the comparative income statement with discontinued operations separately stated.

Glossary

Note that Appendix C in the rear portion of the textbook contains a comprehensive Glossary for all of the terms used in the textbook. That is the place to turn to if you need to look up a word but don't know which chapter(s) it appeared in. The glossary below is identical with one major exception: It contains only those terms used in Chapter 3. This abbreviated Glossary can prove quite useful when reviewing a chapter, when studying for a quiz for a particular chapter, or when studying for an exam which covers only a few chapters including this one. Use it in those instances instead of wading through the 19 pages of comprehensive glossary in the textbook trying to pick out just those words that were used in this chapter.

comparative financial statements Financial statements that enable users to analyze performance over multiple periods and identify significant trends that might impact future performance.

comprehensive income A concept of income measurement and reporting that includes all changes in owners' equity except investments by and distributions to owners.

consolidated financial statements Financial statements that combine the financial results of a parent company and its subsidiaries.

discontinued operations The disposal of a separately identifiable component of a business either through sale or abandonment. The operations and cash flows of the component must be clearly distinguishable, both physically and operationally, from other activities of the company.

earnings per share (EPS) Income for the period reported on a per-share-of-common-stock basis. The presentation of earnings per share on the income statement is required by generally accepted accounting principles. Separate EPS amounts are required for income from continuing operations and for each irregular or extraordinary component of reported income.

expense recognition The process of determining the period in which expenses are to be recorded. Expense recognition is divided into three categories: (1) direct matching, (2) systematic and rational allocation, and (3) immediate recognition.

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

extraordinary items Gains or losses resulting from events and transactions that are both unusual in nature and infrequent in occurrence or otherwise defined as an extraordinary item per accounting standards.

financial capital maintenance A concept under which income is defined as the excess of net assets at the end of an accounting period over the net assets at the beginning of the period, excluding effects of transactions with owners.

gain Amount by which the proceeds from disposing of an asset exceed the book value of the asset.

gross profit Revenue from net sales minus cost of goods sold.

gross profit percentage Gross profit divided by sales; a measure of the profitability of sales in relation to the cost of goods sold.

income A measure of a company's "well-offness." It is often defined as the amount that an entity could return to its investors and still be as well-off at the end of the period as it was at the beginning.

income from continuing operations A measure of the profitability of a firm's operations. The number is obtained by subtracting expenses and losses from revenues and gains. Income from continuing operations is always disclosed after taxes have been subtracted.

intraproduct income tax allocation A method of income statement presentation of irregular or extraordinary items in which the tax effect of each of these special items is reported with the individual item rather than in the income tax expense related to current operations.

loss Amount by which the proceeds from disposing of an asset are less than the book value of the asset.

matching A basic accounting concept that is applied to determine when expenses are recognized (recorded). Under this principle, expenses for a period are determined by associating or "matching" them with specific revenues over a particular time period.

multiple-step form A format of the income statement that lists operating revenues and expenses first, resulting in operating income. From this figure, gains and losses are then added or subtracted to arrive at income from continuing operations. Irregular and extraordinary items are then added or subtracted to arrive at net income.

operating income A measure of the performance of a company's business operations. The formula is revenues minus cost of goods sold and operating expenses. Also called *earnings before interest and taxes*.

physical capital maintenance A concept under which income is defined as the excess of physical productive capacity at the end of an accounting period over the physical productive capacity at the beginning of the period, excluding the effects of transactions with owners.

price-earnings (P/E) ratio A measure of the relationship between the market price of a company's stock and its profitability. The formula is the market price per share of common stock divided by the earnings per share of common stock.

prior-period adjustment An adjustment made directly to the Retained Earnings account to correct errors made in prior accounting periods.

restructuring charge An estimate of the costs expected to be incurred as a result of a plan to significantly modify a company's operations.

return on sales A measure of the profitability of a company that relates net income to the sales of the company. The formula is net income divided by net sales.

revenue recognition A basic accounting concept that is applied to determine when revenue should be recognized (recorded). Generally, under this principle, revenues are recognized when two criteria are met: The earnings process is substantially complete, and the revenues are realized, or realizable.

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

single-step form A format of the income statement that combines revenues and gains and subtracts from them expenses and losses, resulting in income from continuing operations. Irregular and extraordinary items are then added or subtracted to arrive at net income.

transaction approach A method of determining income by defining the financial statement effects of certain events classified as revenues, gains, expenses, and losses. Also known as the *matching method*, this is the traditional accounting approach to measuring and defining income.