CHAPTER 4

INCOME STATEMENT AND RELATED INFORMATION

OVERVIEW

An income statement reports on the results of operations of an entity for a period of time. It is important to classify revenues, expenses, gains, and losses properly on the income statement. In this chapter, we discuss the income statement classifications and the content of the statement of retained earnings along with related disclosure issues. It is imperative that charges and credits that represent elements of income determination be properly reflected in the financial statements. Errors in the determination of income cause errors on the income statement, statement of retained earnings, and balance sheet.

SUMMARY OF LEARNING OBJECTIVES

1. **Identify the uses and limitations of an income statement.** The income statement provides investors and creditors with information that helps them predict the amount, timing and uncertainty of future cash flows. Also, the income statement helps users determine the risk (level of uncertainty) of not achieving particular cash flows. The limitations of an income statement are: (1) the income statement does not include many items that contribute to general growth and well-being of an enterprise; and (2) income numbers are often affected by the accounting methods employed.

   The capital maintenance approach takes the net assets or "capital values" based on some valuation and measures income by the difference in capital values at two points in time. The transaction approach focuses on the activities that have occurred during a given period; instead of presenting only a net change in net assets, it discloses the components of the change. The transaction approach to income measurement requires the use of revenue, expense, gain, and loss accounts.

2. **Prepare a single-step income statement.** In a single-step income statement, just two groupings exist: revenues and expenses. Expenses are deducted from revenues to arrive at net income or net loss. The expression "single-step" is derived from the single subtraction necessary to arrive at net income. Frequently, however, income taxes are reported separately as the last item before net income to indicate their direct relationship to income before taxes.

3. **Prepare a multiple-step income statement.** A multiple-step income statement shows two further classifications: (1) a separation of operating results from those obtained through the subordinate or nonoperating activities of the company; and (2) a classification of expenses by functions, such as merchandising or manufacturing, selling, and administration.

4. **Explain how irregular items are reported.** Irregular gains or losses or nonrecurring items are generally closed to Income Summary and are included in the income statement. These are treated in the income statement as follows: (1) Discontinued operations of a segment of a business is classified as a separate item, after continuing operations; (2) The unusual, material, nonrecurring items that are significantly different from the typical or customary business
activities are shown in a separate section for “extraordinary items,” below discontinued operations; (3) Other items of a material amount that are of an unusual or nonrecurring nature and are not considered extraordinary are separately disclosed as components of income from continuing operations; and (4) The cumulative adjustment that occurs when a change in accounting principle is reported in the income statement is disclosed as a separate item, just before net income.

5. **Explain intraperiod tax allocation.** The tax expense for the year should be related, where possible, to specific items on the income statement to provide a more informative disclosure to statement users. This procedure is called **intraperiod tax allocation**, that is, allocation within a period. Its main purpose is to relate the income tax expense for the fiscal period to the following items that affect the amount of the tax provisions: (1) income from continuing operations, (2) discontinued operations, (3) extraordinary items, and (4) changes in accounting principles.

6. **Explain where earnings per share information is reported.** Because of the inherent dangers of focusing attention solely on earnings per share, the profession concluded that earnings per share must be disclosed on the face of the income statement. A company that reports a discontinued operation, an extraordinary item, or the cumulative effect of a change in accounting principle, must report per share amounts for these line items either on the face of the income statement or in the notes to financial statements.

7. **Prepare a retained earnings statement.** The statement of retained earnings should disclose net income (loss), dividends, prior period adjustments, and transfers to and from unrestricted retained earnings (appropriations).

8. **Explain how other comprehensive income is reported.** The components of other comprehensive income are reported in a second income statement, a combined statement of comprehensive income, or in a statement of stockholders’ equity.

9.* **Measure and report gains and losses from discontinued operations.** The (1) results of operations (income or loss) of a discontinued segment of business and (2) gain or loss on disposal of the discontinued segment are reported net of tax in a separate income statement category after income from continuing operations and before extraordinary items. The accountant may be required to report gains and losses from discontinued operations (sale or abandonment of a segment of the business) under three different situations: (1) no phase-out period, (2) a phase-out period, or (3) an extended phase-out period. The gain or loss on disposal of a segment involves the sum of (1) income or loss from operations after the measurement date (the phase-out period) and (2) the gain or loss on disposal of the assets of the discontinued segment.

*This material is covered in Appendix 4-A in the text.
TIPS ON CHAPTER TOPICS

TIP: The **income statement** or **statement of income** is often referred to as the statement of operations or the operating statement because it reports on the results of operations for a period of time. Other names include the "earnings statement," "statement of earnings," and "profit and loss statement" (or "P&L statement").

TIP: The income statement is often referred to as a link between balance sheets because it explains one major reason why the balance of owners' equity changed during the period. Owners' equity (net assets) at the beginning of the period can be reconciled with ending owners' equity as follows:

- Owners' equity at the beginning of the period
- Additional owner investments during the period
+ Owner withdrawals during the period
- Results of operations for the period (net income or net loss)
= Owners' equity at the end of the period

TIP: A **contra revenue** item has the same effect on net income as that of an expense; it decreases net income. Contra revenue accounts include Sales Discounts and Sales Returns and Allowances.

TIP: It is often helpful to form an acronym when attempting to remember a list of items. In looking at the order of the things that can appear after the "Income from Continuing Operations" line on an income statement, you might come up with **DEC** to help you to remember the exact order of these items:

- Discontinued operations
- Extraordinary items
- Cumulative effect of changes in accounting principles

TIP: The income tax consequences of all items appearing above the line "Income from continuing operations before income taxes" are summarized in the line "Income taxes." Revenues cause an increase in income taxes and expenses cause a decrease in income taxes. The income tax consequences of items appearing below the "income from continuing operations" line are reported right along with the items (hence, these items are reported "net of tax"). This procedure of allocating income taxes within a period is referred to as **intraperiod tax allocation**.

TIP: An extraordinary item is reported "net of tax" by deducting the tax effect from the related gain or loss. For example, if the tax rate is 30%, an extraordinary gain of $400,000 will be reported at $280,000 net of tax. Likewise, an extraordinary loss of $400,000 will be reported at $280,000 net of tax. The gain situation increases net income, whereas the loss reduces it.

TIP: Corrections for errors in the reporting of revenues and expenses in prior periods are accounted for as prior period adjustments. A **prior period adjustment** is reported as an adjustment (debit or credit, whichever is applicable) to the opening balance of Retained Earnings on the statement of retained earnings for the current period (period in which the adjustment is made) and is shown net of any related income tax effect.
TIP: Net income minus preferred stock dividend requirements (i.e., income applicable to common stockholders) is divided by the weighted average of common stock shares outstanding to arrive at earnings per share (EPS). This is a key ratio in financial analysis and must be disclosed on the face of the income statement. A per share amount must always be disclosed for "net income." Also, the following holds true:

(1) A company that reports discontinued operations must report a per share amount for that item.

(2) A company that reports an extraordinary item must report a per share amount for the extraordinary item.

(3) A company that reports a change in accounting principle must report a per share amount for the cumulative effect of a change in accounting principle.

TIP: In the EPS calculation, preferred dividends are deducted from net income if they were declared; however, if the preferred stock is cumulative, the preferred dividend preference for the current period is deducted whether or not the dividends were declared. Dividends declared on common stock have no effect on the EPS calculation.

EXERCISE 4-1

Purpose: (L.O. 1) This exercise reviews the basic accounting formula (Assets = Liabilities + Owners' Equity) and the connection between the income statement and the balance sheet (which is a change in owners' equity due to the net income or net loss for the period). This exercise focuses on the capital maintenance (or change in equity) approach to income determination.

The following data were extracted from the records of Dora Loesing's Cookies, a sole proprietorship:

- Total assets, beginning of the period: $100,000
- Total liabilities, beginning of the period: $36,000
- Owner withdrawals during the period: $30,000
- Total assets, end of the period: $108,000
- Total liabilities, end of the period: $38,000
- Owner's contributions during the period: $10,000

Instructions
Compute the amount of net income (or loss) for the period. Show computations.
Solution to Exercise 4-1

Beginning owner's equity $ 64,000\text{a}
Additional owner contributions 10,000
Owner withdrawals during the period (30,000)
Subtotal 44,000
Net income (loss) for the period + X
Ending owner's equity $ 70,000\text{b}

Solving for X, net income = $ 26,000

\text{a}\ A = L + OE \\
100,000 = 36,000 + ? \\
Beginning owner's equity = $64,000

\text{b}\ A = L + OE \\
108,000 = 38,000 + ? \\
Ending owner's equity = $70,000

**Approach:** The question asks you to solve for net income; however, no information is given regarding revenues and expenses for the period. Only balance sheet data and transactions affecting owner's equity are given. Net income (or net loss) for a period is one reason for a change in the balance of owner's equity. Write down the items that reconcile the beginning owner's equity balance with the ending owner's equity balance, enter the amounts known, compute beginning and ending owner's equity balances by use of the basic accounting equation, and then solve for the amount of net income. Recall that assets − liabilities = net assets; that is, assets − liabilities = owner's equity at a point in time.

**TIP:** The basic accounting equation \((A = L + OE)\) is applied at a specific point in time. When you have the facts for the equation components at two different points in time for the same entity (such as amounts as of the beginning of a year and amounts as of the end of a year), you can modify the basic accounting equation to reflect that total changes in assets equals total changes in liabilities + total changes in owners' equity. Using the symbol \(\Delta\) to designate change, the following equation also holds true:
\[
\Delta A = \Delta L + \Delta OE
\]
Reasons for changes in owners' equity include:
(1) additional owner investments,
(2) owner withdrawals, and
(3) results of operations (net income or net loss).

**TIP:** When using the capital maintenance (or change in equity) approach, the amount of owners' equity is determined at the beginning and at the end of the period (using the same valuation method). The difference between these two amounts, adjusted for owner withdrawals and additional owner investments during the same period, is the measure of net income for the period.

**TIP:** Net income (or net loss) is the change in owners' equity for a period of time, other than from capital transactions. Capital transactions are those that involve owners acting in their capacity of being owners of the entity.
ILLUSTRATION 4-1
ELEMENTS OF THE INCOME STATEMENT (L.O. 1)

REVENUES. Inflows or other enhancements of assets of an entity or settlements of its liabilities during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

EXPENSES. Outflows or other using-up of assets or incurrences of liabilities during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

GAINS. Increases in equity (net assets) from peripheral or incidental transactions of an entity except those that result from revenues or investments by owners.

LOSSES. Decreases in equity (net assets) from peripheral or incidental transactions of an entity except those that result from expenses or distributions to owners.

Revenues take many forms, such as sales revenue, fees earned, dividend income, and rents earned. Expenses also take many forms, such as cost of goods sold, rent, salaries, depreciation, interest, and taxes.

Revenues and gains are similar (they both increase net income), and expenses and losses are similar (they both decrease net income). However, these terms are dissimilar in the fact that they convey significantly different information about an enterprise's performance. Revenues and expenses result from an entity's ongoing major or central operations and activities—that is, from activities such as producing or delivering goods, rendering services, lending, insuring, investing, and financing. In contrast, gains and losses result from incidental or peripheral transactions of an enterprise with other entities and from other events and circumstances affecting it. Gains and losses often arise from the sale of investments; disposal of plant assets; settlement of liabilities for an amount other than their book value; and write-offs of assets due to obsolescence, casualty, or theft.

Revenues and expenses are commonly displayed as gross inflows or outflows of net assets; while gains and losses are usually displayed as net inflows or outflows. For example, assume a company buys an inventory item for $6,000, sells it for $10,000, and pays a sales representative a $1,000 commission. Further, the same company sells for $20,000 a plant asset with a book value (carrying value) of $15,000 and pays an outside agency $2,100 for finding the buyer. The various flows associated with the first transaction (the company's major activity or regular operations) will be reported gross on its income statement, and the various elements of the second transaction (a peripheral transaction) will be reported net. Assuming these were the only two transactions completed during the period and ignoring income taxes, the income statement would reflect the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>$10,000</td>
</tr>
<tr>
<td>Cost of goods sold expense</td>
<td>$6,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$4,000</td>
</tr>
<tr>
<td>Selling expense (sales commission)</td>
<td>$1,000</td>
</tr>
<tr>
<td>Income from operations</td>
<td>$3,000</td>
</tr>
<tr>
<td>Gain on sale of plant asset</td>
<td>$2,900a</td>
</tr>
<tr>
<td>Net income</td>
<td>$5,900</td>
</tr>
</tbody>
</table>

a $20,000 proceeds - $15,000 book value - $2,100 finders fee = $2,900 gain on sale.

TIP: Net income results from revenue, expense, gain, and loss transactions. These transactions are summarized in the income statement. This method of income measurement is called the transaction approach because it focuses on the income-related activities (broken down into completed transactions) that have occurred during the period.
ILLUSTRATION 4-2
SECTIONS OF A MULTIPLE-STEP INCOME STATEMENT (L.O. 3)

1. OPERATING SECTION. A report of the revenues and expenses of the company's principal operations. (This section may or may not be presented on a departmental basis.)
   (a) SALES OR REVENUE SECTION. A subsection presenting sales, discounts, allowances, returns, and other related information. Its purpose is to arrive at the net amount of sales revenue.
   (b) COST OF GOODS SOLD SECTION. A subsection that shows the cost of goods that were sold to produce the sales.
   (c) SELLING EXPENSES. A subsection that lists expenses resulting from the company's efforts to make sales.
   (d) ADMINISTRATIVE OR GENERAL EXPENSES. A subsection reporting expenses of general administration.

2. NONOPERATING SECTION. A report of revenues and expenses resulting from secondary or auxiliary activities of the company. In addition, special gains and losses that are infrequent or unusual, but not both, are normally reported in this section. Generally these items break down into two main subsections:
   (a) OTHER REVENUES AND GAINS. A list of the revenues earned or gains incurred, generally net of related expenses, from nonoperating transactions.
   (b) OTHER EXPENSES AND LOSSES. A list of the expenses or losses incurred, generally net of any related incomes, from nonoperating transactions.

3. INCOME TAXES. A short section reporting federal and state taxes levied on income from continuing operations.

4. DISCONTINUED OPERATIONS. Material gains or losses resulting from the disposal of a segment of the business.

5. EXTRAORDINARY ITEMS. Unusual and infrequent material gains and losses.

6. CUMULATIVE EFFECT OF A CHANGE IN ACCOUNTING PRINCIPLE.

7. EARNINGS PER SHARE.
EXERCISE 4-2

Purpose:  (L.O. 2, 3, 6) This exercise will allow you to contrast the multiple-step format and the single-step format for the income statement.

The accountant for Bubble Bath Products, Inc. has compiled the following information from the company's records as a basis for an income statement for the year ended December 31, 2002. (There was no change during the year in the 12,000 shares of common stock outstanding.)

Net sales $ 970,000
Depreciation on plant assets (60% selling, 40% administrative) 70,000
Dividends declared 14,400
Rent revenue 30,000
Interest on notes payable 17,000
Market appreciation on land held as an investment 44,000
Merchandise purchases 421,000
Transportation-in—merchandise 37,000
Merchandise inventory, January 1, 2002 82,000
Merchandise inventory, December 31, 2002 81,000
Purchase returns and allowances 11,000
Wages and salaries—sales 95,000
Materials and supplies—sales 11,400
Income taxes 45,000
Wages and salaries—administrative 135,900
Other administrative expenses 46,700
Advertising expense 20,000
Express mail 6,000

Instructions
(a) Prepare a multiple-step income statement.
(b) Prepare a single-step income statement.
Solution to Exercise 4-2

(a)

Bubble Bath Products, Inc.
INCOME STATEMENT
For the Year Ending December 31, 2002

<table>
<thead>
<tr>
<th>Sales Revenue</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales revenue</td>
<td>$970,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cost of Goods Sold</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchandise inventory, Jan. 1</td>
<td>$82,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>$421,000</td>
</tr>
<tr>
<td>Less purchase returns &amp; allowances</td>
<td>11,000</td>
</tr>
<tr>
<td>Net purchases</td>
<td>410,000</td>
</tr>
<tr>
<td>Transportation-in</td>
<td>37,000</td>
</tr>
<tr>
<td>Total merchandise available for sale</td>
<td>447,000</td>
</tr>
<tr>
<td>Less merchandise inventory, Dec. 31</td>
<td>81,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>448,000</td>
</tr>
</tbody>
</table>

Gross profit | 522,000 |

<table>
<thead>
<tr>
<th>Operating Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling expenses</td>
<td></td>
</tr>
<tr>
<td>Wages and salaries</td>
<td>95,000</td>
</tr>
<tr>
<td>Advertising</td>
<td>20,000</td>
</tr>
<tr>
<td>Materials and supplies</td>
<td>11,400</td>
</tr>
<tr>
<td>Depreciation (60% x $70,000)</td>
<td>42,000</td>
</tr>
<tr>
<td>Express mail</td>
<td>6,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td></td>
</tr>
<tr>
<td>Wages and salaries</td>
<td>135,900</td>
</tr>
<tr>
<td>Depreciation (40% x $70,000)</td>
<td>28,000</td>
</tr>
<tr>
<td>Other administrative expenses</td>
<td>46,700</td>
</tr>
<tr>
<td></td>
<td>210,600</td>
</tr>
<tr>
<td></td>
<td>385,000</td>
</tr>
</tbody>
</table>

Income from operations | 137,000 |

<table>
<thead>
<tr>
<th>Other Revenues and Gains</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent revenue</td>
<td>30,000</td>
</tr>
<tr>
<td></td>
<td>167,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other Expenses and Losses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>17,000</td>
</tr>
</tbody>
</table>

Income before taxes | 150,000 |
Income taxes | 45,000 |
Net income | $105,000 |

Earnings per share ($105,000 ÷ 12,000) | $8.75 |
**TIP:** Dividends declared do not appear on the income statement. They are a distribution of corporate income—not a determinant of net income. Increases in the market value of assets held (such as plant assets, inventory, and most investments) are not recognized in the accounts until they are realized through the sale of the assets. Hence, the market appreciation on the land held as an investment does not appear on the income statement.

(b)

**Bubble Bath Products, Inc.**

**INCOME STATEMENT**

_For the Year Ending December 31, 2002_

<table>
<thead>
<tr>
<th>Revenues</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$970,000</td>
</tr>
<tr>
<td>Rent revenue</td>
<td>30,000</td>
</tr>
<tr>
<td>Total revenue</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>448,000</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>174,400</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>210,600</td>
</tr>
<tr>
<td>Interest expense</td>
<td>17,000</td>
</tr>
<tr>
<td>Total expenses</td>
<td>850,000</td>
</tr>
</tbody>
</table>

| Income before taxes               | 150,000 |
| Income taxes                      | 45,000  |
| **Net income**                    | $105,000 |

| Earnings per share                | $8.75   |

**TIP:** In the single-step income statement, just two groupings exist: revenues and expenses. Expenses are deducted from revenues to arrive at net income or loss. The expression "single-step" is derived from the single subtraction necessary to arrive at net income. Frequently, however, income taxes are reported separately to indicate their direct relationship to income before income taxes.

**TIP:** In the multiple-step income statement, there are three major subtotals presented before arriving at net income. They are: net sales revenue, gross profit, and income from operations. These subtotals emphasize (1) a classification of expenses by function, such as merchandising or manufacturing (cost of goods sold), selling, and administration, and (2) a separation of operating and subordinate or nonoperating activities of the company. The "other revenues and gains" and "other expenses and losses" sections include (1) investing and financing revenues and expenses such as interest revenue, dividend revenue (from dividends received), and interest expense, and (2) the results of nonoperating items such as the sale of plant assets and investments.
TIP: The nature of an entity's typical operations is critical in determining whether the results of a transaction should be classified as an operating or a nonoperating revenue, gain, expense, or loss. For example, consider rental activities. A business specializing in equipment rentals will classify rent revenue as an operating revenue. Whereas, a retail establishment that occasionally rents its temporarily idle assets to others will classify rent revenue as a nonoperating (other) revenue. For a second example, consider the sale of an investment. An investment dealer will report the revenue from a sale as an operating revenue. Whereas, a retail entity that occasionally sells an investment will report the difference between the proceeds from the sale and the investment's carrying value as a nonoperating gain or loss.

TIP: There is no specific order in which the individual selling expenses and administrative expenses are to be listed in the multiple-step income statement. Very often, they appear in order of decreasing magnitude.

TIP: Some accountants prefer to use a multiple-step income statement format because it discloses the amount of income from operations. Thus, by this disclosure, the difference between regular and irregular or incidental activities is highlighted. Irregular activities encompass transactions and other events that are derived from developments outside the normal operations of the business. Thus, they may not be expected to continue at the same level in future periods.

EXERCISE 4-3

Purpose: (L.O. 2, 7) This exercise will give you practice in identifying components of net income and the order of items appearing on a single-step income statement and on a retained earnings statement.

Presented below is the adjusted trial balance of the Limp Bizkit Corporation at December 31, 2002. The account titles and balances are not in the customary order.
# Limp Bizkit Corporation
## ADJUSTED TRIAL BALANCE
### December 31, 2002

<table>
<thead>
<tr>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$ 958,500</td>
</tr>
<tr>
<td>Notes Receivable</td>
<td>$ 80,000</td>
</tr>
<tr>
<td>Investments</td>
<td>88,500</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>51,000</td>
</tr>
<tr>
<td>Accumulated Depreciation—Equipment</td>
<td>31,000</td>
</tr>
<tr>
<td>Sales Discounts</td>
<td>10,500</td>
</tr>
<tr>
<td>Sales Returns</td>
<td>17,500</td>
</tr>
<tr>
<td>Purchase Discounts</td>
<td>8,000</td>
</tr>
<tr>
<td>Cash</td>
<td>190,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>95,000</td>
</tr>
<tr>
<td>Rent Revenue</td>
<td>14,000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>240,000</td>
</tr>
<tr>
<td>Salaries Payable</td>
<td>22,000</td>
</tr>
<tr>
<td>Notes Payable</td>
<td>75,000</td>
</tr>
<tr>
<td>Common Stock, $15 par</td>
<td>300,000</td>
</tr>
<tr>
<td>Income Tax Expense</td>
<td>68,000</td>
</tr>
<tr>
<td>Cash Dividends Declared</td>
<td>70,000</td>
</tr>
<tr>
<td>Allowance for Doubtful Accounts</td>
<td>6,500</td>
</tr>
<tr>
<td>Supplies on Hand</td>
<td>11,000</td>
</tr>
<tr>
<td>Freight-In</td>
<td>16,000</td>
</tr>
<tr>
<td>Selling Expenses</td>
<td>212,000</td>
</tr>
<tr>
<td>Administrative Expenses</td>
<td>114,000</td>
</tr>
<tr>
<td>Land</td>
<td>65,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>130,000</td>
</tr>
<tr>
<td>Merchandise Inventory</td>
<td>79,000</td>
</tr>
<tr>
<td>Building</td>
<td>104,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>500,000</td>
</tr>
<tr>
<td>Dividend Income</td>
<td>10,000</td>
</tr>
<tr>
<td>Loss on Sale of Investment</td>
<td>13,000</td>
</tr>
<tr>
<td>Interest Revenue</td>
<td>9,000</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>12,500</td>
</tr>
<tr>
<td>Bonds Payable</td>
<td>100,000</td>
</tr>
<tr>
<td>Gain on Sale of Land</td>
<td>24,500</td>
</tr>
<tr>
<td>Accumulated Depreciation—Building</td>
<td>26,500</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$ 1,876,000</strong></td>
</tr>
<tr>
<td></td>
<td><strong>$ 1,876,000</strong></td>
</tr>
</tbody>
</table>

The company uses the periodic inventory system. A physical count of inventory on December 31 resulted in an inventory amount of $100,000.
Instructions
(a) Prepare an income statement for the year ending December 31, 2002 using the single-step form. Assume that twenty thousand shares of common stock were outstanding the entire year.
(b) Prepare a retained earnings statement for the year ending December 31, 2002. Assume that the only changes in retained earnings during the current year were from net income and dividends.

Solution to Exercise 4-3
(a)  

Limp Bizkit Corporation  
INCOME STATEMENT  
For the Year Ended December 31, 2002  

<table>
<thead>
<tr>
<th>Revenues</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales *</td>
<td>$ 930,500</td>
</tr>
<tr>
<td>Gain on sale of land</td>
<td>24,500</td>
</tr>
<tr>
<td>Rent revenue</td>
<td>14,000</td>
</tr>
<tr>
<td>Dividend income</td>
<td>10,000</td>
</tr>
<tr>
<td>Interest revenue</td>
<td>9,000</td>
</tr>
<tr>
<td><strong>Total revenues</strong></td>
<td><strong>988,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold**</td>
<td>487,000</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>212,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>114,000</td>
</tr>
<tr>
<td>Loss on sale of investment</td>
<td>13,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>12,500</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td><strong>838,500</strong></td>
</tr>
</tbody>
</table>

Income before taxes  
Income taxes  
**Net income**  

$ 81,500  

Earnings per common share ($81,500 ÷ 20,000)  

$ 4.08

*Net sales:
Sales  
Less: Sales discounts  
Sales returns  
Net sales  

$ 958,500  
$ 10,500  
17,500  
28,000  

$ 930,500

**Cost of goods sold:
Merchandise inventory, Jan. 1  
Purchases  
Less purchase discounts  
Net purchases  
Add freight-in  
Merchandise available for sale  
Less merchandise inventory, Dec. 31  
Cost of merchandise sold  

$ 79,000  
$ 500,000  
8,000  
492,000  
16,000  
587,000  
100,000  
$ 487,000
TIP: The solution presented here reports income taxes separately as the last item before net income to indicate their relationship to income before taxes. It is acceptable to list the income taxes in the expenses classification and omit the subtotal "income before taxes."

(b) Limp Bizkit Corporation
Retained Earnings Statement
For the Year Ended December 31, 2002

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, January 1</td>
<td>$240,000</td>
</tr>
<tr>
<td>Add: Net income</td>
<td>81,500</td>
</tr>
<tr>
<td></td>
<td>321,500</td>
</tr>
<tr>
<td>Less: Cash dividends declared</td>
<td>70,000</td>
</tr>
<tr>
<td>Balance, December 31</td>
<td>$251,500</td>
</tr>
</tbody>
</table>

Approach:
1. Go through the adjusted trial balance and lightly cross through any account title that does not pertain to the computation of net income. With the exception of the balance of Merchandise Inventory (which is used to compute cost of goods sold when a periodic inventory system is in use), balance sheet account balances are not used in determining net income.
2. Compute intermediate subtotals for items such as (a) net sales, (b) cost of goods sold, (c) selling expenses, and (d) administrative expenses. Show your computations for these subtotals. (In this particular exercise, selling expenses and administrative expenses are already summarized.)
3. Identify revenue and gain items.
4. Identify expense and loss items.
5. Identify income taxes for the period.
6. Identify any discontinued operations, extraordinary items, and cumulative effect on prior periods of a change in accounting principle (none of these appear in this exercise).
7. Compute net income.
8. Compute earnings per share.
9. Identify the retained earnings balance at the beginning of the period.
10. Include any prior period adjustments on the statement of retained earnings (none are identified in this exercise).
11. Add net income for the period.
12. Deduct dividends declared.
13. Arrive at the retained earnings balance at the end of the period.

TIP: The account balances in the adjusted trial balance that are not used for the solution requested are as follows: Notes Receivable, Investments, Accounts Payable, Accumulated Depreciation—Equipment, Cash, Accounts Receivable, Salaries Payable, Notes Payable, Common Stock, Allowance for Doubtful Accounts, Supplies on Hand, Land, Equipment, Building, Bonds Payable, and Accumulated Depreciation—Building.
EXERCISE 4-4

Purpose: (L.O. 3, 4, 5, 6, 7) This exercise is designed to give you practice in preparing a condensed multiple-step income statement and a retained earnings statement when an extraordinary item and a change in accounting principle are to be reported.

Presented below is information related to Will Smith Corp., for the year 2002.

Net sales $650,000
Cost of goods sold 400,000
Selling expenses 32,000
Administrative expenses 24,000
Dividend revenue 10,000
Interest revenue 7,000
Interest expense 15,000
Write-off of goodwill due to impairment 25,000
Depreciation expense omitted in 2000 35,000
Uninsured loss due to flood (unusual and infrequent) 60,000
Dividends declared 42,000
Retained earnings at December 31, 2001 1,800,000
Cumulative effect on prior years of change in accounting principle (credit) 75,000
Federal tax rate of 30% on all items

Instructions
(a) Prepare a multiple-step income statement for 2002. Assume that 50,000 shares of common stock were outstanding during 2002.
(b) Prepare a retained earnings statement for 2002.
Solution to Exercise 4-4

(a)

Will Smith Corp.
INCOME STATEMENT
For the Year Ended December 31, 2002

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$ 650,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>400,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>250,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td></td>
</tr>
<tr>
<td>Selling expenses</td>
<td>$ 32,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>24,000</td>
</tr>
<tr>
<td>Income from operations</td>
<td>194,000</td>
</tr>
<tr>
<td>Other revenues and gains</td>
<td></td>
</tr>
<tr>
<td>Dividend revenue</td>
<td>10,000</td>
</tr>
<tr>
<td>Interest revenue</td>
<td>7,000</td>
</tr>
<tr>
<td>Other expenses and losses</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>15,000</td>
</tr>
<tr>
<td>Loss due to write-off of goodwill</td>
<td>25,000</td>
</tr>
<tr>
<td>Income before taxes and extraordinary item and cumulative effect of change in accounting principle</td>
<td>171,000</td>
</tr>
<tr>
<td>Income taxes</td>
<td>51,300</td>
</tr>
<tr>
<td>Income before extraordinary item and cumulative effect of change in accounting principle</td>
<td>119,700</td>
</tr>
<tr>
<td>Extraordinary item—loss from flood</td>
<td>60,000</td>
</tr>
<tr>
<td>Less applicable income tax effect</td>
<td>18,000</td>
</tr>
<tr>
<td>Cumulative effect on prior years of change in accounting principle</td>
<td>75,000</td>
</tr>
<tr>
<td>Less applicable income tax effect</td>
<td>22,500</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 130,200</td>
</tr>
</tbody>
</table>

Per share of common stock:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before extraordinary item and cumulative effect of change in accounting principle ($119,700 ÷ 50,000)</td>
<td>$2.39</td>
</tr>
<tr>
<td>Extraordinary item (net of tax) ($42,000 ÷ 50,000)</td>
<td>(.84)</td>
</tr>
<tr>
<td>Cumulative effect of accounting change (net of tax) ($52,500 ÷ 50,000)</td>
<td>1.05</td>
</tr>
<tr>
<td>Net income ($130,200 ÷ 50,000)</td>
<td>$2.60</td>
</tr>
</tbody>
</table>
TIP: The total income taxes pertaining to 2002 for this company was $33,300. This amount resulted from a tax bill of $51,300 that relates to the tax consequences of all items reportable on the 2002 tax return before considering the casualty loss of $60,000. This casualty loss caused a tax savings of $18,000. Because the casualty loss is reported as an extraordinary item on the income statement, the requirement for a net-of-tax presentation calls for the $18,000 tax reduction to be reported along with the extraordinary loss, leaving income taxes of $51,300 to be matched with income before extraordinary items. The income tax effect of the accounting change involves deferred income taxes which are discussed in Chapter 20.

TIP: In this case, the change in accounting principle caused an increase in the reported amount of net income for 2002 (because it was a credit). Sometimes the cumulative effect of a change in accounting principle is a charge (debit) to the current income statement which reduces net income.

(b)

Will Smith Corp.
RETAINED EARNINGS STATEMENT
For the Year Ended December 31, 2002

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings, Jan. 1, 2002, as previously reported</td>
<td>$1,800,000</td>
</tr>
<tr>
<td>Correction of an error in depreciation in prior period</td>
<td>(24,500)</td>
</tr>
<tr>
<td>(net of $10,500 income tax effect)</td>
<td></td>
</tr>
<tr>
<td>Adjusted balance of retained earnings at Jan. 1, 2002</td>
<td>1,775,500</td>
</tr>
<tr>
<td>Net income</td>
<td>130,200</td>
</tr>
<tr>
<td></td>
<td>1,905,700</td>
</tr>
<tr>
<td>Dividends declared</td>
<td>42,000</td>
</tr>
<tr>
<td>Retained earnings, December 31, 2002</td>
<td>$1,863,700</td>
</tr>
</tbody>
</table>
ILLUSTRATION 4-3
TREATMENT OF IRREGULAR ITEMS (L.O. 4)

1. DISCONTINUED OPERATIONS. The (1) results of operations (income or loss) of a segment of business that has been or will be disposed of, and (2) gain or loss on disposal of the discontinued segment are reported in a separate income statement category called "Discontinued operations." This category appears after continuing operations but before extraordinary items. Each of the possible two components of this category is reported net of the related income tax effect.

2. EXTRAORDINARY ITEMS. Extraordinary items are reported individually in a separate category (immediately after discontinued operations, if any) net of any related income tax effect. Extraordinary items are defined as nonrecurring (infrequent) material items that differ significantly from the entity's typical business activities. In addition to being material in amount, a transaction or event must meet both of the following criteria to be classified as extraordinary:

   (a) **UNUSUAL NATURE.** The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.

   (b) **INFREQUENCY OF OCCURRENCE.** The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

Examples of items that are not classified as extraordinary:

   (a) Writedown or writeoff of receivables, inventories, equipment leased to others, deferred research and development costs, or other intangible assets.

   (b) Gains or losses from exchange or translation of foreign currencies, including those relating to major devaluations and revaluations.

   (c) Gains or losses on disposal of a segment of a business.

   (d) Other gains or losses from sale or abandonment of property, plant, or equipment used in the business.

   (e) Effects of a strike, including those against competitors and major suppliers.

   (f) Adjustment of accruals on long-term contracts.

Examples of items that are classified as extraordinary:

   An event or transaction that clearly meets both criteria (unusual in nature and infrequent in occurrence) and gives rise to a gain or loss from the writedown or writeoff of assets or to a gain or loss from disposal of assets and is a **direct result** of one of the following:

   (a) A **major casualty** (such as an earthquake, tornado, hurricane, flood, or hail storm).

   (b) An **expropriation** (such as the confiscation of assets by a government or the exercise of eminent domain or condemnation).

   (c) A **prohibition** under a newly enacted law or regulation.
3. **UNUSUAL GAINS AND LOSSES.** A gain or loss that arises from a transaction that is unusual or infrequent, but not both, should be reported in the income statement as part of "income from continuing operations" (or "income before extraordinary items"). If the amount is material, it should be separately disclosed; if the amount is immaterial, it may be combined with other items on the income statement. In a multiple-step income statement, unusual gains and losses normally are classified in the "other revenues and gains" or "other expenses and losses" section, although a separate unusual items section may be displayed. Unusual gains and losses are not to be reported net of tax; rather, the tax consequences of these items are combined with the tax effects of all other components of income from continuing operations in the line called "income taxes."

4. **CHANGES IN ACCOUNTING PRINCIPLE.** A change in accounting principle occurs when a company changes from one generally accepted method to another generally accepted method. Because such a change violates consistency and, therefore, reduces or destroys comparability of successive financial statements, a change in principle should only be made when the newly adopted principle is preferable (e.g., for better matching of revenues and expenses). A change in accounting principle is generally recognized by including the cumulative effect of the change (net of the related income tax effect) as a separate item following extraordinary items in the income statement. This cumulative effect is based on a retroactive computation. That is, the effect on prior periods of using the old method is compared to the effect that would have occurred if the new method had been used for all prior periods; the difference is the cumulative effect of the change on all prior periods. (This subject is more thoroughly discussed in Chapter 23.)

5. **CHANGES IN ACCOUNTING ESTIMATE (Normal Recurring Corrections and Adjustments).** A change from one good faith estimate to another good faith estimate because of new information or experience constitutes a change in accounting estimate. A change in an estimate will affect the amount of related revenue or expense reported in the period of change if the change affects only that period, or in the period of change (called the current period) and future periods if the change affects both. Examples are a change in the estimate of uncollectible accounts receivable (bad debts expense) and a change in the estimated service life of a plant (fixed) asset (depreciation expense). A change in estimate is not considered a correction of an error (prior period adjustment); therefore, it is not handled retroactively.
EXERCISE 4-5

Purpose:  (L.O. 4) This exercise will test your knowledge of the elements and arrangement of the major sections of the income statement.

Instructions
The following list represents captions that would appear on an income statement (single-step format) for a company reporting an extraordinary gain, losses from discontinued operations, and a change in depreciation method, as well as the results of continuing operations for the period. You are to "unscramble" the list and prepare a skeleton income statement using the captions given. (If you do not wish to write out each caption above, you may still test your knowledge by listing the appropriate letters in the correct order.)

(a) Income before extraordinary item and cumulative effect of a change in accounting principle
(b) Revenues
(c) Cumulative effect on prior years of a change in depreciation method (net of tax)
(d) Income taxes
(e) Discontinued operations:
(f) Extraordinary gain (net of tax)
(g) Expenses
(h) Loss from disposal of discontinued segment of business (net of tax)
(i) Net income
(j) Income from continuing operations before income taxes
(k) Loss from operations of discontinued segment of business (net of tax)
(l) Income from continuing operations

Solution to Exercise 4-5

Company Name
INCOME STATEMENT
For the Year Ended December 31, 20XX

(b) Revenues
(g) Expenses
(j) Income from continuing operations before income taxes
(d) Income taxes
(l) Income from continuing operations
(e) Discontinued operations:
(k) Loss from operations of discontinued segment of business (net of tax)
(h) Loss from disposal of discontinued segment of business (net of tax)
(a) Income before extraordinary item and cumulative effect of a change in accounting principle
(f) Extraordinary gain (net of tax)
(c) Cumulative effect on prior years of a change in depreciation method (net of tax)
(l) Net income
EXERCISE 4-6

Purpose: (L.O. 3, 4, 5, 6, 7) This exercise will enable you to practice identifying the proper classification for items on an income statement. It will also give you an example of how the tax effects of various items are reflected in the income statement.

Margaret Moylan had the following selected transactions and events occur during 2002. The corporation is subject to a 30% tax rate on all items. All amounts are material. The corporation is engaged in the sale of energy products.

1. The corporation experienced an uninsured flood loss in the amount of $60,000 during the year. A flood is unusual and infrequent in the region where the corporation resides.

2. At the beginning of 2000, the corporation purchased an office machine for $108,000 (salvage value of $18,000) that has a useful life of six years. The bookkeeper used straight-line depreciation for 2000 and 2001, but failed to deduct the salvage value in computing the depreciable base. The same depreciation calculations were used for tax purposes.

3. Sale of securities held as a part of Moylan's portfolio resulted in a loss of $62,200 (pretax).

4. When its president died, the corporation realized $100,000 from an insurance policy. The cash surrender value of this policy had been carried on the books as an investment in the amount of $34,000 (the gain is nontaxable).

5. The corporation disposed of a segment of business at a loss of $140,000 before taxes. Assume that this transaction meets the criteria for being classified as discontinued operations. There were no results of operations for this division during 2002.

6. The corporation decided to change its method of inventory pricing from average cost to the FIFO method. The effect of this change on prior years would be to increase 2000 income by $64,000 and decrease 2001 income by $20,000 before taxes. The FIFO method has been used for 2002.
Instructions:
Describe how each of the items above will be reported in a multiple-step income statement for 2002. Indicate the amount that will be reported and the section of the income statement in which the amount will appear.

Solution to Exercise 4-6:

1. A loss of $42,000 ($60,000 minus 30% of $60,000) will be reported in the extraordinary items section of the income statement.

2. Depreciation expense of $15,000 [(108,000 - $18,000) ÷ 6 years] will appear in the administrative expense (an operating expense) section of the 2002 income statement. The correction of prior periods' depreciation (a prior period adjustment) will not appear on the income statement. Rather, a credit of $4,200 will appear on the statement of retained earnings for 2002 as an adjustment to the beginning balance of retained earnings. The prior period adjustment is reported net of tax. Computations:
   
   $108,000 ÷ 6 = $18,000 depreciation taken in 2000.
   
   $108,000 ÷ 6 = $18,000 depreciation taken in 2001.
   
   ($108,000 - $18,000) ÷ 6 = $15,000 correct annual depreciation.
   
   $15,000 x 2 = $30,000 correct depreciation for 2000 & 2001.
   
   ($18,000 + $18,000) - $30,000 = $6,000 overstated expense in prior years.
   
   $6,000 - 30%($6,000) = $4,200 addition to retained earnings.

3. A loss of $62,200 will be reported in the other expenses and losses section of the income statement. It is not reported net of tax.

4. A gain of $66,000 ($100,000 - $34,000) will appear in the other revenues and gains section of the income statement. It is not reported net of tax (in this case, it had no tax effect anyway). A good caption for this item is "Gain from proceeds of life insurance policy."

5. A loss of $98,000 ($140,000 minus 30% of $140,000) will appear as a "loss on disposal of assets of discontinued segment" in the discontinued operations section of the income statement.

6. A cumulative effect on prior periods of a change in accounting principle will appear as a $30,800 credit on the 2002 income statement. This is the last item shown on the statement before arriving at net income. Computations:

   $64,000 credit (increase in prior period income)
   
   20,000 debit (decrease in prior period income)
   
   44,000 credit (net catch-up adjustment needed)
   
   70% net of tax rate
   
   $30,800 credit (cumulative effect, net of tax)
ILLUSTRATION 4-4
NET INCOME AND COMPREHENSIVE INCOME (L.O. 8)

Comprehensive income includes all changes in stockholders' equity except those resulting from investments by owners and distributions to owners. Comprehensive income therefore includes all revenues, gains, expenses, and losses reported in net income. In addition, it includes gains and losses that bypass net income but are included as part of comprehensive income. These gains and losses are referred to as other comprehensive income.

An example of a gain or loss that is reported as other comprehensive income is an unrealized gain or loss on available-for-sale securities held as an investment. Excluding this type of gain or loss from net income and disclosing it separately reduces the volatility of net income due to changes in fair value yet informs the financial statement user of the gain or loss that would occur if the securities were sold at fair value. This subject is discussed further in Chapter 18. Other examples of other comprehensive income items are translation gains and losses on foreign currency (a subject in an advanced accounting text) and excess of additional pension liability over unrecognized prior service cost (a subject of Chapter 21).

The FASB requires that components of other comprehensive income be reported in one of three ways: (1) in a separate (second) income statement, (2) in a combined statement of comprehensive income, or (3) as a part of the statement of stockholders' equity. To illustrate these three presentation formats, assume Rosie O'Donnell Inc. reports the following information for 2002: sales revenues, $1,600,000, cost of goods sold $1,200,000, operating expenses $180,000, and an unrealized holding gain on available-for-sale securities of $60,000.

The first approach is to provide information in a two income statement format. It is shown below:

Rosie O'Donnell Inc.
Income Statement
For the Year Ended December 31, 2002

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>$1,600,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>400,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>180,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 220,000</td>
</tr>
</tbody>
</table>

Rosie O'Donnell Inc.
Comprehensive Income Statement
For the Year Ended December 31, 2002

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$220,000</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td></td>
</tr>
<tr>
<td>Unrealized holding gains</td>
<td>60,000</td>
</tr>
<tr>
<td>Comprehensive income</td>
<td>$280,000</td>
</tr>
</tbody>
</table>
Reporting comprehensive income in a separate statement indicates that the gains and losses identified as other comprehensive income do not have the same status as traditional gains and losses. In addition, the relationship of the traditional income statement to the new statement is apparent because net income is the starting point in the new statement.

The second approach is to provide a combined statement. It is shown below:

**Rosie O'Donnell Inc.**  
**Combined Statement of Comprehensive Income**  
**For the Year Ended December 31, 2002**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>$1,600,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$400,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>$180,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$220,000</td>
</tr>
<tr>
<td>Unrealized holding gains, net of tax</td>
<td>$60,000</td>
</tr>
<tr>
<td>Comprehensive income</td>
<td>$280,000</td>
</tr>
</tbody>
</table>

The combined statement has the advantage of not requiring the creation of a new financial statement. However, burying the traditional net income figure as a subtotal on the statement is a disadvantage.

A third approach is to report other comprehensive income items in a statement of stockholders' equity. This statement reports the changes in each stockholders' equity account and in total stockholders' equity during the year. The statement of stockholders' equity is prepared in columnar form with columns for each account and for total stockholders' equity. A statement of stockholders' equity for Rosie O'Donnell Inc. is shown below:

**Rosie O'Donnell Inc.**  
**Statement of Stockholders' Equity**  
**For the Year Ended December 31, 2002**

<table>
<thead>
<tr>
<th>Description</th>
<th>Accumulated Other Comprehensive Income</th>
<th>Common Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>Retained Earnings</td>
<td></td>
</tr>
<tr>
<td>Beginning balance</td>
<td>$820,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>Issuance of stock</td>
<td>$100,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$120,000</td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>$60,000</td>
<td></td>
</tr>
<tr>
<td>Ending balance</td>
<td>$750,000</td>
<td></td>
</tr>
</tbody>
</table>

The net income for a period of time is closed to Retained Earnings (a component of stockholders' equity). Other comprehensive income for a period is closed to Accumulated Other Comprehensive Income (a separate component of stockholders' equity). The accumulated other comprehensive income is reported in the stockholders' equity section of the balance sheet as follows:
ILLUSTRATION 4-4 (Continued)

Rosie O'Donnell Inc.
Balance Sheet (Partial)
As of December 31, 2002

Stockholders' equity
  Common stock  $ 750,000
  Retained earnings  320,000
  Accumulated other comprehensive income      180,000
  Total stockholders’ equity  $1,250,000

TIP: By providing a comprehensive income statement and a stockholders’ equity statement, the company reports information about all changes in net assets (owners' equity). With this information, users will be better able to understand the quality of the company's earnings. This information should help users to predict the amount, timing, and uncertainty of future cash flows.

TIP: The statement of stockholders’ equity is often called the statement of changes in stockholders’ equity or stockholders' equity statement.

TIP: If a company chooses to report the components of other comprehensive income in a statement of stockholders' equity, that statement must be displayed as a primary financial statement.

TIP: A company is required to display the components of other comprehensive income either (1) net of related tax effects or (2) before related tax effects with one amount shown for the aggregate amount of tax related to the total amount of other comprehensive income. Under either alternative, each component of other comprehensive income must be shown, net of related taxes, either on the face of the statement or in the notes.

EXERCISE 4-7

Purpose: (L.O. 9) This exercise will give you examples of the various situations possible [realized gains (losses) and expected gains (losses)] when you have an extended phase-out period for discontinued operations.

Koon Company has discontinued operations. The basic facts are as follows:
  Measurement date: October 1, 2002.
  Disposal is expected to be completed by May 1, 2003.
  Accounting period ends December 31, 2002.

Instructions
For each of the following independent cases, indicate the amount of "gain (loss) on disposal of segment" to be reported on the 2002 and 2003 income statements by filling in the blanks provided. Assume all amounts are net of tax.
### Solution to Exercise 4-7

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>(144,000)</td>
<td>(52,500)</td>
<td>(117,600)</td>
<td>(88,200)</td>
<td>2002 ________</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2003 ________</td>
</tr>
<tr>
<td>2</td>
<td>300,000</td>
<td>(52,500)</td>
<td>(117,600)</td>
<td>(88,200)</td>
<td>2002 ________</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2003 ________</td>
</tr>
<tr>
<td>3</td>
<td>(144,000)</td>
<td>(52,500)</td>
<td>324,000</td>
<td>(88,200)</td>
<td>2002 ________</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2003 ________</td>
</tr>
<tr>
<td>4</td>
<td>(144,000)</td>
<td>(52,500)</td>
<td>(117,600)</td>
<td>360,000</td>
<td>2002 ________</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2003 ________</td>
</tr>
<tr>
<td>5</td>
<td>300,000</td>
<td>(52,500)</td>
<td>324,000</td>
<td>(88,200)</td>
<td>2002 ________</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2003 ________</td>
</tr>
</tbody>
</table>

### Approach and Explanation:

To compute the amount to report as the gain or loss on disposal of a segment:

1. Compute the net realized items.
2. Compute the net estimated items.
3. Follow the rules for handling the income (loss) on operations and the gains and losses on disposal of assets estimated in the phase-out of discontinued operations, which are as follows:
   (a) If the estimated items net to a loss, accrue the net estimated losses in total to the period of the date of measurement.
   (b) If the estimated items net to a gain and the realized items net to a gain, defer recognition of all of the estimated items to the period these gains are realized (period of date of disposal).
   (c) If the estimated items net to a gain and the realized items net to a loss, use the net estimated gain (or portion thereof) to offset the net realized loss in the period of the date of measurement. Defer the recognition of any excess of net estimated gains over net realized losses.
<table>
<thead>
<tr>
<th>Case</th>
<th>Net Realized Items</th>
<th>Net Estimated Items</th>
<th>Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>($196,500)</td>
<td>$(205,800)</td>
<td>Accrue net estimated losses to 2002 (See &quot;a&quot; above).</td>
</tr>
<tr>
<td>2</td>
<td>$247,500</td>
<td>$(205,800)</td>
<td>Accrue net estimated losses to 2002 (see &quot;a&quot; above).</td>
</tr>
<tr>
<td>3</td>
<td>$(196,500)</td>
<td>$235,800</td>
<td>Use some estimated gains to offset net realized losses in 2002; defer the rest to 2003 (see &quot;c&quot; above).</td>
</tr>
<tr>
<td>4</td>
<td>$(196,500)</td>
<td>$242,400</td>
<td>Use some estimated gains to offset net realized losses in 2002; defer the rest to 2003 (see &quot;c&quot; above).</td>
</tr>
<tr>
<td>5</td>
<td>$247,500</td>
<td>$235,800</td>
<td>Do not reflect any estimated gains in 2002; there are no realized losses to offset. Defer all estimated gains to period realized (2003) (see &quot;b&quot; above).</td>
</tr>
</tbody>
</table>

**TIP:** To qualify for treatment as discontinued operations, the assets, results of operations, and activities of a segment of business must be clearly distinguishable, physically and operationally, from the other assets, results of operations, and activities of the entity. The **measurement date** is the date that management commits itself to a formal plan to dispose of a segment of business. The **disposal date** is the date of closing the sale if the disposal is by sale or the date that operations cease if the disposal is by abandonment. The period of time between the measurement date and the disposal date is called the **phase-out period**.

**TIP:** Discontinued operations are reported in a separate section of the income statement, net of tax. There are two components to this section of the income statement: (1) income or loss from operations of the discontinued segment, and (2) gain or loss on disposal of the discontinued segment. The first component reflects the results of operations (revenues and expenses) of the discontinued segment from the beginning of the year (period) **up to the measurement date**. Included in the second component are the results of operations of the discontinued segment **after the measurement date** (the phase-out period) and the gain or loss on disposal of the assets of the discontinued segment.

**TIP:** An extended phase-out period for discontinued operations refers to a situation where the disposal of the discontinued segment of business occurs in the reporting period following the reporting period in which the date of measurement occurs. Thus, at the date financial statements are to be prepared, estimates must be made for the (1) income (loss) from operations of the discontinued segment during the phase-out period, and (2) ultimate gain or loss on disposal of the assets of the discontinued segment.
ANALYSIS OF MULTIPLE-CHOICE TYPE QUESTIONS

QUESTION
1. (L.O. 3) In a multiple-step income statement, the excess of gross profit over operating expenses is called:
   a. net margin.
   b. income from operations.
   c. net profit.
   d. earnings.

Approach and Explanation: Visualize a multiple-step income statement. Net sales less cost of goods sold yields gross profit (sometimes called gross margin). Gross profit less operating expenses equals income from operations. From there, other revenues and gains are added, other expenses and losses are deducted, and income tax expense is deducted to arrive at net income. Another popular name for net income is earnings. Net profit would likely refer to net income. Net margin is not a term applied to the income statement. (Solution = b.)

QUESTION
2. (L.O. 3) The following expenses and loss were among those incurred by Mitzer Company during 2002:

   Rent for office space $ 660,000
   Loss on sale of office furniture           55,000
   Interest                               132,000
   Accounting and legal fees            352,000
   Freight-out                             70,000

One-half of the rented premises is occupied by the sales department. How much of the items listed above should be classified as general and administrative expenses in Mitzer's income statement for 2002?
   a. $682,000
   b. $869,000
   c. $884,000
   d. $939,000

Approach and Explanation: For each item listed, identify where it is reported. Then collect together the ones that you identify as general and administrative (G&A) expenses.

Rent for office space: One-half selling; one-half G&A
Loss on sale of equipment: Other expenses and losses
Interest: Other expenses and losses
Accounting and legal fees: G&A expenses
Freight-out: Selling expenses

One-half of office space (.5 x $660,000) $330,000
Accounting and legal fees 352,000
General and administrative expenses $682,000 (Solution = a.)
QUESTION
3. (L.O. 3) Which of the following is not a selling expense?
   a. Advertising expense
   b. Office salaries expense
   c. Freight-out
   d. Store supplies consumed

Approach and Explanation: Take each account and determine its classification. Items "a," "c," and "d" are selling expenses because they are associated with the sales function. Office salaries are related to normal operations, but they are not related to the sales function of the business. Therefore, they are not classified as a selling expense. (Solution = b.)

QUESTION
4. (L.O. 3) The accountant for the Orion Sales Company is preparing the income statement for 2002 and the balance sheet at December 31, 2002. The January 1, 2002 merchandise inventory balance will appear:
   a. only as an asset on the balance sheet.
   b. only in the cost of goods sold section of the income statement.
   c. as a deduction in the cost of goods sold section of the income statement and as a current asset on the balance sheet.
   d. as an addition in the cost of goods sold section of the income statement and as a current asset on the balance sheet.

Explanation: The January 1, 2002 inventory amount is the beginning inventory figure. Beginning inventory is a component of the cost of goods available for sale for the period which is a component of cost of goods sold. (Solution = b.)

TIP: If the question asked about the December 31, 2002 merchandise inventory balance (ending inventory) rather than the beginning inventory balance, the correct answer would have been "c" (as a deduction in computing cost of sales and as a current asset).

QUESTION
5. (L.O. 2, 3) The following amounts relate to the current year for the Ira Company:
   Beginning inventory $  20,000
   Ending inventory 28,000
   Purchases 166,000
   Purchase returns 4,800
   Transportation-out 6,000

The amount of cost of goods sold for the period is:
   a. $169,200.
   b. $162,800.
   c. $153,200.
   d. $147,200.
Approach and Explanation: Write down the computation model for cost of goods sold. Enter the amounts given and solve for the unknown.

\[
\begin{align*}
& \text{Beginning Inventory} \quad \text{Purchases} \\
& \quad + \quad \begin{array}{c}
\text{Purchases} \\
\text{Purchase Returns and Allowances} \\
\text{Purchase Discounts} \\
\text{Freight-in}
\end{array} \\
& \quad = \quad \text{Cost of Goods Available for Sale} \\
& \quad - \quad \text{Ending Inventory} \\
& \quad = \quad \text{Cost of Goods Sold}
\end{align*}
\]

\[
\begin{align*}
$20,000 & \quad + \quad 166,000 \\
- \quad 4,800 & \quad - \quad 28,000 \\
& \quad = \quad 181,200 \\
& \quad = \quad 153,200
\end{align*}
\]

TIP: Transportation-out is classified as a selling expense, not a component of cost of goods sold. "Transportation-out" is often called "freight-out"; "transportation-in" is another name for "freight-in."

QUESTION

6. (L.O. 4) A loss from the disposal of a segment of business should be reported in the income statement:
   a. after extraordinary items and before cumulative effect of an accounting change.
   b. before extraordinary items and after cumulative effect of an accounting change.
   c. after extraordinary items and cumulative effect of an accounting change.
   d. before extraordinary items and cumulative effect of an accounting change.

Approach and Explanation: Keep in mind the acronym DEC. Write the items down in the proper order. Read each answer response to see if it properly describes the order in which you have listed the items.

The correct order of the items involved in the question is as follows:
   (1) Discontinued operations
   (2) Extraordinary items
   (3) Cumulative effect of a change in accounting principle (Solution = d.)

QUESTION

7. (L.O. 4) A material loss should be presented separately as a component of income from continuing operations when it is:
   a. unusual in nature and infrequent in occurrence.
   b. unusual in nature but not infrequent in occurrence.
   c. an extraordinary loss.
   d. a cumulative effect of a change in accounting principle.

Approach and Explanation: Visualize an income statement and mentally identify the section that reports income from continuing operations. Read one answer at a time and determine if it correctly describes how the statement in the question stem can be completed. A material loss that is (1) unusual in nature and (2) infrequent in occurrence should be reported as an
extraordinary item. A loss that meets one of the criteria for being classified as extraordinary, but not both, should be separately disclosed as a component of income from continuing operations. An extraordinary item and a cumulative effect of a change in accounting principle are to be reported after (and not part of) income from continuing operations. (Solution = b.)

QUESTION
8. (L.O. 4) During the year ended December 31, 2002, Schmelya Corporation incurred the following infrequent losses:
   1. A factory was shut down during a major strike by employees; costs were $120,000.
   2. A loss of $50,000 was incurred on the abandonment of computer equipment used in the business.
   3. A loss of $82,000 was incurred as a result of flood damage to a warehouse.

   How much total loss should Schmelya report in the extraordinary item section of its 2002 income statement?
   a. $82,000
   b. $120,000
   c. $202,000
   d. $252,000

   Approach and Explanation: It is wise to review the list of items that are classified as extraordinary items and the list of items that are not extraordinary items (see Illustration 4-3) until you can readily recognize items that appear in the list. In the question at hand, the first two items are on the list of items that are not extraordinary. Therefore, the only possible one being extraordinary is the loss from flood damage. A flood would be considered infrequent in some locations but not others. The stem of the question indicates it is deemed infrequent for Schmelya. To be classified as extraordinary, an item needs to be unusual in nature and infrequent in occurrence. However, there are certain items that do not constitute extraordinary items. (Solution = a.)

QUESTION
9. (L.O. 4) Which of the following should be classified as an extraordinary item?
   a. Loss from extinguishment of debt.
   b. Loss from exchange of foreign currencies.
   c. Loss from abandonment of plant assets.
   d. Loss from writedown of goodwill.

   Explanation: Answer selections "b.", "c.", and "d." involve transactions that appear on the list of items that are not to be classified as extraordinary items on the income statement. A gain or loss from extinguishment of debt is to be classified as an extraordinary item even though the extinguishment of debt does not meet the two criteria for classifying an item as an extraordinary item (unusual in nature and infrequent in occurrence). (Solution = a.)
QUESTION 10. (L.O. 4) When a piece of office equipment is sold at a gain of $70,000 less related taxes of $28,000, and the gain is not considered unusual or infrequent, the income statement for the period would show these effects as:
   a. an extraordinary item net of applicable income taxes, $420,000.
   b. a prior period adjustment net of applicable income taxes, $420,000.
   c. an other gain net of applicable income taxes, $420,000.
   d. an other gain of $700,000 and an increase in income tax expense of $280,000.

Explanation: A gain or loss on the disposal of property, plant and equipment that is not unusual and infrequent is not to be classified as an extraordinary item. Therefore, a gain from such a disposal goes in the "other revenues and gains" classification. The related tax effect is reflected in the "income tax expense" figure. The only items reported net of tax are extraordinary items, discontinued operations, changes in accounting principle, and prior period adjustments. The tax effects of all other transactions are summarized in the amount captioned "income tax expense." (Solution = d.)

QUESTION 11. (L.O. 7) A correction of an error in prior periods' income will be reported:

<table>
<thead>
<tr>
<th>In the income statement</th>
<th>Net of tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Approach and Explanation: Write down what you know about the accounting for a correction of an error in computing income in a prior period. Then answer "yes" or "no" to each question posed at the top of the appropriate column. Find the combination that matches yours. A correction of an error is a prior period adjustment; it is reported net of tax as an adjustment to the beginning retained earnings balance on the statement of retained earnings in the period the error is corrected. (Solution = d.)

QUESTION 12. (L.O. 7) The OVA Company had the following errors occur in its financial statements:

<table>
<thead>
<tr>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ending inventory $12,000 Understated</td>
<td>$18,000 Overstated</td>
</tr>
<tr>
<td>Depreciation expense $24,000 Overstated</td>
<td>$14,000 Overstated</td>
</tr>
</tbody>
</table>

Assuming that none of the errors were detected or corrected, by what amount will retained earnings at December 31, 2002 be misstated?
   a. $18,000 overstated.
   b. $20,000 understated.
   c. $32,000 understated.
   d. $14,000 understated.
   e. None of the above.
Approach and Explanation: Explain the effects of each error separately and then combine your results. The $12,000 understatement of ending inventory for 2001 causes a $12,000 understatement of net income for 2001 and a $12,000 overstatement of net income for 2002 (because the ending inventory for 2001 is the beginning inventory for 2002); this nets to be a zero impact on the retained earnings balance at December 31, 2002. The $24,000 overstatement of depreciation expense in 2001 causes an understatement of net income for 2001 and a corresponding $24,000 understatement of retained earnings at December 31, 2001 and at December 31, 2002. The $18,000 overstatement of ending inventory for 2002 causes an overstatement of net income for 2002 and an $18,000 overstatement of retained earnings at December 31, 2002. A $14,000 overstatement of depreciation expense for 2002 causes a $14,000 understatement of net income for 2002 and a $14,000 understatement of retained earnings at December 31, 2002. The net effect on retained earnings at December 31, 2002 is therefore a $24,000 understatement + an $18,000 overstatement + a $14,000 understatement which equals a $20,000 understatement. (Solution = b.)

QUESTION
13. (L.O. 8) Comprehensive income includes all of the following except:
   a. unrealized holding losses.
   b. dividends declared and paid.
   c. interest income.
   d. gains on disposal of assets.

Approach and Explanation: Define comprehensive income before reading the answer selections. Then analyze each answer selection to see how it relates to the definition. Comprehensive income includes all changes in stockholders' equity except those resulting from investments by owners and distributions to owners. Dividends declared and paid are a distribution to owners. (Solution = b.)

QUESTION
14. (L.O. 9) When a segment of a business has been discontinued during the year, that segment's operating losses of the current year after the measurement date should be included in the:
   a. income statement as part of the income (loss) from operations of the discontinued segment.
   b. income statement as part of the gain (loss) on disposal of the discontinued segment.
   c. income statement as part of the income (loss) from continuing operations.
   d. statement of retained earnings as a direct decrease in retained earnings.

Approach and Explanation: Read the question and write down the two captions used to report discontinued operations and also write down a brief description of what goes in each category. Read each answer selection and answer True or False as to whether or not it correctly completes the statement in the stem. There are two lines in the "discontinued operations" section of the income statement: (1) income (loss) from operations of discontinued segment, and (2) gain or loss on disposal of discontinued segment. The results of operations
of the discontinued segment from the beginning of the year up to the measurement date are to be reported in the first line. The results of operations of the discontinued segment after the measurement date go in the second line, along with the gain or loss in disposal of the assets of the discontinued segment. (Solution = b.)