LECTURE OUTLINE

The material in this chapter can be covered in two to three class sessions. Most students have had previous exposure to the concepts presented in the chapter.

The lecture and assigned problems should be directed toward three areas of concentration:

(1) An understanding of the concepts underlying the measurement and presentation of income. These include concepts such as the capital maintenance approach, the quality of earnings, the all-inclusive approach versus the current operating performance approach, etc.

(2) An understanding of each of the intermediate components of income and other irregular items, including prior period adjustments, extraordinary items, changes in accounting principle, etc. Students should be able to: (1) recognize these items when encountered in problem material, and (2) identify the proper accounting and disclosure procedure for each of them.

(3) An understanding of proper format for income and retained earnings statements. Given transaction data or account balances, students should be able to prepare single- and multiple-step income statements, retained earnings statements, and combined statements of income and retained earnings.

The material in the chapter can be presented with the following lecture outline:

A. The Relative Importance of the Income Statement as Providing a Measure of Profit.

1. Income information helps interested parties predict the amount, timing, and uncertainty of future cash flows. Income information is useful:

   a. for evaluating past performance of a company.

   b. for determining the risk (uncertainty) of achieving future cash flows. Information about the various components of income—revenues, expenses, gains, and losses—is helpful for assessing the likelihood that particular cash flows will continue in the future.
2. Discuss the attention focused on a firm's earnings.

Use Illustration 4-1 to demonstrate the focus on earnings by the financial press. Articles from the Wall Street Journal, Forbes, Business Week, or some other business periodical might be used as examples.

Students may be asked why information about the earnings of a firm is desired? Stress the point that the ability of a firm to generate earnings is essential for its long-run survival. Investors and creditors use earnings information in making investment and credit decision that involve the firm.

B. Limitations of the Income Statement.

1. Discuss the notion of "economic income:" the maximum amount that can be consumed during the period while leaving the entity as well off at the end as at the beginning.

   a. There is no general agreement on how to measure "well-offness."

   b. Accounting income does not include many items that would be included in economic income, e.g., accountants do not capitalize expenditures for many research and development and internally developed goodwill activities.

2. Income numbers are affected by the accounting method used. Discuss the concept of the quality of earnings. (See Schwartz, bibliography reference 13; Siegel, bibliography reference 14, Worthy, bibliography reference 11; St. Goar, bibliography reference 9; and Weiss, bibliography reference 10.)

3. Profits measured by accountants may have limited usefulness for economists. (See Friedlob, bibliography reference 12.)
C. Concepts of Income Measurement.

1. Review concepts such as revenue recognition, matching, periodicity.

2. Discuss the capital maintenance approach (difference in net assets approach) versus the transactions approach (which focuses on underlying revenue and expense transactions).
   
   a. Capital maintenance approach: measures income as the difference in capital values (net assets) at 2 points in time.
   
   b. Transacting approach: focuses on the activities that create income and summarizes them in an income statement. Focuses on the components of income.

3. Discuss the question: Which of the transactions that produce changes in net assets should be included in income for the period?
   
   a. All-inclusive approach: any gain or loss, whether related to operations or not, should be included in the computation of net income.
   
   b. Current operating performance approach: net income should include only regular, recurring earnings from normal operations. Irregular gains and losses and other items such as changes in accounting principle should be closed directly to retained earnings.
   
   c. The accounting profession has adopted a modified all-inclusive approach: all changes in net assets except the following are included in income:
      
      (1) capital transactions (investments by owners or distributions to owners).
      
      (2) prior period adjustments.
      
      (3) certain changes in net assets such as unrealized holding gains or losses on available-for-sale securities. (This is discussed in Chapter 18.)

1. What are the intermediate components of income? Review the definitions of the **elements** of income on text page 149: Revenues, expenses, gains, losses.

2. Presentation of items **before** income from continuing operations.
   
   a. **Multiple-step format.**

   Use **Illustration 4-2** to describe the multiple-step format. Emphasize the intermediate components such as gross profit, income from operations, and other revenues and expenses.

   b. **Single-step format.**

   Use **Illustration 4-3** can be used to describe the single-step format. Make comparisons with the multiple-step format in **Illustration 4-2**.

   c. Point out that the difference between the two formats affects only the presentation of items before income from continuing operations.

   d. GAAP permits either multiple-step or single-step format.
3. Presentation of items after income from continuing operations.

TEACHING TIP

Illustration 4-4 can be used to discuss each of the special items after income from continuing operations. Emphasize that separate disclosures of these items are the result of pronouncements by the accounting profession.

a. An acronym to help students remember the order of presentation of items in this section of the income statement is "D-E-C."

(1) "D" — Discontinued Operations.

(2) "E" — Extraordinary Items.

(3) "C" — Changes in Accounting Principle.

b. GAAP requires presentation of these items net of tax.

E. Discontinued Operations—results from disposal of a segment of the business.

TEACHING TIP

Use Illustration 4-9 can be used to illustrate how the gains and losses are determined when reporting discontinued operations on the income statement.

1. Examples of disposals of segments are:

a. A sale by a diversified company of a major division which represents the company's only activities in the electronics industry. The assets and results of operations of the division are clearly segregated for internal financial reporting purposes from the other assets and results of operations of the company.

b. A sale by a meat packing company of a 25% interest in a professional football team which has been accounted for under the equity method. All other activities of the company are in the meat packing business.

c. A sale by a communications company of all its radio stations which represent 30% of gross revenues. The company's remaining activities are three television stations and a publishing company. The assets and results of operations of the radio stations are clearly distinguishable physically, operationally, and for financial reporting purposes.
d. A food distributor disposes of one of its two divisions. One division sells food wholesale primarily to supermarket chains and the other division sells food through its chain of fast food restaurants, some of which are franchised and some of which are company-owned. Both divisions are in the business of distribution of food. However, the nature of selling food through fast food outlets is vastly different than that of wholesaling food to supermarket chains. Thus by having two major classes of customers, the company has two segments of its business.

2. Disposals that do not qualify as disposals of segments are:

a. The sale of a major foreign subsidiary engaged in silver mining by a mining company which represents all of the company’s activities in that particular country. Even though the subsidiary being sold may account for a significant percentage of gross revenue of the consolidated group and all of its revenues in the particular country, the fact that the company continues to engage in silver mining activities in other countries would indicate that there was a sale of only a part of a line of business.

b. The sale by a petrochemical company of a 25% interest in a petrochemical plant which is accounted for as an investment in a corporate joint venture under the equity method. Since the remaining activities of the company are in the same line of business as the 25% interest which has been sold, there has not been a sale of a major line of business but rather a sale of part of a line of business.

c. A manufacturer of children’s wear discontinues all of its operations in Italy which were composed of designing and selling children’s wear for the Italian market. In the context of determining a segment of a business by class of customer, the nationality of customers or slight variations in product lines in order to appeal to particular groups are not determining factors.

d. A diversified company sells a subsidiary which manufactures furniture. The company has retained its other furniture manufacturing subsidiary. The disposal of the subsidiary, therefore, is not a disposal of a segment of the business but rather a disposal of part of a line of business. As discussed in paragraph 13 of APB Opinion No. 30, such disposals are incident to the evolution of the entity’s business.

e. The sale of all the assets (including the plant) related to the manufacture of men’s woolen suits by an apparel manufacturer in order to concentrate activities in the manufacture of men’s suits from synthetic products. This would represent a disposal of a product line as distinguished from the disposal of a major line of business.
3. Disposals of segments are reported net of tax in the income statement immediately below income from continuing operations. Results of the disposal are reported in two components.

   a. Income or loss from operation of the discontinued segment up to the measurement date, net of tax.

   b. Gain or loss from disposal of the discontinued segment, net of tax.

4. Accounting for discontinued operations is discussed in more detail in Appendix 4-A.

F. **Extraordinary Items**—unusual in nature and infrequent in occurrence, considering the environment in which the entity operates.

1. Examples of extraordinary items are:

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

   b. A steel fabricating company sells the only land it owns. The land was acquired ten years ago for future expansion, but shortly thereafter the company abandoned all plans for expansion and held the land for appreciation.

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

   d. An earthquake destroys one of the oil refineries owned by a large multi-national oil company.
2. Examples of items that are not extraordinary are:

   a. A citrus grower’s Florida crop is damaged by frost. Frost damage is normally experienced every three or four years. The criterion of infrequency of occurrence taking into account the environment in which the company operates would not be met since the history of losses caused by frost damage provides evidence that such damage may reasonably be expected to recur in the foreseeable future.

   b. A company which operates a chain of warehouses sells the excess land surrounding one of its warehouses. When the company buys property to establish a new warehouse, it usually buys more land than it expects to use for the warehouse with the expectation that the land will appreciate in value. In the past five years, there have been two instances in which the company sold such excess land. The criterion of infrequency of occurrence has not been met since past experience indicates that such sales may reasonably be expected to recur in the foreseeable future.

   c. A large diversified company sells a block of shares from its portfolio of securities which it has acquired for investment purposes. This is the first sale from its portfolio of securities. Since the company owns several securities for investment purposes, it should be concluded that sales of such securities are related to its ordinary and typical activities in the environment in which it operates and thus the criterion of unusual nature would not be met.

   d. A textile manufacturer with only one plant moves to another location. It has not relocated a plant in twenty years and has no plans to do so in the foreseeable future. Notwithstanding the infrequency of occurrence of the event as it relates to this particular company, moving from one location to another is an occurrence which is a consequence of customary and continuing business activities, some of which are finding more favorable labor markets, more modern facilities, and proximity to customers or suppliers. Therefore, the criterion of unusual nature has not been met and the moving expenses (and related gains and losses) should not be reported as an extraordinary item. Another example of an event which is a consequence of customary and typical business activities (namely financing) is an unsuccessful public registration, the cost of which should not be reported as an extraordinary item.

3. If an item is not unusual and infrequent and material, it is disclosed in some section of the income statement other than the extraordinary item section.
4. Some items are given extraordinary item treatment by pronouncement, and not necessarily because they are unusual or infrequent. An example is material gains and losses from extinguishment of debt.

5. Extraordinary items are presented net of tax in the income statement, below discontinued operations and above changes in accounting principle.

G. Unusual Gains and Losses—items that are unusual or infrequent but not both.

1. In a multiple-step statement, these are reported in the "other revenues and gains" or "other expenses and losses" section.

2. These items may not be presented net of tax.

H. Changes in Accounting Principle—adoption of an accounting method that is different from the one previously used.

1. Examples:
   a. Change from FIFO to average cost.
   b. Change from double-declining to straight-line depreciation.

2. Discuss the distinction between a change in accounting principle and a change in accounting estimate.

3. Point out that it is the cumulative effect of the change on prior years’ income which is separately disclosed.

4. Changes in accounting principle are disclosed net of tax in the income statement immediately before net income.
I. Changes in Estimates (Normal, Recurring Corrections and Adjustments)—adjustments that result from periodic revisions in estimates.

1. Examples.

   a. Changes in the estimated lives or salvage values of fixed assets.

   b. Changes in estimated collectibility of receivables.

   c. Adjustment of inventory costs or estimated realizability.

2. These adjustments are not treated as errors or extraordinary items. Students frequently misunderstand this. They erroneously believe that special journal entries or separate disclosures must be made.

   

The treatment of the Special Items discussed in E through I of the lecture outline is summarized in Illustration 4-5.

J. Tax Allocation—the process of associating income tax expense with related income. The principle is "let the tax follow the income."

1. Interperiod tax allocation involves procedures for recognizing differences between taxable income and accounting income. This is discussed in Chapter 20.

2. Intraperiod tax allocation involves a breakdown of total income tax expense into separate components which are disclosed in different portions of the financial statements. Intraperiod tax allocation is applied to:

   a. income from continuing operations.
b. discontinued operations.

c. extraordinary items.

d. changes in accounting principle.

e. prior period adjustments.

3. Use the income statement on text page 165 to demonstrate intraperiod tax allocation. Ask students to compute the total tax expense for 1998. It is $137,900, disclosed for accounting purposes as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax associated with continuing operations</td>
<td>$208,000</td>
</tr>
<tr>
<td>Tax on operation of discontinued division</td>
<td>24,800</td>
</tr>
<tr>
<td>Reduction of tax due to loss on disposal of discontinued division</td>
<td>(41,000)</td>
</tr>
<tr>
<td>Reduction of tax due to extraordinary loss</td>
<td>(23,000)</td>
</tr>
<tr>
<td>Reduction of tax due to change in accounting method</td>
<td>(30,900)</td>
</tr>
<tr>
<td><strong>Total tax expense</strong></td>
<td><strong>$137,900</strong></td>
</tr>
</tbody>
</table>

Without intraperiod tax allocation, total tax expense would merely be reported as $137,900 and financial statement users would not be able to assess the tax consequences of operations or of special items.

4. Point out that the net-of-tax amount of an item is calculated by multiplying the item by (1 minus the tax rate).

K. **Earnings Per Share**—a widely used measure of business performance.

1. Discuss the importance of EPS in the financial press using examples from *The Wall Street Journal*.

2. As defined in Chapter 4, EPS is equal to

\[
\frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Weighted Average Common Shares Outstanding}}
\]
3. Discuss the concept of **dilution**. The existence of convertible securities, stock options, and stock warrants may reduce EPS when these securities become common stock. The computation of EPS in figures that reflect potential dilution is discussed in Chapter 17.

4. Per share figures must be disclosed in the income statement for the following amounts:

   a. income from continuing operations.

   b. income before extraordinary items and cumulative effect of changes in accounting principle.

   c. cumulative effect of changes in accounting principle.

   d. net income.

5. In addition, per share information is usually provided for:

   a. discontinued operations.

   b. extraordinary items.

L. **Stockholders’ Equity Statement**—shows the changes in each stockholders’ equity account and in total stockholders’ equity during a year.

M. **Statement of Retained Earnings**—a summary disclosure of the changes in the balance of the Retained Earnings account from the beginning to the end of the year. The following items are disclosed in the retained earnings statement:

   1. Prior period adjustments. Adjustments to the beginning balance of retained earnings.
a. Transactions that are accounted for as prior period adjustments:

   (1) Correction of errors in financial statements of prior periods.

   (2) Realization of tax benefits from pre-acquisition operating loss carry forwards of purchased subsidiaries.

   (3) Certain accounting changes such as a change in the method of accounting for long-term construction contracts.

b. The entry to record a prior period adjustment usually involves the following types of accounts:

   (1) The Retained Earnings account.

   (2) A balance sheet account (e.g., Accumulated Depreciation, Inventory, etc.).

   (3) The Taxes Payable account. When a prior period adjustment is recorded, ordinarily an amended tax return is filed for the affected year, and a tax refund or an additional tax liability results.

c. Prior period adjustments are reported net of tax on the retained earnings statement.

2. Dividends and net income.

3. Appropriations of retained earnings.

N. **Accumulated Other Comprehensive Income**—consists of gains and losses not reflected as part of net income, e.g., unrealized gains/losses on available for sale securities.

   1. FASB requires that components be reported in a:

      a. separate income statement, or

      b. combined income statement of comprehensive income.
2. Is also disclosed in the stockholders’ equity statement as a separate column.

Illustrations 4-6 and 4-7 can be used to discuss the presentation of accumulated other comprehensive income in the financial statements.

O. APPENDIX 4A. Accounting for Discountinued Operations

1. Measurement date. When management commits to a formal plan to dispose of a segment.

Use Illustration 4-8 to discuss the elements of a formal disposal plan.

2. When no phase-out period exists, the measurement and disposal dates coincide.

3. When a phase-out period exists, the disposal date occurs in the same year as the measurement date.

   a. The Income/loss on operations of the discontinued segment consists of the revenues/expenses that occurred between the end of the previous period and the measurement date.

   b. The gain/loss on disposal consists of:

      (1) Income/loss on operations between the measurement and disposal dates, plus

      (2) Gain/loss on disposal.

4. When an extended phase-out period exists, the disposal occurs in a year subsequent to the measurement date.

   a. Net all realized and estimated unrealized gains/losses related to the extended phase-out period.
b. The amount reported as the gain/loss from disposal is:

(1) the amount of the overall loss, if an overall loss is computed.

(2) the lesser of the overall gain or the realized gain, if an overall gain is computed.

**TEACHING TIP**

Use **Illustration 4-9** to demonstrate the accounting for discontinued operations.