Financial Statement Analysis: The Big Picture
1. Discuss the need for comparative analysis.
2. Identify the tools of financial statement analysis.
3. Explain and apply horizontal analysis.
4. Describe and apply vertical analysis.
5. Identify and compute ratios used in analyzing a firm’s liquidity, profitability, and solvency.
6. Understand the concept of earning power, and how irregular items are presented.
7. Understand the concept of quality of earnings.
Financial Statement Analysis

- Basics of Financial Statement Analysis
  - Need for comparative analysis
  - Tools of analysis
- Horizontal and Vertical Analysis
  - Balance sheet
  - Income statement
  - Retained earnings statement
- Ratio Analysis
  - Liquidity
  - Profitability
  - Solvency
  - Summary
- Earning Power and Irregular Items
  - Discontinued operations
  - Extraordinary items
  - Changes in accounting principle
  - Comprehensive income
- Quality of Earnings
  - Alternative accounting methods
  - Pro forma income
  - Improper recognition
Analyzing financial statements involves:

### Characteristics
- Liquidity
- Profitability
- Solvency

### Comparison Bases
- Intracompany averages
- Intercompany

### Tools of Analysis
- Horizontal
- Vertical
- Ratio

LO 1  Discuss the need for comparative analysis.
LO 2  Identify the tools of financial statement analysis.
Horizontal analysis, also called trend analysis, is a technique for evaluating a series of financial statement data over a period of time. Its purpose is to determine the increase or decrease that has taken place.

Horizontal analysis is commonly applied to the balance sheet, income statement, and statement of retained earnings.
**Exercise:** The comparative condensed balance sheets of Ramsey Corporation are presented below.

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$76,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>$99,000</td>
<td>$90,000</td>
</tr>
<tr>
<td>Intangibles</td>
<td>$25,000</td>
<td>$40,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$200,000</strong></td>
<td><strong>$210,000</strong></td>
</tr>
<tr>
<td>Current liabilities</td>
<td>$40,800</td>
<td>$48,000</td>
</tr>
<tr>
<td>Long-term liabilities</td>
<td>$143,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Stockholders' equity</td>
<td>$16,200</td>
<td>$12,000</td>
</tr>
<tr>
<td><strong>Total liabilities &amp; equity</strong></td>
<td><strong>$200,000</strong></td>
<td><strong>$210,000</strong></td>
</tr>
</tbody>
</table>

**Instructions:** Prepare a horizontal analysis of the balance sheet data for Ramsey Corporation using 2008 as a base.
**Exercise:** The comparative condensed balance sheets of Ramsey Corporation are presented below.

<table>
<thead>
<tr>
<th>Category</th>
<th>2009</th>
<th>2008</th>
<th>Increase (Decrease)</th>
<th>Percentage Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ 76,000</td>
<td>$ 80,000</td>
<td>$(4,000)</td>
<td>-5.0%</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>99,000</td>
<td>90,000</td>
<td>9,000</td>
<td>10.0%</td>
</tr>
<tr>
<td>Intangibles</td>
<td>25,000</td>
<td>40,000</td>
<td>(15,000)</td>
<td>-37.5%</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$200,000</td>
<td>$210,000</td>
<td>$(10,000)</td>
<td>-4.8%</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>$ 40,800</td>
<td>$ 48,000</td>
<td>$(7,200)</td>
<td>-15.0%</td>
</tr>
<tr>
<td>Long-term liabilities</td>
<td>143,000</td>
<td>150,000</td>
<td>(7,000)</td>
<td>-4.7%</td>
</tr>
<tr>
<td>Stockholders' equity</td>
<td>16,200</td>
<td>12,000</td>
<td>4,200</td>
<td>35.0%</td>
</tr>
<tr>
<td><strong>Total liabilities &amp; equity</strong></td>
<td>$200,000</td>
<td>$210,000</td>
<td>$(10,000)</td>
<td>-4.8%</td>
</tr>
</tbody>
</table>

**Instructions:** Prepare a horizontal analysis of the balance sheet data for Ramsey Corporation using 2008 as a base.

**LO 3** Explain and apply horizontal analysis.
Vertical analysis, also called common-size analysis, is a technique that expresses each financial statement item as a percent of a base amount.

On an income statement, we might say that selling expenses are 16% of net sales.

Vertical analysis is commonly applied to the balance sheet and the income statement.
Exercise: The comparative condensed income statements of Hendi Corporation are shown below.

<table>
<thead>
<tr>
<th></th>
<th>2009 Amount</th>
<th>2008 Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$ 600,000</td>
<td>$ 500,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>483,000</td>
<td>420,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>117,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Operating expense</td>
<td>57,200</td>
<td>44,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 59,800</td>
<td>$ 36,000</td>
</tr>
</tbody>
</table>

Instructions: Prepare a vertical analysis of the income statement data for Hendi Corporation in columnar form for both years.

LO 4 Describe and apply vertical analysis.
**Exercise:** The comparative condensed income statements of Hendi Corporation are shown below.

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>Percent</th>
<th>2008</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net sales</strong></td>
<td>$ 600,000</td>
<td>100.0%</td>
<td>$ 500,000</td>
<td>100.0%</td>
</tr>
<tr>
<td><strong>Cost of goods sold</strong></td>
<td>483,000</td>
<td>80.5%</td>
<td>420,000</td>
<td>84.0%</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>117,000</td>
<td>19.5%</td>
<td>80,000</td>
<td>16.0%</td>
</tr>
<tr>
<td><strong>Operating expense</strong></td>
<td>57,200</td>
<td>9.5%</td>
<td>44,000</td>
<td>8.8%</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$ 59,800</td>
<td>10.0%</td>
<td>$ 36,000</td>
<td>7.2%</td>
</tr>
</tbody>
</table>

**Instructions:** Prepare a **vertical analysis** of the income statement data for Hendi Corporation in columnar form for both years.

Chapter 14-11

LO 4 Describe and apply vertical analysis.
Ratio Analysis

Ratio analysis expresses the relationship among selected items of financial statement data.

Financial Ratio Classifications

Liquidity
Measures short-term ability of the company to pay its maturing obligations and to meet unexpected needs for cash.

Profitability
Measures the income or operating success of a company for a given period of time.

Solvency
Measures the ability of the company to survive over a long period of time.

LO 5 Identify and compute ratios used in analyzing a firm’s liquidity, profitability, and solvency.
A single ratio by itself is not very meaningful.

The discussion of ratios will include the following types of comparisons.

**Intracompany**

| XYZ Co. | 2008 ↔ 2009 |

**Intercompany**

| XYZ Co. | ↔ | A Co. |

**Industry averages**

\[
\text{A Co.} \\
\text{B Co.} \\
\text{C Co.} \\
\frac{A + B + C}{3}
\]
Ratio Analysis

Liquidity Ratios

Measure the short-term ability of the company to pay its maturing obligations and to meet unexpected needs for cash.

- Short-term creditors such as bankers and suppliers are particularly interested in assessing liquidity.
- Ratios include the current ratio, the acid-test ratio, receivables turnover, and inventory turnover.

LO 5 Identify and compute ratios used in analyzing a firm’s liquidity, profitability, and solvency.
Taylor Tool Company

Income Statement

For the Year Ended December 31

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1,818,500</td>
<td>$1,750,500</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>1,011,500</td>
<td>996,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>807,000</td>
<td>754,500</td>
</tr>
<tr>
<td>Selling and administrative expenses</td>
<td>506,000</td>
<td>479,000</td>
</tr>
<tr>
<td>Income from operations</td>
<td>301,000</td>
<td>275,500</td>
</tr>
<tr>
<td>Other expenses and losses:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>18,000</td>
<td>14,000</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>283,000</td>
<td>261,500</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>84,000</td>
<td>77,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$199,000</td>
<td>$184,500</td>
</tr>
</tbody>
</table>

LO 5  Identify and compute ratios used in analyzing a firm's liquidity, profitability, and solvency.
## Ratio Analysis

### Taylor Tool Company

**Balance Sheets**

**December 31**

<table>
<thead>
<tr>
<th>Assets</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td>$60,100</td>
<td>$64,200</td>
</tr>
<tr>
<td><strong>Short-term investments</strong></td>
<td>69,000</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Accounts receivable (net)</strong></td>
<td>107,800</td>
<td>102,800</td>
</tr>
<tr>
<td><strong>Inventory</strong></td>
<td>133,000</td>
<td>115,500</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td>369,900</td>
<td>332,500</td>
</tr>
<tr>
<td><strong>Plant assets (net)</strong></td>
<td>600,300</td>
<td>520,300</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$970,200</td>
<td>$852,800</td>
</tr>
</tbody>
</table>

LO 5 Identify and compute ratios used in analyzing a firm's liquidity, profitability, and solvency.
## Ratio Analysis

<table>
<thead>
<tr>
<th>Liabilities and Stockholders' Equity</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$160,000</td>
<td>$145,400</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>43,500</td>
<td>42,000</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>203,500</td>
<td>187,400</td>
</tr>
<tr>
<td><strong>Bonds payable</strong></td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>403,500</td>
<td>387,400</td>
</tr>
<tr>
<td><strong>Stockholders' equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock ($5 par)</td>
<td>280,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>286,700</td>
<td>165,400</td>
</tr>
<tr>
<td><strong>Total stockholders' equity</strong></td>
<td>566,700</td>
<td>465,400</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$970,200</td>
<td>$852,800</td>
</tr>
</tbody>
</table>

All sales were on account. The allowance for doubtful accounts was $3,200 on December 31, 2009, and $3,000 on December 31, 2008.

LO 5 Identify and compute ratios used in analyzing a firm’s liquidity, profitability, and solvency.
Compute the **Current Ratio** for 2009.

\[
\frac{\text{Current Assets}}{\text{Current Liabilities}} = \text{Current Ratio}
\]

\[
\frac{\$369,900}{\$203,500} = 1.82 : 1
\]

The ratio of 1.82:1 means that for every dollar of current liabilities, the company has $1.82 of current assets.
Compute the Acid-Test Ratio for 2009.

\[
\frac{\text{Cash} + \text{Short-Term Investments} + \text{Receivables (Net)}}{\text{Current Liabilities}} = \text{Acid-Test Ratio}
\]

\[
\frac{\$60,100 + \$69,000 + \$107,800}{\$203,500} = 1.16 : 1
\]

The acid-test ratio measures immediate liquidity.
Compute the **Receivables Turnover** ratio for 2009.

\[
\text{Receivables Turnover} = \frac{\text{Net Credit Sales}}{\text{Average Net Receivables}}
\]

\[
\frac{$1,818,500}{($107,800 + $102,800) / 2} = 17.3 \text{ times}
\]

It measures the number of times, on average, the company collects receivables during the period.
A variant of the receivables turnover ratio is to convert it to an **average collection period** in terms of days.

\[
\frac{365 \text{ days}}{17.3 \text{ times}} = \text{every 21.1 days}
\]

This means that receivables are collected on average every 21 days.
Compute the **Inventory Turnover** ratio for 2009.

\[
\frac{\text{Cost of Good Sold}}{\text{Average Inventory}} = \text{Inventory Turnover}
\]

\[
\frac{\$1,011,500}{\frac{\$133,000 + \$115,500}{2}} = 8.1 \text{ times}
\]

Inventory turnover measures the number of times, on average, the inventory is sold during the period.

LO 5 Identify and compute ratios used in analyzing a firm's liquidity, profitability, and solvency.
A variant of inventory turnover is the **days in inventory**.

\[
\frac{1,011,500}{\frac{$133,000 + $115,500}{2}} = 8.1 \text{ times}
\]

365 days / 8.1 times = every 45.1 days

Inventory turnover ratios vary considerably among industries.

**Ratio Analysis**

**Liquidity Ratios**

LO 5 Identify and compute ratios used in analyzing a firm’s liquidity, profitability, and solvency.
Ratio Analysis

Profitability Ratios

Measure the income or operating success of a company for a given period of time.

- Income, or the lack of it, affects the company’s ability to obtain debt and equity financing, liquidity position, and the ability to grow.

- Ratios include the profit margin, asset turnover, return on assets, return on common stockholders’ equity, earnings per share, price-earnings, and payout ratio.

LO 5 Identify and compute ratios used in analyzing a firm’s liquidity, profitability, and solvency.
Compute the **Profit Margin** ratio for 2009.

\[
\frac{\text{Net Income}}{\text{Net Sales}} = \text{Profit Margin}
\]

\[
\frac{\$199,000}{\$1,818,500} = 10.9\%
\]

Measures the percentage of each dollar of sales that results in net income.
Compute the **Asset Turnover** ratio for 2009.

\[
\frac{\text{Net Sales}}{\text{Average Assets}} = \text{Asset Turnover}
\]

\[
\frac{\$1,818,500}{\left(\$970,200 + \$852,800\right)/2} = 2.0 \text{ times}
\]

Measures how efficiently a company uses its assets to generate sales.
比率分析

计算2009年资产回报率（Return on Assets）。

\[
\frac{\text{Net Income}}{\text{Average Assets}} = \text{Return on Assets}
\]

\[
\frac{$199,000}{($970,200 + $852,800) / 2} = 21.8\%
\]

一个整体的盈利性衡量指标。
Compute the Return on Common Stockholders’ Equity ratio for 2009.

\[
\frac{\text{Net Income - Preferred Dividends}}{\text{Average Common Stockholders' Equity}} = \text{Return on Common Stockholders’ Equity}
\]

\[
\frac{$199,000 - $0}{($566,700 + $465,400) / 2} = 38.6\%
\]

Shows how many dollars of net income the company earned for each dollar invested by the owners.
Compute the **Earnings Per Share** for 2009.

\[
\frac{\text{Net Income}}{\text{Weighted Average Common Shares Outstanding}} = \text{Earnings Per Share}
\]

\[
\frac{$199,000}{57,000 \text{ (given)}} = $3.49 \text{ per share}
\]

A measure of the net income earned on each share of common stock.
Compute the **Price Earnings Ratio** for 2009.

\[
\text{Price Earnings Ratio} = \frac{\text{Market Price per Share of Stock}}{\text{Earnings Per Share}}
\]

\[
\frac{25 \text{ (given)}}{3.49} = 7.16 \text{ times}
\]

The price-earnings (P-E) ratio reflects investors' assessments of a company's future earnings.

**LO 5** Identify and compute ratios used in analyzing a firm's liquidity, profitability, and solvency.
Compute the **Payout Ratio** for 2009.

\[
\text{Payout Ratio} = \frac{\text{Cash Dividends}}{\text{Net Income}}
\]

\[
\frac{\$77,700^*}{\$199,000} = 39\%
\]

Measures the percentage of earnings distributed in the form of cash dividends.

* From analysis of retained earnings.

LO 5 Identify and compute ratios used in analyzing a firm’s liquidity, profitability, and solvency.
Ratio Analysis

Solvency Ratios

Solvency ratios measure the ability of a company to survive over a long period of time.

- Debt to total assets and times interest earned are two ratios that provide information about debt-paying ability.

LO 5 Identify and compute ratios used in analyzing a firm’s liquidity, profitability, and solvency.
Compute the Debt to Total Assets Ratio for 2009.

\[
\frac{\text{Total Debt}}{\text{Total Assets}} = \text{Debt to Total Assets Ratio}
\]

\[
\frac{\$403,500}{\$970,200} = 41.6\%
\]

Measures the percentage of the total assets that creditors provide.

LO 5 Identify and compute ratios used in analyzing a firm’s liquidity, profitability, and solvency.
Compute the **Times Interest Earned** ratio for 2009.

\[
\frac{\text{Income before Income Taxes and Interest Expense}}{\text{Interest Expense}} = \frac{\$199,000 + \$84,000 + \$18,000}{\$18,000} = 16.7 \text{ times}
\]

Provides an indication of the company's ability to meet interest payments as they come due.

LO 5 Identify and compute ratios used in analyzing a firm's liquidity, profitability, and solvency.
Earning Power and Irregular Items

Earning power means the normal level of income to be obtained in the future.

“Irregular” items are separately identified on the income statement. Two types are:

1. Discontinued operations.
2. Extraordinary items.

These “irregular” items are reported net of income taxes.
Discontinued Operations

(a) Refers to the disposal of a significant component of a business.

(b) Report the income (loss) from discontinued operations in two parts:

1. income (loss) from operations (net of tax) and

2. gain (loss) on disposal (net of tax).
Exercise: McCarthy Corporation had after tax income from continuing operations of $55,000,000 in 2009. During 2009, it disposed of its restaurant division at a pretax loss of $270,000. Prior to disposal, the division operated at a pretax loss of $450,000 in 2009. Assume a tax rate of 30%. Prepare a partial income statement for McCarthy.

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

LO 6 Understand the concept of earning power, and how irregular items are presented.
Earning Power and Irregular Items

Income Statement (in thousands)

Sales $285,000
Cost of goods sold 149,000

Other revenue (expense):

- Interest revenue 17,000
- Interest expense (21,000)
  Total other (4,000)

Income before taxes 79,000
Income tax expense 24,000

Income from continuing operations 55,000

Discontinued operations:

- Loss from operations, net of tax 315
- Loss on disposal, net of tax 189
  Total loss on discontinued operations 504

Net income $54,496

Discontinued Operations are reported after “Income from continuing operations.”

Previously labeled as “Net Income”.

Moved to

LO 6 Understand the concept of earning power, and how irregular items are presented.
Extraordinary items are nonrecurring material items that differ significantly from a company's typical business activities.

An extraordinary item must be both of an

- Unusual Nature and
- Occur Infrequently

Company must consider the environment in which it operates.

Amounts reported “net of tax.”
Earning Power and Irregular Items

Are these considered Extraordinary Items?

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

(c) Loss from sale of temporary investments.  

(d) Loss attributable to a labor strike.

<table>
<thead>
<tr>
<th></th>
<th>YES</th>
<th>NO</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

LO 6 Understand the concept of earning power, and how irregular items are presented.
Earning Power and Irregular Items

Are these considered Extraordinary Items?

(d) Loss from flood damage. (The nearby Black River floods every 2 to 3 years.)  

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

(f) Write-down of obsolete inventory.

(g) Expropriation of a factory by a foreign government.
**Exercise:** McCarthy Corporation had after tax income from continuing operations of $55,000,000 in 2009. In addition, it suffered an unusual and infrequent pretax loss of $770,000 from a volcano eruption. The corporation’s tax rate is 30%. Prepare a partial income statement for McCarthy Corporation beginning with income from continuing operations.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations</td>
<td>$55,000,000</td>
</tr>
<tr>
<td>Extraordinary loss, net of $231,000 tax</td>
<td>539,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$54,461,000</td>
</tr>
</tbody>
</table>

($770,000 \times 30\% = $231,000 \text{ tax})

**LO 6 Understand the concept of earning power, and how irregular items are presented.**
Earning Power and Irregular Items

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

Previously labeled as "Net Income".

Moved to

Income Statement (in thousands)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$285,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>149,000</td>
</tr>
<tr>
<td>Other revenue (expense):</td>
<td></td>
</tr>
<tr>
<td>Interest revenue</td>
<td>17,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(21,000)</td>
</tr>
<tr>
<td>Total other</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Income before taxes</td>
<td>79,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>24,000</td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>55,000</td>
</tr>
<tr>
<td>Extraordinary loss, net of tax</td>
<td>539</td>
</tr>
<tr>
<td>Net income</td>
<td>$54,461</td>
</tr>
</tbody>
</table>

LO 6 Understand the concept of earning power, and how irregular items are presented.
Reporting when both Discontinued Operations and Extraordinary Items are present.

### Income Statement (in thousands)

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

**LO 6** Understand the concept of earning power, and how irregular items are presented.
Change in Accounting Principle

- Occurs when the principle used in the current year is different from the one used in the preceding year.
- Accounting rules permit a change if justified.
- Changes are reported retroactively.
- Example would include a change in inventory costing method such as FIFO to average cost.

LO 6 Understand the concept of earning power, and how irregular items are presented.
Earning Power and Irregular Items

Comprehensive Income

<table>
<thead>
<tr>
<th>Income Statement (in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
</tr>
<tr>
<td>Cost of goods sold</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Operating expenses:</td>
</tr>
<tr>
<td>Advertising expense</td>
</tr>
<tr>
<td>Depreciation expense</td>
</tr>
<tr>
<td>Total operating expense</td>
</tr>
<tr>
<td>Income from operations</td>
</tr>
<tr>
<td>Other revenue:</td>
</tr>
<tr>
<td>Interest revenue</td>
</tr>
<tr>
<td>Total other</td>
</tr>
<tr>
<td>Income before taxes</td>
</tr>
<tr>
<td>Income tax expense</td>
</tr>
<tr>
<td>Net income</td>
</tr>
</tbody>
</table>

All changes in stockholders' equity except those resulting from investments by stockholders and distributions to stockholders.

+ Reported in Stockholders’ Equity
  - Unrealized gains and losses on available-for-sale securities.
  - Plus others

LO 6 Understand the concept of earning power, and how irregular items are presented.
Comprehensive Income

Why are gains and losses on available-for-sale securities excluded from net income?

Because disclosing them separately

1. reduces the volatility of net income due to fluctuations in fair value,

2. yet informs the financial statement user of the gain or loss that would be incurred if the securities were sold at fair value.
A company that has a high **quality of earnings** provides full and transparent information that will not confuse or mislead users of the financial statements.

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

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

**LO 7** Understand the concept of quality of earnings.
Quality of Earnings

Alternative Accounting Methods

- Variations among companies in the application of GAAP may hamper comparability and reduce quality of earnings.

Pro Forma Income

- Pro forma income usually excludes items that the company thinks are unusual or nonrecurring.

- Some companies have abused the flexibility that pro forma numbers allow.

LO 7 Understand the concept of quality of earnings.
Improper Recognition

Some managers have felt pressure to continually increase earnings and have manipulated the earnings numbers to meet these expectations.

Abuses include:

- Improper recognition of revenue (channel stuffing).
- Improper capitalization of operating expenses (WorldCom).
- Failure to report all liabilities (Enron).

LO 7 Understand the concept of quality of earnings.
The percentage of Americans who buy stock, either through mutual funds or individual shares, has increased significantly in recent years. A big part of this increase is due to the increasing prevalence of employer-sponsored retirement plans, such as 401(k) plans.

**Equity Ownership in the U.S., 1983–2002, Selected Years**

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of U.S. Households (in millions)</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>15.9</td>
<td>19.0%</td>
</tr>
<tr>
<td>1989</td>
<td>30.2</td>
<td>32.5%</td>
</tr>
<tr>
<td>1992</td>
<td>34.6</td>
<td>36.6%</td>
</tr>
<tr>
<td>1995</td>
<td>40.6</td>
<td>41.0%</td>
</tr>
<tr>
<td>1999</td>
<td>49.2</td>
<td>48.2%</td>
</tr>
<tr>
<td>2002</td>
<td>52.7</td>
<td>49.5%</td>
</tr>
</tbody>
</table>
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