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I. INTRODUCTION

Generally accepted accounting principles (GAAP) are those accounting principles that have substantial authoritative support. Substantial authoritative support is a question of fact and a matter of judgment. The power to establish GAAP actually rests with the Securities and Exchange Commission (SEC); however, except for rare instances, it has essentially allowed the accounting profession itself to establish GAAP and self-regulate. Three bodies of the accounting profession have determined GAAP since 1939.

A. COMMITTEE ON ACCOUNTING PROCEDURE

The Committee on Accounting Procedure (CAP) was a part-time committee of the American Institute of Certified Public Accountants (AICPA) that promulgated Accounting Research Bulletins (ARB), which determined GAAP from 1939 until 1959.

B. ACCOUNTING PRINCIPLES BOARD

The Accounting Principles Board (APB) was another part-time committee of the AICPA. It issued Accounting Principles Board Opinions (APBO) and APB Interpretations, which determined GAAP from 1959 until 1973.

C. FINANCIAL ACCOUNTING STANDARDS BOARD

In 1973, an independent full-time organization called the Financial Accounting Standards Board (FASB) was established, and it has determined GAAP since then.


These statements establish GAAP and define the specific methods and procedures for various accounting issues. Each statement is issued after extensive research, discussion memoranda, exposure drafts, and public comments.

2. FASB Interpretations

FASB Interpretations clarify GAAP by addressing issues that may be conflicting or ambiguous and may establish GAAP.

3. Technical Bulletins

Technical bulletins may expand upon or further clarify GAAP because of problems that may exist in accounting or reporting under the standard or interpretation.

Statements of Financial Accounting Concepts (SFAC) are intended to establish the objectives and concepts for use by the FASB in developing accounting and reporting standards. They provide a common foundation and basic reasoning on which to consider the merits of the alternatives and a coherent system of interrelated objectives and fundamentals; however, they do not establish GAAP.

5. **Emerging Issues Task Force Statements (EITF)**

EITF statements address emergent issues and may show how to account for specific or unusual applications of GAAP. They are less authoritative than Category A pronouncements (see *Hierarchy of Sources of GAAP*).

6. **FASB Implementation Guides**

The FASB may also issue implementation guides (in a question/answer format) on certain accounting issues that the public may have questions on. These are even less authoritative than EITF Statements.

II. **HIERARCHY OF SOURCES OF GAAP**

In 2007, the Hierarchy of Generally Accepted Accounting Principles replaced Statement on Auditing Standards (SAS) No. 69 as the source of the hierarchy of sources of GAAP. This statement indicates the six most authoritative GAAP pronouncements (provided they are not superseded by another pronouncement). It is permissible, but extremely rare, to deviate from one of the six pronouncements if compliance would cause the financial statements to be misleading.

- A. Accounting Research Bulletins (ARBs)
- B. Accounting Principles Board Opinions (APBOs)
- C. FASB Statements of Financial Accounting Standards
- D. FASB Staff Positions
- E. FASB Interpretations
- F. FASB Statement Implementation Issues
The House of GAAP

<table>
<thead>
<tr>
<th>Category A</th>
<th>Category B</th>
<th>Category C</th>
<th>Category D</th>
</tr>
</thead>
<tbody>
<tr>
<td>AICPA Accounting Research Bulletins</td>
<td>AICPA Industry Audit and Accounting Guides*</td>
<td>AICPA Accounting Interpretations and Implementation Guides</td>
<td>Other Accounting Literature</td>
</tr>
<tr>
<td>Financial Accounting Standards Board Opinions – APBO (From AICPA)</td>
<td>AICPA Statements of Position*</td>
<td>Questions and Answers published by FASB staff</td>
<td>Prevalent industry practices</td>
</tr>
<tr>
<td>Financial Accounting Standards Board FASB Statements</td>
<td>FASB Staff Positions</td>
<td>FASB Emerging Issues Task Force Consensus Positions</td>
<td>EITF D Topics</td>
</tr>
</tbody>
</table>

The foundation of GAAP consists of the Financial Accounting Concepts issued by the FASB.

*AICPA Industry Audit and Accounting Guides and AICPA Statements of Position are included in Category B only if the FASB has cleared the pronouncements. AICPA Practice Bulletins are included in Category C only if cleared by the FASB. If not cleared by the FASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position are included in Category D.

NOTE: If the accounting treatment of a transaction or event is not specified by a pronouncement in "Category A" (first floor), the auditor should consider whether one or more sources in Category (B), (C), or (D) is relevant to the circumstances. The auditor should be prepared to justify a conclusion that another treatment is generally accepted.

If there is a conflict between accounting principles relevant to the circumstances from one or more sources in Category (B), (C), or (D), the auditor should follow the treatment specified by the source in the more authoritative category – for example, follow Category (B) treatment over Category (C) – or be prepared to justify a conclusion that a treatment specified by a source in the less authoritative category better presents the substance of the transaction in the circumstances.
III. CONCEPTUAL FRAMEWORK UNDERLYING FINANCIAL ACCOUNTING

As discussed earlier, the FASB has created a conceptual framework (set forth in pronouncements called Statements of Financial Accounting Concepts, or SFAC) that serves as a basis for all FASB pronouncements. Six SFAC provide a basis for financial accounting concepts for business enterprises (SFAC No. 4 relates to non-business enterprises).

A. SFAC NO. 1 "OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES"

SFAC No. 1 defines the potential users of financial reporting as those who base their decisions on their relationships to and knowledge about the business enterprise. This group includes external users (e.g., investors, creditors, and customers) and those who advise these users.

The objectives essentially identify the purposes and goals of financial accounting and focus on providing information that is useful in making business and economic decisions to persons with reasonable knowledge of business and the economy.

The objectives provide:

1. Information useful in investment and credit decisions.
2. Information useful in assessing future cash flow prospects.
3. Information useful in assessing an enterprise's resources, the debt and equity claims to those resources, and the changes in them.

B. SFAC NO 2 "QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION"

The qualitative characteristics of accounting information provide the criteria used to select and evaluate accounting information so that it will meet the objectives set forth in SFAC No. 1. This statement identifies the hierarchy of qualitative characteristics that are to be considered when accounting alternatives are available in order to choose the alternative that produces the most useful information.

Financial information must be:

(i) Understandable to decision makers,
(ii) Relevant (timely information with predictive or feedback value),
(iii) Reliable (verifiable, faithfully representable, and neutral),
(iv) Comparable,
(v) Consistent,
(vi) Material, and
(vii) Less costly than the benefit provided.
1. Illustration of Hierarchy of Accounting Qualities

A Hierarchy of Accounting Qualities
FAC No. 2

Users of Accounting Information

Decision Makers and Their Characteristics (for example, understanding or prior knowledge)

Pervasive Constraint

Benefits > Costs

User-Specific Qualities

Understandability

Primary Decision-Specific Qualities

Decision Usefulness

Primary Qualities

Relevance

Reliability

Ingredients of Primary Qualities

Timeliness

Verifiability

Predictive Value

Representational Faithfulness

Feedback Value

Neutralty

Secondary and Interactive Qualities

Comparability

Consistency

Threshold for Recognition

Materiality

2. Constraints

Two pervasive constraints (one on the top and one on the bottom of the illustration) must be considered.

a. Costs and Benefits

The benefits of accounting information must be greater than the costs of obtaining and presenting the information.

b. Materiality

The information must be material with respect to the financial statements (so that the lack of the information could make a difference in decisions made by the users).
3. **Understandability**

The accounting information presented should be understandable to a wide variety of users who possess a reasonable amount of knowledge about the economy and are willing to exert a reasonable amount of effort to study the information presented. Understandability serves as a link between the characteristics of users and the decision-specific qualities of information.

4. **Primary Qualities of Decision Usefulness**

Decision usefulness is the primary quality of accounting information. It can be broken down into two specific categories:

   a. **Relevance**

   In order for information to be useful, it has to be relevant (i.e., make a difference) to the decision-making process. The quality of relevance has three sub-categories:

   (1) **Predictive Value**

   When information has predictive value, it has the ability to assist users in evaluating past, present, or future events.

   (2) **Feedback Value**

   Feedback value enables decision-makers to confirm prior expectations or to adjust or correct the assessment made.

   (3) **Timeliness**

   Timeliness is having the information available while it is able to influence decisions.

   b. **Reliability**

   In order for information to be reliable, the users must be able to reasonably depend on it to be free from error and bias and to be faithfully representative of what it claims to represent. The quality of reliability has three sub-categories:

   (1) **Neutrality**

   Neutrality means that the information is free from bias and free from outside influences.

   (2) **Representational Faithfulness**

   Representational faithfulness is agreement between financial reporting and the resources or events represented. It means that the information is valid (e.g., economic substance over legal form).

   (3) **Verifiability**

   If the information is verifiable (i.e., objective), it means that the same results could be duplicated with the same measurement techniques (which is the primary concern for auditors of financial statements).
5. **Secondary Characteristics**

Comparability and consistency are secondary characteristics, which means that they apply to BOTH relevance and reliability.

a. **Comparability**

Comparability is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena. It allows users to compare the information with similar information for other business enterprises.

b. **Consistency**

In order for users to be able to compare the performance of a company in one period with the performance of a company in another period, consistent accounting policies and procedures must be applied by the company from period to period. This does not mean that the company cannot change accounting policies if the new method more fairly presents the information; however, the cumulative effect of the change must be accounted for and disclosed in the financial statements (discussed later in this lecture).

C. **SFAC NO. 3 "ELEMENTS OF FINANCIAL STATEMENTS OF A BUSINESS"**

This statement was replaced by SFAC No. 6.

D. **SFAC NO. 5 "RECOGNITION AND MEASUREMENT IN THE FINANCIAL STATEMENTS"**

This statement sets forth the recognition criteria and guidance on what and when information should be incorporated in the financial statements.

1. **Full Set of Financial Statements**
   a. Statement of Financial Position (the Balance Sheet)
   b. Statement of Earnings (the Income Statement)
   c. Statement of Comprehensive Income
   d. Statement of Cash Flows
   e. Statement of Changes in Owners' Equity

2. **Fundamental Recognition Criteria**

Recognition is the process of formally recording or incorporating an item in the financial statements of an entity and classifying it as asset, liability, equity, revenue, or expense.

   a. Definitions (i.e., Does it meet the definition of an element defined in SFAC No. 6?)
   b. Measurability
   c. Relevance
   d. Reliability

3. **Measurement Attributes for Assets and Liabilities**
   a. Historical Cost
   b. Current Cost
   c. Net Realizable Value
   d. Current Market Value
   e. Present Value of Future Cash Flows
4. **Fundamental Assumptions**
   
a. **Entity Assumption**
   Economic activity can be accounted for when considering an identifiable set of activities (e.g., a separate corporation, division, etc.).

b. **Going Concern Assumption**
   For financial accounting, it is presumed (subject to rebuttal by evidence to the contrary) that the entity will continue to operate in the foreseeable future.

c. **Monetary Unit Assumption**
   It is assumed that money is an appropriate basis by which to measure economic activity. The assumption is that the monetary unit does not change over time; thus, the effects of inflation are not reflected in the financial statements.

d. **Periodicity Assumption**
   Economic activity can be divided into meaningful time periods.

e. **Historical Cost Principle**
   As a general rule, financial information is accounted for and based on cost, not current market value.

f. **Revenue Recognition Principle**
   As a general rule, revenue should be recognized when it is earned and when it is realized or realizable.
   
   (1) **Earned**
   Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

   (2) **Realized or Realizable**
   Revenues and gains are recognized when products, merchandise, or other assets are exchanged for cash or claims to cash or when related assets received or held are readily convertible to known amounts of cash or claims to cash.

g. **Matching Principle**
   Expenses are necessarily incurred to generate revenue. In accordance with the matching principle, all expenses incurred to generate a specific amount of revenue in a period are matched against that revenue. The matching principle does not govern the recognition of losses since they result from unusual events.

h. **Accrual Accounting**
   Revenues are recognized when they are earned and expenses are recognized in the same period as the related revenue (matching or using a systematic and rational allocation or expensing in the period in which they expire), not necessarily in the period in which the cash is received or expended by the company.

i. **Full Disclosure Principle**
   It is important that the user be given information that would make a difference in the decision process but not so much information that the user is impeded in analyzing what is important.
j. **Conservatism Principle**

When selecting alternative GAAP methods, the method that is least likely to overstate assets (and revenues/gains) and understate liabilities (and expenses/losses) in the current period should be selected.

(1) Recognize revenues/gains when the earnings process is complete (or virtually completed).

(2) Recognize expenses/losses immediately.

E. **SFAC NO. 6 "ELEMENTS OF FINANCIAL STATEMENTS"**

Elements are the components of the financial statements. They must be measurable and meet the recognition requirements previously discussed. Ten elements provide the information required in the objectives stated in SFAC No. 1.

1. **Comprehensive Income**

   Comprehensive income includes all differences between beginning equity and ending equity other than transactions with owners (i.e., net income plus other comprehensive income).

2. **Revenues**

   Revenues are inflows, enhancements of assets, or reductions of liabilities from delivering goods or services as a part of normal operations. Recognize revenue at the gross amount (less allowances for returns and discounts given).

3. **Expenses**

   Expenses are outflows, uses of assets, or the incurrence of liabilities from delivering goods or services as part of normal operations.

4. **Gains**

   Gains are increases in equity from peripheral transactions and other events except revenue and investments from owners.

5. **Losses**

   Losses are decreases in equity from peripheral transactions and other events except expenses and distributions to owners.

6. **Assets**

   Assets are probable future economic benefits to be received by the company as a result of past transactions or events. Valuation accounts may be used to show reductions to or increases in an asset that reflect adjustments beyond the historical cost or carrying amount of the asset.

7. **Liabilities**

   Liabilities are probable future sacrifices of economic benefits arising from a present obligation of the company to transfer assets or provide services to other entities in the future as a result of past transactions or events.

8. **Equity (of Net Assets)**

   Equity is the residual interest in the assets of the company that remains after deducting its liabilities.
9. **Investments by Owners**
   Investments by owners are the increases in assets from transfers of cash, property, or services from owners.

10. **Distributions to Owners**
    Distributions to owners are decreases in assets from transfers of cash, property, or services, or the incurrence of a liability to owners.

F. **SFAC NO. 7 "USING CASH FLOW INFORMATION AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS"**
    SFAC No. 7 provides a framework for accountants to employ when using future cash flows as a measurement basis for assets and liabilities, especially when the factors to consider in the measurement are complex. It also provides a set of principles that govern the use of present value, especially when the timing and/or amount of future cash flows are uncertain.

1. **Measurements Based on Future Cash Flows Only**
    SFAC No. 7 only applies to measurement issues for assets and liabilities that are determined using future cash flows only.

2. **Five Elements of Present Value Measurement**
    The FASB identified five elements of present value (or economic value) measurement that were used as the basis for determining the measurement objective of SFAC No. 7.
    a. Estimate of Future Cash Flow
    b. Expectations about Timing Variations of Future Cash Flows
    c. Time Value of Money (the Risk-free Rate of Interest)
    d. The Price for Bearing Uncertainty
    e. Other Factors (e.g., Liquidity Issues and Market Imperfections)

3. **Fair Value Objective**
    If fair value cannot be determined in the marketplace, the objective must be to obtain an estimate of fair value (i.e., a present value of future cash flows).

4. **Present Value Computations**
    SFAC No. 7 allows the use of two approaches to determine present value (each considering the interest method of allocation), depending on the circumstances.
    a. **Traditional Approach**
       The traditional approach (i.e., one discount rate used to take the present value of a future cash flow stream) to present value computations may be used when assets and liabilities have contractual (i.e., fixed) cash flows that are not expected to vary. In this approach, interest rate selection is paramount.
    b. **Expected Cash Flow Approach**
       In more complex cases, the expected cash flow approach is to be used. Rather than focusing on the interest rate selection, this approach uses only the risk-free rate of return as the discount rate and then turns its attention to the expected future cash flows, considering uncertainties (e.g., default risk) as adjustments to the future cash flows.
(1) Expected Cash Flow
The expected cash flow approach considers a range of possible cash flows and assigns a (subjective) probability to each cash flow in the range to determine the weighted-average, or "expected," future cash flow.

(2) Risk and Uncertainty Adjustments to Cash Flows
Adjustments to the expected cash flows used in complex present value computations (rather than interest rate adjustments) are required for uncertainties (e.g., default risk).

5. Liability Measurement Considers Additional Factors
The FASB determined that, when using present value, the objective of estimating the fair value of a liability must consider certain other factors, including:
   a. Costs to Settle
   b. Credit Standing of the Company

6. Changes in Estimated Cash Flows Using the Catch-up Approach
To use this approach, simply adjust the carrying amount of the asset or liability to the present value determined using the revised estimates and discount using the original effective interest rate.
REPORTING NET INCOME

I. USES AND TERMINOLOGY

The purpose of the income statement is to provide information about the uses of funds in the income process (i.e., expenses), the uses of funds that will never be used to earn income (i.e., losses), the sources of funds created by those expenses (i.e., revenues), and the sources of funds not associated with the earnings process (i.e., gains).

A. USES OF THE INCOME STATEMENT

The income statement is useful in determining profitability, value for investment purposes, and credit worthiness. The income statement is also useful in predicting information about future cash flows (e.g., the amounts, timing, and uncertainty of cash flows) based on past performance.

B. TERMINOLOGY

1. Cost and Unexpired Costs
   a. **Cost**
      
      Cost is an amount (measured in money) expended for items such as capital assets, services (e.g., payroll), and merchandise received. Cost is the amount actually paid for something.

   b. **Unexpired Costs**
      
      Unexpired costs are costs that will expire in future periods and be charged (allocated in a systematic and rational manner or matched) against revenues from future periods.

   c. **Examples**
      
      | **Unexpired Costs** (Asset) | **Expired Costs** (Expense) |
      |------------------------------|-----------------------------|
      | (1) Inventory                | Cost of goods sold          |
      | (2) Unexpired (prepaid) cost of insurance | Insurance expense |
      | (3) Net book value of fixed assets | Depreciation expense |
      | (4) Unexpired cost of patents | Patents expense (amortization) |

2. Gross Concept (Revenues and Expenses)
   a. **Revenues**
      
      Revenues are reported at their gross amounts (less allowance for returns and discounts given).

   b. **Expenses**
      
      Expenses (costs that only benefit the current period or the allocation of unexpired costs to the current period for the benefit received) are reported at their gross amounts.
3. **Net Concept (Gains and Losses)**
   a. **Gains**
      Gains are reported at their net amounts (i.e., proceeds less net book value). A gain is the recognition of an asset either not in the ordinary course of business (e.g., gains on the sale of a fixed asset) or without the incurrence of an expense (e.g., finding gold on the company's property).
   b. **Losses**
      Losses are reported at their net amounts (i.e., proceeds less net book value). A loss is cost expiration either not in the ordinary course of business (e.g., loss on the sale of investment assets) or without the generation of revenue (e.g., abandonment).

II. **PRESENTATION ORDER OF THE MAJOR COMPONENTS OF AN INCOME AND RETAINED EARNINGS STATEMENT**

<table>
<thead>
<tr>
<th>Reported on Income Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A.</strong> INCOME (OR LOSS) FROM CONTINUING OPERATIONS (REPORT &quot;GROSS OF TAX&quot;)</td>
</tr>
<tr>
<td>Income from continuing operations includes operating activities (i.e., revenues, costs of goods sold, selling expenses, and administrative expenses), non-operating activities (e.g., other revenues and gains and other expenses and losses), and income taxes.</td>
</tr>
<tr>
<td><strong>B.</strong> INCOME (OR LOSS) FROM DISCONTINUED OPERATIONS (REPORT &quot;NET OF TAX&quot;)</td>
</tr>
<tr>
<td>Income from discontinued operations is presented net of tax.</td>
</tr>
<tr>
<td><strong>C.</strong> EXTRAORDINARY ITEMS (REPORT &quot;NET OF TAX&quot;)</td>
</tr>
<tr>
<td>Extraordinary items are presented net of tax and include items that are unusual in nature and infrequent in occurrence.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Reported on Statement of Retained Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>D.</strong> CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE (REPORT &quot;NET OF TAX&quot;)</td>
</tr>
<tr>
<td>The cumulative effect of a change in accounting principle is presented net of tax. It is the cumulative effect (calculated as of the beginning of the earliest period presented in the period of implementation of the new method) of a change from one acceptable method of accounting to another (&quot;GAAP to GAAP&quot;) because the new method presents the financial information more fairly than the old method.</td>
</tr>
</tbody>
</table>
Company Name

INCOME STATEMENT
For the Year Ended XXXX

Net sales XXX
Cost of sales (XXX)
Gross profit XXX
Selling expenses (XXX)
General & administrative expenses (XXX)
Operating income XXX
Other income (expense)
  Interest income (expense) (XXX)
  Gain (loss) on transactions in foreign currencies XXX XXX
Income before unusual items and income tax XXX
Unusual or infrequent items
  Gain on litigation settlement XXX
  Gain on sale of available-for-sale investments XXX XXX
Income from continuing operations before income tax XXX
Income tax
  Current XXX
  Deferred XXX XXX
Income from continuing operations XXX
Discontinued operations
  Loss from operations of Division A (including disposal loss of $XX and less income tax benefit of $XX) XXX
Income (loss) before extraordinary item XXX
Extraordinary items [Note _____(less applicable income taxes of $XX)] XXX
Net income XXX

PASS KEY
The examiners will ask specific questions regarding the placement on the income and retained earnings statements of various items. Remember "IDEA," and you will have the answer quickly!

REPORTING RULES
Rule 1: Line items above "income from continuing operations" are shown "gross" (i.e., before tax).
Rule 2: Line items below "income from continuing operations" are shown "net" (i.e., after tax).

Income Statement
1. Income from continuing operations – "gross"
2. Discontinued operations – "net"
3. Extraordinary items – "net"
4. Accounting principle change – "net"

Retained Earnings Statement

INCOME FROM CONTINUING OPERATIONS

Income statement
Discontinued operations
Extraordinary items
Accounting principle change

I. SINGLE STEP INCOME STATEMENT

In the single step income statement presentation of income from continuing operations, total expenses (including income tax expense) are subtracted from total revenues; thus, the income statement has a single step. The benefits of a single step income statement are its simple design and the fact that the presentation of types of revenues or expenses do not appear to the user to be classified as more important than others.

Radon Industries, Inc.
Income Statement (single step)
For the Year Ended December 31, 20X1 (in thousands)

<table>
<thead>
<tr>
<th>Revenues and other items</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of goods</td>
<td>350</td>
</tr>
<tr>
<td>Sale of services</td>
<td>200</td>
</tr>
<tr>
<td>Interest income</td>
<td>170</td>
</tr>
<tr>
<td>Rental income</td>
<td>100</td>
</tr>
<tr>
<td>Gain on sale of fixed assets (e.g., equipment)</td>
<td>50</td>
</tr>
<tr>
<td>Other income</td>
<td>130</td>
</tr>
<tr>
<td><strong>Total revenues and other items</strong></td>
<td><strong>1,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses and other items</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold (including freight in)</td>
<td>200</td>
</tr>
<tr>
<td>Cost of services sold</td>
<td>150</td>
</tr>
<tr>
<td>Cost of rental income</td>
<td>60</td>
</tr>
<tr>
<td>Selling expenses (including freight out)</td>
<td>100</td>
</tr>
<tr>
<td>General and administrative expenses</td>
<td>70</td>
</tr>
<tr>
<td>Interest expense</td>
<td>50</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>80</td>
</tr>
<tr>
<td>Loss on sale of fixed assets (e.g., equipment)</td>
<td>40</td>
</tr>
<tr>
<td>Loss on sale of available-for-sale securities</td>
<td>100</td>
</tr>
<tr>
<td>Income tax expense (provision for income tax)</td>
<td>100</td>
</tr>
<tr>
<td><strong>Total expenses and other items</strong></td>
<td><strong>950</strong></td>
</tr>
<tr>
<td><strong>Net income (or income from continuing operations, if necessary)</strong></td>
<td><strong>50</strong></td>
</tr>
</tbody>
</table>

Statement of Retained Earnings

| Add: Retained earnings at the beginning of the period | $500 |
| Subtotal                                           | **$550** |
| Less: Dividends declared                           | (30)  |
| Cumulative effects of change in accounting principle (less applicable income taxes of $60) | 90   |
| Retained earnings at the end of the period         | **$610** |
II. MULTIPLE STEP INCOME STATEMENT

The multiple step income statement reports operating revenues and expenses separately from non-operating revenues and expenses and other gains and losses. The benefit of the multiple step income statement is enhanced user information (because the line items presented often provide the user with readily available data with which to calculate various analytical ratios).

Radon Industries, Inc.
Income Statement (multiple step)
For the Year Ended December 31, 20X1 (in thousands)

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales (including goods, services, and rentals)</td>
<td>$650</td>
</tr>
<tr>
<td>Cost of sales (including goods, services, and rentals)</td>
<td>$(410)</td>
</tr>
<tr>
<td>Gross margin</td>
<td>$240</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>$100</td>
</tr>
<tr>
<td>General and administrative expenses</td>
<td>70</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>80</td>
</tr>
<tr>
<td></td>
<td>(250)</td>
</tr>
<tr>
<td>Income (loss) from operations</td>
<td>$(10)</td>
</tr>
<tr>
<td>Other revenues and gains:</td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>170</td>
</tr>
<tr>
<td>Gain on sale of fixed assets (e.g., equipment)</td>
<td>50</td>
</tr>
<tr>
<td>Other income</td>
<td>130</td>
</tr>
<tr>
<td></td>
<td>350</td>
</tr>
<tr>
<td>Other expenses and losses:</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>50</td>
</tr>
<tr>
<td>Loss on sale of fixed assets (e.g., equipment)</td>
<td>40</td>
</tr>
<tr>
<td></td>
<td>(90)</td>
</tr>
<tr>
<td>Income before unusual items and income tax</td>
<td>$250</td>
</tr>
<tr>
<td>Unusual or infrequent items</td>
<td></td>
</tr>
<tr>
<td>Loss on sale of available-for-sale securities</td>
<td>(100)</td>
</tr>
<tr>
<td>Income before income tax</td>
<td>150</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>180</td>
</tr>
<tr>
<td>Deferred</td>
<td>(80)</td>
</tr>
<tr>
<td>Net income (or &quot;income from continuing operations&quot;)*</td>
<td>$50</td>
</tr>
</tbody>
</table>

* "Income from continuing operations" would be used if other categories are applicable, such as "discontinued operations," or "extraordinary items."

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Inventory Cost</td>
<td>Purchase price, freight in</td>
</tr>
<tr>
<td>2. Selling Expense</td>
<td>Freight out, salaries and commissions, advertising</td>
</tr>
<tr>
<td>3. General &amp; Administrative</td>
<td>Officers’ salaries, accounting and legal, insurance</td>
</tr>
<tr>
<td>4. Non-operating</td>
<td>Auxiliary activities, interest expense</td>
</tr>
</tbody>
</table>
DISCONTINUED OPERATIONS

I. INTRODUCTION
The treatment of discontinued operations, previously accounted for under APB 30, now follows SFAS No. 144 (which also replaced SFAS No. 121 related to the impairment of long-lived assets, discussed in lecture F-4). Discontinued operations are still reported separately from continuing operations in the income statement according to the IDEA mnemonic, net of tax. The (normally) loss from discontinued operations can consist of an impairment loss, a gain/loss from actual operations, and a gain/loss on disposal. All of these amounts are included in discontinued operations in the period in which they occur (anticipated losses are no longer allowed as called for by APBO No. 30).

II. DEFINITIONS
A. COMPONENT OF AN ENTITY
A component of an entity is a part of an entity (the lowest level) for which operations and cash flows can be clearly distinguished, both operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be:
1. An operating segment,
2. A reportable segment (as those terms are defined in segment reporting),
3. A reporting unit (as that term is defined in goodwill impairment testing),
4. A subsidiary, or
5. An asset group.

B. ASSET GROUP
An asset group is a collection of assets to be disposed of together as a group in a single (disposal) transaction and the liabilities directly associated with those assets that will be transferred in that same transaction.

C. HELD FOR SALE
A component of a business is classified as "held for sale" in the period in which ALL of the following criteria are met:
1. Management commits to a plan to sell the component.
2. The component is available for immediate sale in its present condition.
3. An active program to locate a buyer has been initiated.
4. The sale of the component is probable and the sale is expected to be complete within one year.
5. The sale of the component is being actively marketed.
6. Actions required to complete the sale make it unlikely that significant changes to the plan will be made or that the plan will be withdrawn.
III. ACCOUNTING RULES

A. TYPES OF ENTITIES TO BE CONSIDERED

The results of operations of a component of an entity will be reported in discontinued operations if either the component:

1. Has been disposed of, or
2. Is classified as held for sale.

B. CONDITIONS THAT MUST BE PRESENT

All related costs shall be recognized when the obligations to others exist, not necessarily in the period of commitment to a plan. Both of the following conditions must be met in order to report in discontinued operations the results of operations of a component that has been disposed of or is held for sale:

1. Eliminated from Ongoing Operations
   The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal.

2. No Significant Continuing Involvement
   The entity will not have any significant continuing involvement in the operations of the component after the disposal.

C. REPORT RESULTS OF OPERATIONS IN PERIOD COMPONENT IS DISPOSED OF OR IS CLASSIFIED AS HELD FOR SALE

1. Types of Items Included in Results of Discontinued Operations
   a. Results of Operations of the Component
   b. Gain or Loss on Disposal of the Component
   c. Impairment Loss (and Subsequent Increases in Fair Value) of the Component
      
      (1) Initial and Subsequent Impairment Losses
      A loss is recognized for recording the impairment of the component (i.e., any initial or subsequent write-down to fair value less costs to sell).

      (2) Subsequent Increases in Fair Value
      A gain is recognized for any subsequent increase in fair value minus the costs to sell (but not in excess of the previously recognized cumulative loss).

2. Report in the Period Disposed of or Held for Sale
   The results of discontinued operations of a component are reported in discontinued operations (for the current period and for all prior periods presented) in the period the component is either disposed of or is held for sale. The results of subsequent operations of a component classified as held for sale are reported in discontinued operations in the period in which they occur.

3. Depreciation and Amortization
   Assets within the component are no longer depreciated or amortized.
D. **ANTICIPATED FUTURE GAINS OR LOSSES**

A gain or loss not previously recognized that results from the sale of the component is recognized at the date of sale and not before (i.e., gains or losses anticipated to occur in future periods are not recognized until they occur).

E. **SUBSEQUENT ADJUSTMENTS TO AMOUNTS PREVIOUSLY REPORTED**

Adjustments to amounts previously reported in discontinued operations that are directly related (see definition in item E.2, below) to the disposal of a component of an entity in a prior period are classified in the current period in discontinued operations.

1. **Examples**
   a. Resolution of contingencies related to terms of the disposal transaction (e.g., purchase price adjustments and indemnification issues)
   b. Resolution of contingencies directly related to the operations the component before it was disposed of (e.g., warranty obligations and environmental responsibilities)
   c. Settlement of employee benefit plan obligations

2. **Definition of "Directly Related"**

   In order for a settlement to be considered directly related to a component of an entity, it must:
   a. Have a demonstrated cause-and-effect relationship and
   b. Occur no later than one year after the date of the disposal transaction (unless circumstances beyond the control of the entity exist).

F. **MEASUREMENT AND VALUATION**

A component classified as held for sale is measured at the lower of its carrying amount or fair value less costs to sell. Costs to sell are the incremental direct costs to transact the sale.

G. **PRESENTATION AND DISCLOSURE**

1. **Present as a Separate Component of Income**

   The results of discontinued operations, net of tax, are reported as a separate component of income before extraordinary items.

2. **Disclose in Face or in Notes**

   A gain or loss recognized on the disposal shall be disclosed either on the face of the income statement or in the notes to the financial statements.

IV. **EXAMPLE**

See the required homework reading in this section for examples on reporting, presenting, and measuring the results of discontinued operations.
EXTRAORDINARY ITEMS

I. EXTRAORDINARY ITEMS

A. DEFINED (UNUSUAL AND INFREQUENT)

According to APB Opinion No. 30, extraordinary items are transactions and other events that are:

1. Material in nature,
2. Of a character significantly different from the typical or customary business activities,
3. Not expected to recur in the foreseeable future, and
4. Not normally considered in evaluating the ordinary operating results of an enterprise.

B. HOW TO CLASSIFY

Extraordinary items are usually determined by informed professional judgment, taking into consideration all the facts involved in a particular situation. Since the issuance of SFAS No. 145, the provisions of APB Opinion No. 30 dictate the classification of all extraordinary items.

C. SEPARATE DISCLOSURE

Extraordinary items must be separately disclosed in the income statement, net of any related tax effects, after discontinued operations.

D. EXAMPLES OF EXTRAORDINARY ITEMS

1. The abandonment of, or damage to, a plant due to an infrequent earthquake or an infrequent flood
2. An expropriation of a plant by the government
3. A prohibition of a product line by a newly enacted law or regulation
4. Certain gains or losses from extinguishment of long-term debt, provided they are not part of the entity's recurring operations and, thus, meet the criteria of APB Opinion No. 30 (per SFAS No. 145).
E. **EXAMPLES OF NONEXTRAORDINARY ITEMS**

   The following gains or losses are NOT extraordinary (they are presented as a separate component of "continuing operations"):  
   1. Gain or loss from sale or abandonment of property, plant, or equipment used in the business  
   2. Large writedowns or writeoffs of:  
      a. Receivables  
      b. Inventories  
      c. Intangibles (including goodwill)  
      d. Long-term securities (permanent decline)  
   3. Gain or loss from foreign currency transactions or translation, whether from major devaluations or otherwise (provided these occur on a regular basis as part of normal business operations)  
   4. Losses from major strike by employees  
   5. Long-term debt extinguishments that are part of a common management strategy (i.e., **not** unusual and infrequent)

II. **MATERIAL UNUSUAL OR INFREQUENT ITEMS**

   Items of income or loss that are either unusual or infrequent are **not** extraordinary (e.g., gain on the sale of a factory building). If material, these items should be reported as a separate line item as part of income from continuing operations (and not net of tax). The nature of the item and the financial effects should be disclosed on the face of the income statement or in the footnotes.
ACCOUNTING CHANGES AND PRIOR PERIOD ADJUSTMENTS

I. GENERAL

Accounting changes are broadly classified as:
(i) Changes in accounting estimate,
(ii) Changes in accounting principle, and
(iii) Changes in accounting entity.

Note that prior period adjustments are not considered accounting changes.

II. CHANGES IN ACCOUNTING ESTIMATE (PROSPECTIVELY)

A change in accounting estimate occurs when it is determined that the estimate previously used by the company is incorrect.

A. EVENTS RESULTING IN ESTIMATE CHANGES

1. Changes in the lives of fixed assets
2. Adjustments of year-end accrual of officers’ salaries and/or bonuses
3. Write-downs of obsolete inventory
4. Material non-recurring IRS adjustments
5. Settlement of litigation
6. Changes in accounting principle that are inseparable from a change in estimate (e.g., a change from the installment method to immediate recognition method because uncollectible accounts can now be estimated)

EXAMPLE

Carlin Company buys a truck for $90,000. The truck is expected to last 10 years. During the third year, Carlin Company realizes that the truck is only going to last a total of 5 years. The truck is depreciated on the straight-line basis and has no estimated salvage value.

Depreciation Schedule Illustration

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$9,000 [90,000/10]</td>
</tr>
<tr>
<td>2</td>
<td>$9,000 [90,000/10]</td>
</tr>
<tr>
<td>3</td>
<td>$24,000 [72,000/3]</td>
</tr>
<tr>
<td>4</td>
<td>$24,000 [72,000/3]</td>
</tr>
<tr>
<td>5</td>
<td>$24,000 [72,000/3]</td>
</tr>
<tr>
<td></td>
<td><strong>$90,000</strong></td>
</tr>
</tbody>
</table>
B. REPORTING A CHANGE IN ESTIMATE

1. Prospectively
   Changes in accounting estimate are accounted for prospectively (i.e., implement in the current period and continue in future periods). They do not affect previous periods (i.e., no effect on previously reported retained earnings).

2. Change in Estimate Affecting Future Periods
   If a change in accounting estimate affects several future periods (e.g., a revision of service lives of depreciable assets), the effect on income before extraordinary items, net income, and the related per share information for the current year should be disclosed in the notes to the financial statements.

   Note: Changes in ordinary accounting estimates (e.g., uncollectible accounts and inventory adjustments) usually made each period do not have to be disclosed unless they are material.

III. CHANGES IN ACCOUNTING PRINCIPLE (REUTERSPECTIVE APPLICATION)

A change in accounting principle is a change in accounting from one acceptable method of GAAP to another acceptable method of GAAP (i.e., GAAP to GAAP).

A. RULE OF PREFERABILITY
   An accounting principle may be changed only if the alternative principle is preferable and more fairly presents the information. Justification for the change may stem from certain current and future AICPA Statements of Position and AICPA Industry and Audit and Accounting Guides.

B. NONRECURRING CHANGES
   An accounting change should not be made for a transaction or event in the past that has been terminated or is nonrecurring.

C. EFFECTS OF A CHANGE

1. Direct Effects
   The direct effects of a change in accounting principle are adjustments that would be necessary to restate the financial statements of prior periods.

2. Indirect Effects
   The indirect effects of a change in accounting principle are differences in nondiscretionary items based on earnings (e.g., bonuses) that would have occurred if the new principle had been used in prior periods.

3. Cumulative Effect
   If non-comparative financial statements are being presented, then the cumulative effect of a change in accounting principle is equal to the difference between the amount of beginning retained earnings in the period of change and what the retained earnings would have been if the accounting change had been retroactively applied to all prior affected periods. It includes direct effects and only those indirect effects that are entered in the accounting records. If comparative financial statements are being presented, then the cumulative effect is equal to the difference between beginning retained earnings in the first period presented and what retained earnings would have been if the new principle had been applied to all prior periods.
Cumulative Effect of a Change in Accounting Principle

On January 1, 20X5, Harbor Construction Company decided to switch to the percentage-of-completion method in accounting for all of its long-term construction contracts. Prior to 20X5, Harbor used the completed contract method for some of its contracts. Harbor's effective tax rate is 30%. For income tax purposes, Harbor continues to use the completed contract method for all its contracts.

Contract information is as follows:

<table>
<thead>
<tr>
<th>Pretax Income from</th>
<th>Percentage-of-Completion</th>
<th>Completed Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior to 20X5</td>
<td>$800,000</td>
<td>$600,000</td>
</tr>
</tbody>
</table>

Cumulative effect adjustment as of 1/1/20X5 = $200,000
Less income tax effect @ 30%     (60,000)
Cumulative effect net of income tax $140,000

The Journal Entry to record the change is:

Construction in Progress (see F-2) 200,000
Deferred Tax Liability (see F-6)   60,000
Retained Earnings 140,000

D. REPORTING CHANGES IN AN ACCOUNTING PRINCIPLE

The consistency characteristic of accounting information requires that once an accounting principle has been adopted it should not be changed. However, a change is sometimes desirable for various reasons. The general rule is that such changes should be recognized by adjusting beginning retained earnings in the earliest period presented for the cumulative effect of the change, and, if prior period financial statements are presented, they should be restated (retrospective application). There are, of course, exceptions to this general rule.

1. Exceptions to the General Rule
   a. Impracticable to Estimate
      To prepare a change in accounting principle handled retrospectively, the amount of the cumulative effect adjustment must be calculated as of the beginning of the first period presented. If it is considered "impractical" to accurately calculate this cumulative effect adjustment, then the change is handled prospectively (like a change in estimate). An example of a change handled in this manner is a change in inventory cost flow assumption to LIFO. Since a cumulative effect adjustment to LIFO would require the reestablishment and recalculation of old inventory layers, it is considered impractical to try and rebuild those old cost layers. This change is therefore handled prospectively. The beginning inventory of the year of change is the first LIFO layer. Additional LIFO layers are added on from that point forward.

   b. Change in Depreciation Method
      A change in the method of depreciation, amortization, or depletion is considered to be both a change in accounting principle and a change in estimate. These changes should be accounted for as changes in estimate and are handled prospectively. The new depreciation method should be used as of the beginning of the year of the change in estimate and should start with the current book value of the underlying asset. No retroactive or retrospective calculations should be made, and no adjustment should be made to retained earnings.
2. Applications of the General Rule

a. The amount of cumulative effect to be reported on the retained earnings statement is the difference between:
   (1) Retained earnings at the beginning of the earliest period presented, and
   (2) Retained earnings that would have been reported at the beginning of the earliest period presented if the new accounting principle had been applied retrospectively for all prior periods, by recognizing only the direct effects and related income tax effect.

b. The new accounting principle is used for all periods presented (prior periods are restated).

c. If an accounting change is not considered material in the year of change but is reasonably expected to become material in later periods, it should be fully disclosed in the year of change.

---

**EXAMPLE**

Julie Enterprises, Inc. has been using the completed contract method of accounting for its long-term construction contracts since start-up of operations on January 1, 2004. No contracts were completed during 2004 or 2005. During 2006, Julie decided to change to the percentage-of-completion method for financial statement purposes. They have used, and continue to use, the completed contract method for tax purposes. Income statements for 2004 and 2005 are as follows:

<table>
<thead>
<tr>
<th>Julie Enterprises, Inc.</th>
<th>Income Statements</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Sales</strong></td>
<td></td>
<td>$3,560,000</td>
<td>$4,120,000</td>
</tr>
<tr>
<td><strong>Cost of goods sold</strong></td>
<td></td>
<td>(2,130,000)</td>
<td>(3,005,000)</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td></td>
<td>1,430,000</td>
<td>1,115,000</td>
</tr>
<tr>
<td><strong>Selling, general and administrative expenses</strong></td>
<td></td>
<td>(860,000)</td>
<td>(810,000)</td>
</tr>
<tr>
<td><strong>Operating income</strong></td>
<td></td>
<td>570,000</td>
<td>305,000</td>
</tr>
<tr>
<td><strong>Interest expense</strong></td>
<td></td>
<td>(85,000)</td>
<td>(79,000)</td>
</tr>
<tr>
<td><strong>Income before tax</strong></td>
<td></td>
<td>485,000</td>
<td>226,000</td>
</tr>
<tr>
<td><strong>Income tax expense – current</strong></td>
<td></td>
<td>(194,000)</td>
<td>(90,400)</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td></td>
<td>$291,000</td>
<td>$135,600</td>
</tr>
</tbody>
</table>

If Julie Enterprises had used the percentage-of-completion method during 2004 and 2005, income on partially completed contracts would have been $420,000 in 2004 and $380,000 in 2005. To record the change to the percentage-of-completion method in 2006, Julie would prepare the following journal entry:

- **Construction-in-process**: 800,000 (420,000 + 380,000)
- **Deferred tax liability**: 320,000*
- **Retained earnings**: 480,000

* Changing to the percentage-of-completion method only for financial reporting purposes causes a temporary difference that creates a deferred tax liability (a 40% tax rate is assumed, $168,000 increase for 2004 [420,000 × 40%], and a $152,000 increase for 2005 [380,000 × 40%]).
If the income statements for 2004 and 2005 were shown in comparison format with the income statement for 2006, retrospective application of the new accounting principle would be reflected in the income statements for 2004 and 2005, as follows:

Julie Enterprises, Inc.
Income Statements
2004 and 2005

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restated</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>$3,560,000</td>
<td>$4,120,000</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>(2,130,000)</td>
<td>(3,005,000)</td>
<td></td>
</tr>
<tr>
<td>Gross profit</td>
<td>1,430,000</td>
<td>1,115,000</td>
<td></td>
</tr>
<tr>
<td>Income on long-term construction contracts</td>
<td>420,000</td>
<td>380,000</td>
<td></td>
</tr>
<tr>
<td>Selling, general &amp; administrative expenses</td>
<td>(860,000)</td>
<td>(810,000)</td>
<td></td>
</tr>
<tr>
<td>Operating income</td>
<td>990,000</td>
<td>685,000</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>(85,000)</td>
<td>(79,000)</td>
<td></td>
</tr>
<tr>
<td>Income before tax</td>
<td>905,000</td>
<td>606,000</td>
<td></td>
</tr>
<tr>
<td>Income tax expense – current</td>
<td>(194,000)</td>
<td>(90,400)</td>
<td></td>
</tr>
<tr>
<td>Income tax expense – deferred</td>
<td>(168,000)</td>
<td>(152,000)</td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>$543,000</td>
<td>$363,600</td>
<td>$906,600</td>
</tr>
</tbody>
</table>

A summary of the change is:

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income restated</td>
<td>$543,000</td>
<td>$363,600</td>
<td>$906,600</td>
</tr>
<tr>
<td>Net income as previously reported</td>
<td>(291,000)</td>
<td>(135,600)</td>
<td>(426,600)</td>
</tr>
<tr>
<td>Increase</td>
<td>$252,000</td>
<td>$228,000</td>
<td>$480,000</td>
</tr>
</tbody>
</table>

IV. CHANGES IN ACCOUNTING ENTITY (RETROSPECTIVE APPLICATION)

A change in accounting entity occurs when the entity being reported on has changed composition. Examples include consolidated or combined financial statements that are presented in place of statements of the individual companies and changes in the companies included in the consolidated or combined financial statements from year to year.

A. RESTATEMENT TO REFLECT INFORMATION FOR THE NEW ENTITY (IF COMPARATIVE FINANCIAL STATEMENTS ARE PRESENTED)

If a change in accounting entity occurs in the current year, all previous financial statements that are presented in comparative financial statements along with the current year should be restated to reflect the information for the new reporting entity.

B. FULL DISCLOSURE

Full disclosure of the cause and nature of the change should be made, including changes in income before extraordinary items, net income, and retained earnings.
V. PRIOR PERIOD ADJUSTMENTS (RESTATEMENT)

Prior period adjustments consist of:

(i) Corrections of errors in the financial statements of prior periods,
(ii) Retroactive restatements required by new GAAP pronouncements, and
(iii) Changes from a non-GAAP method of accounting to a GAAP method of accounting (e.g., cash basis to accrual basis), which is a specific correction of an error.

A. ACCOUNTING

1. Comparative Financial Statements Presented
   a. Correct the Information, if the Year is Presented
      If comparative financial statements are presented and financial statements for the year with the error are presented, merely correct the error in those prior financial statements.
   b. Adjust Beginning Retained Earnings of the Earliest Year Presented, if the Year is Not Presented
      If comparative financial statements are presented and financial statements for the year with the error are not presented (e.g., because it is too far back in years), adjust (net of tax) the opening retained earnings of the earliest year presented.

2. Comparative Financial Statements Not Presented
   If comparative financial statements are not presented, the error correction should be reported as an adjustment to the opening balance of retained earnings (net of tax).

B. EXAMPLE STATEMENT OF RETAINED EARNINGS (WITH RESTATEMENT EFFECTS)

The purpose of the statement of retained earnings is to reconcile the beginning balance of retained earnings with the ending balance. It is usually presented immediately following the income statement.

Jordan Manufacturing
STATEMENT OF RETAINED EARNINGS
For the Year Ended December 31, 20X5

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning balance (as previously reported)</td>
<td>$28,000,000</td>
</tr>
<tr>
<td>Prior period adjustment (Note 5)</td>
<td>$(4,500,000)</td>
</tr>
<tr>
<td>Add: Income tax benefit</td>
<td>1,800,000</td>
</tr>
<tr>
<td>Cumulative effect of accounting change</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Less: Income tax effect</td>
<td>(2,000,000)</td>
</tr>
<tr>
<td>Beginning balance (restated)</td>
<td>28,300,000</td>
</tr>
<tr>
<td>Add: Net income</td>
<td>1,700,000</td>
</tr>
<tr>
<td>Less: Dividends</td>
<td>30,000,000</td>
</tr>
<tr>
<td>Cash dividend declared on preferred stock</td>
<td>500,000</td>
</tr>
<tr>
<td>Cash dividend declared on common stock</td>
<td>350,000</td>
</tr>
<tr>
<td>Property dividend declared on common stock</td>
<td>100,000</td>
</tr>
<tr>
<td>Stock dividend declared on common stock</td>
<td>50,000</td>
</tr>
<tr>
<td>Ending balance</td>
<td>$29,000,000</td>
</tr>
</tbody>
</table>
VI. SUMMARY OF ACCOUNTING CHANGES AND PRIOR PERIOD ADJUSTMENTS

<table>
<thead>
<tr>
<th>Treatment of Accounting Changes</th>
<th>Estimater</th>
<th>Principle</th>
<th>Entity</th>
<th>Prior Period Adjustment</th>
<th>Error Correction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjust accounts so that only CURRENT and SUBSEQUENT income statement(s) will be affected.</td>
<td>YES</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td></td>
</tr>
<tr>
<td>If comparative FS, restate PRIOR period FS.</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td>If not comparative FS, restate Retained Earnings only.</td>
<td>NO</td>
<td>YES</td>
<td>N/A</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td>CUMULATIVE EFFECT of &quot;change&quot; of GAAP should be shown in the Retained Earnings Statement of the earliest period presented as an adjustment to beginning retained earnings.</td>
<td>NO</td>
<td>YES</td>
<td>NO</td>
<td>NO</td>
<td></td>
</tr>
</tbody>
</table>
I. DEFINITIONS

A. COMPREHENSIVE INCOME

Comprehensive income is the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

\[
\text{Net income} + \text{Other comprehensive income} \\
\text{Comprehensive income}
\]

B. NET INCOME

Net income includes the following items:
1. Income from continuing operations
2. Discontinued operations
3. Extraordinary items

C. OTHER COMPREHENSIVE INCOME

Other comprehensive income includes those items in comprehensive income that are excluded from net income. Prior to the implementation of SFAS No. 130, these types of items were reported as separate line items (components) of owners’ equity. SFAS No. 130 grouped all of these items together and called the changes in them for the period "Other Comprehensive Income."

An entity must classify the specific items by their nature, such as:

1. Pension Changes in Funded Status
   Changes in the funded status of a pension plan due to gains or losses, prior service costs, and net transition assets or obligations must be recognized in other comprehensive income in the year the changes occur. All gains or losses, prior service costs, and transition assets or obligations are included in other comprehensive income until recognized as a component of net periodic benefit cost. (Pensions are covered in detail in lecture F-6, later in the course.)

2. Unrealized Gains and Losses
   The following types of unrealized gains and losses on certain investments in debt and equity securities (per SFAS No. 115) are reported as components of other comprehensive income. (All are covered in detail in lecture F-3, later in the course.)
a. Unrealized holding gains and losses on "available-for-sale securities."
b. Unrealized holding gains and losses that result from a debt security being transferred into the "available-for-sale" category from "held-to-maturity."
c. Subsequent decreases or increases in the fair value of "available-for-sale" securities previously written down as impaired.

3. Foreign Currency Items

Foreign currency translation adjustments and gains and losses on foreign currency transactions that are designated as (and are effective as) economic hedges of a net investment in a foreign entity (part of SFAS No. 133 and discussed in the F-7 lecture on derivatives and other financial instruments) are reported as a component of other comprehensive income. (Foreign currency and its related effects are covered in detail in lecture F-2, later in the course.)

4. Effective Portion of Cash Flow Hedges

Cash flow hedges are part of SFAS No. 133 and are discussed in the F-7 lecture on derivatives and other financial instruments, later in the course. The effective portion of a cash flow hedge is reported as a component of other comprehensive income.

D. RECLASSIFICATION ADJUSTMENTS

Adjustments for items that are displayed as part of net income for a period that had previously been displayed as part of other comprehensive income are referred to as reclassification adjustments. These adjustments may be displayed on the face of the financial statement in which comprehensive income is reported or disclosed in the notes to the financial statements.

E. ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income is a component of equity that includes the total of other comprehensive income for the period and previous periods. Other comprehensive income for the current period is "closed" to this account, which is reconciled each period similar to the manner in which retained earnings is reconciled.
II. **FINANCIAL STATEMENT REPORTING**

Comprehensive income and its components shall be displayed in a financial statement that is presented with the same prominence as the other financial statements that constitute a full set of financial statements. The requirements to present comprehensive income do not apply to not-for-profit entities or to any company that does not have any item of other comprehensive income. Comprehensive income should not be reported on a per share basis.

One of three formats must be used to present comprehensive income:

1. Below the total for net income in a statement that reports results of operations;
2. In a separate statement of comprehensive income that begins with net income; or
3. In a statement of changes in equity.

---

**A. SINGLE STATEMENT APPROACH**

The single statement approach displays other comprehensive income below the income statement and totals them for comprehensive income.

---

**Sydney Technologies, Inc.**

**Statement of Income and Comprehensive Income**

*For the Year Ended December 31, 20X5*

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td>$ 20,000,000</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td>(18,400,000)</td>
</tr>
<tr>
<td><strong>Income before income taxes</strong></td>
<td>1,600,000</td>
</tr>
<tr>
<td><strong>Income tax (25%)</strong></td>
<td>(400,000)</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>1,200,000</td>
</tr>
</tbody>
</table>

*Other comprehensive income, net of income tax:

- **Pension net loss** | $(25,000)
- **Unrealized holding gains (available-for-sale securities)** | 300,000
- **Foreign currency items** | $(75,000) 200,000

**Comprehensive income** | $1,400,000
B. TWO-STATEMENT APPROACH
The two-statement approach displays comprehensive income as a separate statement that begins with net income.

Sydney Technologies, Inc.
Statement of Comprehensive Income
For the Year Ended December 31, 20X5

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Retained earnings</th>
<th>Accumulated other comprehensive income</th>
<th>Common stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$1,200,000</td>
<td>$1,200,000</td>
<td>$1,200,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Pension net loss</td>
<td>(25,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrealized holding gains</td>
<td>300,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign currency items</td>
<td>(75,000)</td>
<td></td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>Comprehensice income</td>
<td>$1,400,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

C. COMPONENT WITHIN THE STATEMENT OF OWNERS’ EQUITY
Comprehensive income may be displayed as a separate column in the statement of owners’ equity. Note that the separate presentation of accumulated other comprehensive income is required as part of the statement of owners’ equity.

Sydney Technologies, Inc.
Statement of Changes in Stockholders’ Equity
For the Year Ended December 31, 20X5

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Retained earnings</th>
<th>Accumulated other comprehensive income</th>
<th>Common stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning balance</td>
<td>$30,000,000</td>
<td>$8,500,000</td>
<td>$1,500,000</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$1,200,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pension net loss</td>
<td>(25,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrealized holding gains</td>
<td>300,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign currency items</td>
<td>(75,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>200,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Comprehensice income</td>
<td>$1,400,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock issued</td>
<td>1,000,000</td>
<td></td>
<td></td>
<td>1,000,000</td>
</tr>
<tr>
<td>Dividends declared on common stock</td>
<td>(700,000)</td>
<td></td>
<td>(700,000)</td>
<td></td>
</tr>
<tr>
<td>Ending balance</td>
<td>$31,700,000</td>
<td>$9,000,000</td>
<td>$1,700,000</td>
<td>$21,000,000</td>
</tr>
</tbody>
</table>

Total = $31,700,000
III. OTHER REPORTING ISSUES

A. OTHER COMPREHENSIVE INCOME

Components of other comprehensive income may be reported either (i) net of tax or (ii) before related tax effects with one amount shown for the aggregate income tax expense or benefit related to the total of other comprehensive income items.

B. INCOME TAX EXPENSE OR BENEFIT

The amount of income tax expense or benefit allocated to each component of other comprehensive income is disclosed either on the face of the statement in which those components are displayed or in the notes to the financial statements.

C. INTERIM PERIOD REPORTING

A total for comprehensive income shall be reported in condensed financial statements of interim periods issued to shareholders.

D. REQUIRED DISCLOSURES

All three formats must disclose:

1. The tax effects of each component included in (current) "Other Comprehensive Income," either as part of the statement presentation or in the notes to the financial statements.
2. The accumulated balances of components of "Other Comprehensive Income" (e.g., pension funded status changes, unrealized holding gains/losses on securities, foreign currency items, and the effective portion of cash flow hedges).
   (a) The accumulated balances by component may be shown on the balance sheet, in the statement of changes in equity, or in the notes to the financial statements.
3. Total "Accumulated Other Comprehensive Income" in the balance sheet as an item of "Equity" (see "required format" on above example).
4. The reclassification adjustments, which are made to avoid double counting in "Other Comprehensive Income" items that are displayed in net income for the current year (e.g., previously reported unrealized gains on available-for-sale securities that were realized during the current year).

<table>
<thead>
<tr>
<th>EXAMPLE</th>
<th>Reclassification Adjustment Disclosure Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized holding gains arising during the period</td>
<td>$400,000</td>
</tr>
<tr>
<td>Less: Reclassification adjustments for gain included in net income</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Net unrealized holding gain</td>
<td>$300,000</td>
</tr>
</tbody>
</table>
**BALANCE SHEET AND DISCLOSURES OVERVIEW**

### I. BALANCE SHEET OVERVIEW

Below is an example of a classified balance sheet:

*Company Name*

**BALANCE SHEET**  
*As of December 31, 20X5*

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Stockholders’ Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td></td>
</tr>
<tr>
<td>Trading securities, at fair value</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable, net of allowance for uncollectible accounts</td>
<td></td>
</tr>
<tr>
<td>Notes receivable</td>
<td></td>
</tr>
<tr>
<td>Merchandise inventory, at lower of cost or market</td>
<td></td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td></td>
</tr>
<tr>
<td><strong>Investments</strong></td>
<td></td>
</tr>
<tr>
<td>Available-for-sale securities, at fair value</td>
<td></td>
</tr>
<tr>
<td>Held to maturity securities</td>
<td></td>
</tr>
<tr>
<td>Land held for future plant site</td>
<td></td>
</tr>
<tr>
<td><strong>Property, plant, and equipment</strong></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td></td>
</tr>
<tr>
<td>Less: Accumulated depreciation</td>
<td></td>
</tr>
<tr>
<td><strong>Intangible assets</strong></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
</tr>
<tr>
<td>Patents, net of amortization</td>
<td></td>
</tr>
<tr>
<td><strong>Other assets</strong></td>
<td></td>
</tr>
<tr>
<td>Bond issue costs</td>
<td></td>
</tr>
<tr>
<td>Pension and other postretirement benefit assets*</td>
<td></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td></td>
</tr>
</tbody>
</table>

| **Current liabilities**             |                                     |
| Long-term debt due within one year  |                                     |
| Accounts payable                    |                                     |
| Notes payable                       |                                     |
| Interest payable                    |                                     |
| Salaries payable                    |                                     |
| Income tax payable                  |                                     |
| Advances from customers (unearned revenue) |                                 |
| Unearned rent revenue               |                                     |

| **Long-term liabilities**           |                                     |
| Bonds payable (10%, due December 31, 20X9) |                                 |
| Plus: Unamortized premium on bonds   |                                     |
| or                                   |                                     |
| Less: Unamortized discount on bonds  |                                     |
| Deferred income tax liability        |                                     |
| Pension and other postretirement benefit liabilities* |                                 |

| **Total liabilities**               |                                     |

| **Stockholders’ equity**            |                                     |
| Capital stock                        |                                     |
| Preferred stock, $10 par, 8% cumulative and nonparticipating, 10,000 shares authorized, 5,000 shares issued and outstanding |                                 |
| Common stock, $0.01 par, 600,000,000 shares authorized, 57,598,000 shares issued and 57,178,485 shares outstanding |                                 |
| Paid-in capital in excess of par    |                                     |
| Total paid-in capital                |                                     |
| Retained earnings                    |                                     |
| Accumulated other comprehensive income |                                     |
| Treasury stock at cost (419,515 shares) |                                 |

| **Total stockholders’ equity**      |                                     |

| **Total liabilities and stockholders’ equity** |                                     |

* For balance sheet reporting purposes, all overfunded pension plans are aggregated and reported in total as a noncurrent asset. All underfunded pension plans are also aggregated and reported as a current liability, a noncurrent liability (as shown), or both. See further discussion of pension plan reporting in F-6.
II. DISCLOSURES (NOTES TO THE FINANCIAL STATEMENTS) OVERVIEW

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

GAAP requires that a description of all significant policies should be included as an integral part of the financial statements. The preferred presentation is to include the "Summary of Significant Accounting Policies" as the first or second note to the financial statements. Policies presented in other notes should not be duplicated.

1. Identify and describe:
   a. Principles and methods
   b. Criteria
   c. Policies
   d. Pricing

2. Items not included in this footnote:
   a. Composition of accounts
   b. Amounts in dollars of account balances
   c. Details relating to changes in accounting principles
   d. Dates of maturity and amounts of long-term debt
   e. Yearly computation of depreciation, depletion and amortization

B. REMAINING NOTES TO THE FINANCIAL STATEMENTS

The remaining notes contain all other information relevant to decision makers (e.g., investors, creditors, etc.) These notes are used to disclose facts not presented in either the body of the financial statements or in the "Summary of Significant Accounting Policies." Examples of relevant note information include the following:

1. Changes in stockholders' equity including capital stock, paid-in capital, retained earnings, treasury stock, stock dividends and other capital changes;

2. Required marketable securities disclosure including carrying value and gross unrealized gains and losses;

3. Contingency losses;

4. Contractual obligations, including restrictions on specific assets or liabilities;

5. Pension plan description; and

6. Post-balance sheet disclosures of certain events that occurred before the financial statements were issued.
INTERIM FINANCIAL REPORTING

I. GENERAL
Interim financial reporting is generally concerned with the quarterly reports that public companies must file with the SEC. Generally accepted accounting principles that were used in the most recent annual report of an enterprise should be applied to interim financial statements of the current year, unless a change in accounting principle is adopted in the current year.

II. MATCHING OF REVENUES AND EXPENSES
The general rule in preparing interim financial statements is that costs and expenses that clearly benefit more than one period should be properly allocated to the periods affected. Revenues should be recognized in the period in which they were earned and realized or realizable. Also, a total for comprehensive income in condensed financial statements of interim periods issued to shareholders shall be reported.

III. TIMELINESS OVER RELIABILITY
For interim reporting only, timeliness is emphasized over reliability.

IV. AN INTEGRAL PART OF ANNUAL FINANCIAL STATEMENTS
Interim financial statements must be viewed as an integral part of the annual financial statements. Because interim financial statements generally are not audited, each statement presented should be marked "unaudited."

V. INCOME TAXES
Income tax expense is estimated each quarter, using the estimated average tax rate that will apply for the entire year.

VI. ADDITIONAL INFORMATION
See the enhanced outline for interim financial reporting in the Homework Reading section at the back of this chapter.
SEGMENT REPORTING

I. GENERAL
SFAS No. 131 significantly increased the items of disclosure that previously existed in segment reporting. The objective of requiring these disclosures was to provide information on the business activities and the economic environment of a company to help users of the financial statements:

(i) Better understand the enterprise's performance,
(ii) Better assess its prospects for future net cash flows, and
(iii) Make more informed judgments about the enterprise as a whole.

In general, an enterprise is required to report a measure of segment profit or loss, segment assets, and certain related items, but is not required to report segment cash flow or segment liabilities.

A. REQUIRED DISCLOSURES FOR ALL PUBLIC ENTERPRISES
In order to conform with GAAP, financial statements for public business enterprises must report segment information about a company's:

1. Operating Segments (Annual and Interim)
2. Products and Services
3. Geographic Areas
4. Major Customers

B. USE SAME ACCOUNTING PRINCIPLES AS MAIN FINANCIAL STATEMENTS
The required financial statement information is essentially a disaggregation of the entity's regular financial statements. The accounting principles used in preparing the financial statements should be used for the segment information. Segment information presented must be reconciled to the related aggregate amounts in the financial statements.

C. INTERCOMPANY TRANSACTIONS NOT ELIMINATED FOR REPORTING
It is important to remember that transactions between the segments of an enterprise are not eliminated as in consolidation between the parent company and subsidiaries.

D. SCOPE (PUBLIC COMPANIES ONLY)
Segment reporting applies to public companies only. It does not apply to not-for-profit organizations, nonpublic companies, or separate financial statements of members of a consolidated group if both the separate company statements and the consolidated or combined financial statements are included in the same financial report.

E. ADDITIONAL INFORMATION
See the Homework Reading at the back of this chapter for an expanded discussion of segment disclosures.
II. OPERATING SEGMENTS

A. DEFINITION

An operating segment is a component of an enterprise:

(i) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise),

(ii) Whose operating results are regularly reviewed by the enterprise's "Chief Operating Decision Maker" to make decisions about resources to be allocated to the segment and assess its performance, and

(iii) For which discrete financial information is available.

The definition of a segment depends on how management uses information, which is called the management approach method. For example, management may report results both by product and service lines and by geographical lines.

B. NOT EVERY ENTERPRISE IS AN OPERATING SEGMENT

Not every part of an enterprise is necessarily an operating segment or part of an operating segment.

1. Corporate Headquarters Not an Operating Segment

A corporate headquarters or certain functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the enterprise and would, therefore, not be operating segments.

2. Pension Plan Not an Operating Segment

An enterprise's pension and other post-retirement benefit plans are not considered to be operating segments.

C. REPORTABLE SEGMENT

Reportable segments are operating segments of an enterprise that meet the criteria for separate reporting.

Those operating segments that exhibit similar long-term financial performance may be aggregated into a single operating segment if (i) aggregation is consistent with the objective and principles of segment reporting, (ii) the segments have similar economic characteristics, and (iii) the segments are similar in:

1. The nature of the products and services,
2. The nature of the production processes,
3. The type or class of customer for their products and services,
4. The methods used to distribute their products or provide their services, and
5. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.
D. QUANTITATIVE THRESHOLDS FOR REPORTABLE SEGMENTS

1. 10% "Size" Test (must only meet one)
   a. Revenue
      A segment meets the size test if its reported revenue, including both sales to external customers and intersegment sales or transfers (but excluding interest income on advances and loans to other segments), is 10% or more of the combined revenue, internal and external, of all operating segments.
   b. Reported Profit or Loss
      A segment meets the size test if the absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of
      (1) The combined reported profit of all operating segments that did not report a loss, or
      (2) The combined reported loss of all operating segments that did report a loss.
   c. Assets
      A segment meets the size test if its assets are 10% or more of the combined assets of all operating segments. The assets of a segment are those assets included in the measure of the segment's assets that are reviewed by the chief operating decision maker.

2. 75% "Reporting Sufficiency" Test
   If the total of external (consolidated) revenue reported by operating segments constitutes less than 75% of external (consolidated) revenue, additional operating segments need to be identified as reportable segments, even if they do not meet the above three tests, until at least 75% of external (consolidated) revenue is included in reportable segments. The practical limit to the number of segments is 10, which is not a precise limit.

3. 90% "Single Industry Dominance" Test
   There is no requirement to report any segment if a single segment accounts for 90% or more of the following combined amounts for all segments:
   a. Revenue,
   b. Reported profit or loss, and
   c. Assets.
E. SEGMENT PROFIT (OR LOSS) DEFINED (see 1.b, above)

1. Formula

```
Revenues
Less: Directly traceable costs
Less: Reasonably allocated costs
Operating Profit (or loss)
```

2. Items Normally Excluded from Segment Profit (or Loss)
   a. General corporate revenues
   b. General corporate expenses
   c. Interest expense (except for financial institutions)
   d. Income taxes
   e. Equity in earnings and losses of an unconsolidated subsidiary (i.e., under the equity method)
   f. Gains or losses from discontinued operations
   g. Extraordinary items
   h. Minority interest

3. Income and Expense Allocation
   Income and expenses are not allocated to a segment unless they are included in the determination of segment profit or loss reported to the "Chief Operating Decision Maker."
DEVELOPMENT-STAGE ENTERPRISES

I. OVERVIEW

A development-stage enterprise is one in which either:

(i) Principal operations have not yet commenced, or
(ii) Principal operations have generated an insignificant amount of revenue (or a loss).

During the development stage, a company devotes most of its activities and resources toward establishing the business.

II. DISCLOSURE

A development-stage enterprise must issue the same financial statements as any other enterprise. These statements should be prepared in conformity with GAAP. The additional required disclosures are as follows:

A. Identify the financial statements as those of a development stage enterprise.
B. In the balance sheet, describe cumulative net losses as "deficit accumulated during the development stage."
C. In the income statement, show revenues and expenses for each period being presented, and present a cumulative amount (generally of losses) from the company's inception.
D. In the statement of cash flows, include:
   1. Cumulative amounts of cash inflows and cash outflows from the company's inception, and
   2. Current amounts of cash inflows and cash outflows for each period presented.
E. In the statement of stockholders' equity, include the following:
   1. Number of shares of stock (or other securities) issued,
   2. Dates of issuance, and
   3. Dollar amounts assigned.
   4. If noncash consideration is involved in the issuance, then include:
      a. A description of the nature of the consideration, and
      b. The basis for its valuation.
FAIR VALUE MEASUREMENTS

I. OVERVIEW

Before SFAS No. 157 was issued, GAAP standards included different definitions of fair value and little information regarding how to use those definitions. SFAS No. 157 standardizes the definition of fair value, establishes a framework for measuring fair value, and expands fair value disclosures. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, and it applies to all other accounting pronouncements that require or permit fair value measurement, except:

A. SFAS No. 123(R), Share-Based Payment and related interpretative pronouncements,
B. ARB No. 43, Chapter 4, "Inventory Pricing," and
C. Accounting pronouncements that permit measurements based on or using vendor-specific objective evidence of fair value. (Note that these pronouncements are beyond the scope of the CPA Exam.)

II. TERMINOLOGY

A. FAIR VALUE

Fair value is the price to sell an asset or transfer a liability in an orderly transaction between market participants at the measurement date.

1. Fair value is measured for a specific asset or liability, or a group of assets and/or liabilities.
2. Fair value is a market-specific measure, not an entity-specific measure.
3. Fair value is measured in the principal, or most advantageous, market for the asset or liability.
4. Fair value is an exit price (the price to sell an asset or transfer a liability), not an entrance price (the price to acquire an asset or assume a liability).
5. A fair value measure should reflect all of the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk.
6. Fair value does not include transaction costs, but may include transportation costs if location is an attribute of the asset or liability.
7. The fair value of an asset assumes the highest and best use of the asset.
8. The fair value of a liability should include the liability's nonperformance risk, which is the risk that the obligation will not be fulfilled.

B. ORDERLY TRANSACTION

An orderly transaction is one in which the asset or liability is exposed to the market for a period before the measurement date long enough to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities. An orderly transaction cannot be a forced transaction.

C. MARKET PARTICIPANTS

Market participants are buyers and sellers who are independent (not related parties), knowledgeable about the asset or liability, able to transact for the asset or liability, and willing to transact for the asset or liability.
D. PRINCIPAL MARKET

The principal market is the market with the greatest volume or level of activity for the asset or liability. If there is a principal market for an asset or liability, the price in that market will be the fair value measurement, even if there is a more advantageous price in a different market.

E. MOST ADVANTAGEOUS MARKET

The most advantageous market is the market with the best price for the asset or liability, after considering transaction costs. Note that although transactions costs are used to determine the most advantageous market, transaction costs are not included in the final fair value measurement (see the illustration below). The price in the most advantageous market will be the fair value measurement only if there is no principal market.

ILLUSTRATION

- Gearty holds Foxy Co. stock, which trades on two exchanges (Gearty Inc. can access both the New York and London markets).
- The stock price and transaction costs at the measurement date follow:

<table>
<thead>
<tr>
<th>Exchange</th>
<th>Quoted Stock Price</th>
<th>Transactions Costs</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>New York</td>
<td>$52</td>
<td>$(6)</td>
<td>$46</td>
</tr>
<tr>
<td>London</td>
<td>$50</td>
<td>$(2)</td>
<td>$48</td>
</tr>
</tbody>
</table>

- What is the fair value of Foxy stock?
  - If New York is the principal market = $52
  - If London is the principal market = $50
  - If no principal market, with London's price (net of transaction costs) having the most advantageous result = $50

F. HIGHEST AND BEST USE

The "highest and best use" is the use that maximizes the value of an asset or group of assets.

1. In-Use
   - If an asset's highest and best use is when in-use, such as a fixed asset, then the fair value of the asset is based on the price to sell the asset to be used by the buyer with other assets in a group.

2. In-Exchange
   - If an asset's highest and best use is in-exchange, such as a financial asset, then the fair value of the asset is based on the price to sell the asset standalone.
III. FAIR VALUE MEASUREMENT FRAMEWORK

SFAS No. 157 establishes a framework for measuring the fair value of an asset or liability. This framework (i) outlines the valuation techniques that can be used to measure fair value and (ii) establishes a hierarchy of the inputs that can be used in these valuation techniques.

A. VALUATION TECHNIQUES

Under SFAS No. 157, entities can use the market approach, the income approach, the cost approach, or a combination of these approaches, as appropriate, when measuring the fair value of an asset or a liability. A change in valuation technique or its application is accounted for as a change in accounting estimate (which is accounted for prospectively).

1. The Market Approach

   The market approach uses prices and other relevant information from market transactions involving identical or comparable assets or liabilities to measure fair value.

2. The Income Approach

   The income approach converts future amounts, including cash flows or earnings, to a single discounted amount to measure fair value. This method can be applied to assets or liabilities.

3. The Cost Approach

   The cost approach uses current replacement cost to measure the fair value of assets.

B. HIERARCHY OF INPUTS

The fair value hierarchy prioritizes the inputs that can be used in the valuation techniques described above. Level 1 inputs have the highest priority, and Level 3 inputs have the lowest priority. The level in the fair value hierarchy in which a fair value measurement falls is determined by the lowest level input that is significant to the fair value measurement.

1. Level 1 Inputs

   Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the reporting entity has access to on the measurement date. Level 1 inputs are the most reliable measures of fair value and should be used when available.

2. Level 2 Inputs

   Level 2 inputs are inputs other than quoted market prices (Level 1) that are directly or indirectly observable for the asset or liability. Level 2 inputs include:
   a. Quoted prices for similar assets or liabilities in active markets.
   b. Quoted prices for identical or similar assets in markets that are not active.
   c. Inputs other than quoted prices that are observable for the asset or liability.
   d. Inputs that are derived from or corroborated by observable market data.

3. Level 3 Inputs

   Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs reflect the reporting entity's assumptions and should be based on the best available information. Level 3 inputs should be used only when there are no observable (Level 1 or Level 2) inputs or when undue cost and effort is required to obtain observable inputs.
IV. FAIR VALUE DISCLOSURES

The SFAS No. 157 disclosure requirements depend on whether the assets and liabilities to be measured at fair value are measured on a recurring basis (e.g., financial instruments) or on a nonrecurring basis (e.g., impaired assets).

A. RECURRING FAIR VALUE MEASUREMENT DISCLOSURES

For assets and liabilities that are measured at fair value on a recurring basis, the reporting entity must disclose the following information for each interim and annual period for each major category of assets and liabilities:

1. Fair value measurements at the reporting date.
2. The level in the fair value hierarchy in which the fair value measurements fall, segregating fair value measurements using Level 1, Level 2 and Level 3 inputs.
3. For fair value measurements based on Level 3 inputs, a reconciliation of beginning and ending balances, showing separately changes due to:
   a. Realized and unrealized gains and losses, segregating gains and losses included in earnings, and describing where gains and losses included in earnings are shown on the income statement,
   b. Purchases, sales, issuances and settlements, and
   c. Transfers in and out of Level 3.
4. The amount of total gains and losses attributable to unrealized gains and losses on assets and liabilities still held on the reporting date and a description of where the unrealized gains and losses are showing on the statement of income.
5. In annual periods, the valuation technique(s) used to measure fair value and a discussion of changes in valuation technique, if any.

B. NONRECURRING FAIR VALUE MEASUREMENT DISCLOSURES

For assets that are measured at fair value on a nonrecurring basis in periods after initial recognition, the reporting entity must disclose the following information for each interim and annual period for each major category of assets and liabilities:

1. The fair value measurements recorded and the reasons for the fair value measurements.
2. The level in the fair value hierarchy in which the fair value measurements fall, segregating fair value measurements using Level 1, Level 2 and Level 3 inputs.
3. For fair value measurements based on Level 3 inputs, a description of the inputs and the information used to develop the inputs.
4. In annual periods, the valuation technique(s) used to measure fair value and a discussion of changes in valuation technique, if any.
ILLUSTRATION: Disclosure – Recurring

<table>
<thead>
<tr>
<th>Description</th>
<th>12/31/XX</th>
<th>Level 1: Quoted prices in active markets for identical assets</th>
<th>Level 2: Significant other observable inputs</th>
<th>Level 3: Significant unobservable inputs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading Securities</td>
<td>$115</td>
<td>$105</td>
<td>$10</td>
<td>-0-</td>
</tr>
<tr>
<td>Available-for-Sale Securities</td>
<td>75</td>
<td>75</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Derivatives</td>
<td>60</td>
<td>25</td>
<td>15(^2)</td>
<td>$20(^3)</td>
</tr>
<tr>
<td>Venture Capital Investments</td>
<td>10</td>
<td>-0-</td>
<td>-0-</td>
<td>$ 10</td>
</tr>
<tr>
<td>Total</td>
<td>$260</td>
<td>$205</td>
<td>$25</td>
<td>$ 30</td>
</tr>
</tbody>
</table>

\(^1\) Additional disclosures are required for recurring Level 3 measurements

\(^2\) Standard interest rate swaps

\(^3\) 20-year energy contract

ILLUSTRATION: Level 3 Recurring

| Level 3: Assets Measured on Recurring Basis Using Significant Unobservable Inputs |
|--------------------------------|--------------------------------|--------------------------------|
| Derivatives                    | Investments by Venture Capitalists | Total |
| Beginning Balance 01/01/XX     | $14                               | $11   | $25   |
| Total gains or losses (realized / unrealized): |
| Included in:                   |                                  |       |       |
| • Income Statement             | 11                               | (3)   | 8     |
| • Included in Other Comprehensive Income | 4 | -0- | 4 |
| • Purchases, issuances, and settlements | (7) | 2 | (5) |
| • Transfers in and/or out of Level 3 | (2) | -0- | (2) |
| Ending Balance 12/31/XX        | $20                               | $10   | $30   |
| Unrealized gain (loss) in earnings from assets still held at period end | $ 7 | $ 2 | $ 9 |
# ILLUSTRATION: Nonrecurring

## Level 3:
**Assets Measured on a Recurring Basis Using Significant Unobservable Inputs**

<table>
<thead>
<tr>
<th>Description</th>
<th>End of Year 12/31/XX</th>
<th>Level 1 Quoted prices in active markets for identical assets</th>
<th>Level 2 Significant other observable inputs</th>
<th>Level 3 Significant unobservable inputs</th>
<th>Total Gains (Losses)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-lived assets held and used</td>
<td>$225</td>
<td>-0-</td>
<td>$225</td>
<td>-0-</td>
<td>($75)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$90</td>
<td>-0-</td>
<td>-0-</td>
<td>$90</td>
<td>($40)</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>($115)</td>
</tr>
</tbody>
</table>
HOMEWORK READING
Discontinued Operations Examples

I. DETERMINATION OF WHETHER THE CONDITIONS TO REPORT AS DISCONTINUED OPERATIONS EXIST

A. FACTS AND CIRCUMSTANCES
An entity that manufactures and sells various types of sporting goods determines its product groups by type of sport (e.g., basketball, tennis, golf, swimming, hockey, etc.). The product group is the lowest level of operations at which cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity, so each product group is considered a component of the entity.

B. REPORT AS PART OF DISCONTINUED OPERATIONS
The entity decides to sell its golf sports business and commits to a plan to sell that product group along with its operations. As of the date of the commitment, the golf product group is classified as held for sale. In addition, the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal and the entity will not have any significant continuing involvement in the operations of the component after the disposal. In this case, the results of operations of the golf product group will be reported as income from discontinued operations, net of related tax effects.

C. REPORT AS PART OF CONTINUING OPERATIONS
The entity decides that it will remain in the golf product business but that it will discontinue its manufacture and sale of giant metal woods, which has been experiencing significant losses due to losing sales to its largest competitor, who specializes in giant metal woods and has brand recognition. Because the giant metal woods manufacture and sale is part of a larger component of the business and is not a component on its own, the conditions for reporting the related losses as part of discontinued operations for the period are not met. The related operations will be reported as part of continuing operations.

II. MEASUREMENT, PRESENTATION, AND DISCLOSURE OF DISCONTINUED OPERATIONS

A. FACTS
The Golf Division is losing $200,000 per month, and management of All Sports Company, which includes the Golf Division as a component, discovers this on March 31, 20X1. The Board of Directors decides on April 30, 20X1 to dispose of the Golf Division. The carrying value of the Golf Division on April 30, 20X1 is $4,000,000, and its fair value is $2,200,000. After months of negotiations, the division's net assets are sold on June 30, 20X2 for $2,000,000. In the meantime, the Golf Division has continued losing $200,000 per month. All Sports Company's income tax rate is 40%.
B. **QUESTION**

How should the disposal of the Golf Division be reported on All Sports Company's 20X1 and 20X2 financial statements?

C. **ANSWER**

1. **Reporting for 20X1**

   The Golf Division was not disposed of until 20X2 and would be reported as "held for sale" in the 20X1 financial statements. The decision was made in 20X1 (management committed to a plan to sell the component), and we will assume that all of the other criteria were met.

   The Golf Division would be measured at the lower of its carrying amount or fair value less costs to sell. The lower of the two amounts is the fair value of $2,200,000, and the loss of $1,800,000 to recognize this impairment would be included in discontinued operations in 20X1. Because we have no information on "costs to sell", we will assume that the cost to sell is zero.

   The continuing loss from the Golf Division would be included in discontinued operations in 20X1 for the number of months in 20X1. The total loss to be included would be the $200,000 per month x 12 months, or $2,400,000, for a total of $4,200,000. (The anticipated continuing losses of $200,000 per month for 20X2 would not be included in the 20X1 discontinued operations but would be included in the 20X2 discontinued operations.)

   Reporting for 20X1 would be as follows:

<table>
<thead>
<tr>
<th>DISCONTINUED OPERATIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss from operations of held-for-sale Golf Division</td>
</tr>
<tr>
<td>(including impairment loss of $1,800,000)</td>
</tr>
<tr>
<td>Income tax benefit</td>
</tr>
<tr>
<td>Loss from discontinued operations</td>
</tr>
</tbody>
</table>

2. **Reporting for 20X2**

   For 20X2, discontinued operations would include the continuing losses of $200,000 per month x 6 months, or $1,200,000, and the loss on disposal of $200,000 ($2,200,000-$2,000,000), for a total of $1,400,000.

   Reporting for 20X2 would be as follows:

<table>
<thead>
<tr>
<th>DISCONTINUED OPERATIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss from operations of held-for-sale Golf Division</td>
</tr>
<tr>
<td>(including disposal loss of $200,000)</td>
</tr>
<tr>
<td>Income tax benefit</td>
</tr>
<tr>
<td>Loss from discontinued operations</td>
</tr>
</tbody>
</table>
HOMEWORK READING
Sources of GAAP and Basic Framework and Concepts

I. INTRODUCTION

Generally accepted accounting principles (GAAP) are those accounting principles that have substantial authoritative support. Substantial authoritative support is a question of fact and a matter of judgment. The accounting profession itself determines generally accepted accounting principles.

The development of accounting principles began with the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities and Exchange Commission, the body formed to enforce the acts, was given the authority to regulate securities traded on the national exchanges. This, in essence, gave the Securities and Exchange Commission (SEC) the power to establish generally accepted accounting principles and to regulate the accounting profession. However, the SEC has seldom interfered with the accounting profession's practices of establishing generally accepted accounting principles and of self-regulation.

A. THE AICPA

The American Institute of Certified Public Accountants (AICPA) took on the role of the developer of GAAP in 1939 with the formation of the Committee on Accounting Procedures and the Committee on Accounting Terminology.

From 1939 to 1953, the AICPA issued 42 Accounting Research Bulletins (ARBs), of which 8 were on accounting terminology and 34 were on problems that the accounting profession was most concerned with at that time. In June 1953, the AICPA issued ARB 43, "Restatement and Revision of Accounting Research Bulletins," which, excluding the ARBs on terminology, condensed all prior ARBs, eliminating what was no longer applicable, clarifying what continued to be of value, and arranging the retained material by subjects. Subsequently, ARBs 44 to 51 were issued between October 1954 and August 1959. Accounting Research Bulletins that have not been modified are still an important source of generally accepted accounting principles.

In 1959 the AICPA created the Accounting Principles Board (APB). From 1959 to 1972, the APB issued 31 Opinions. Any departure from an APB Opinion must be disclosed in an entity's financial statements. Therefore, CPAs are forced to comply with the APBs or justify the departure with "substantial authoritative support." Statements of the APB that have not been superseded are considered GAAP.

B. FINANCIAL ACCOUNTING STANDARDS BOARD

In 1972 the Accounting Principles Board was abolished and was replaced by the Financial Accounting Standards Board (FASB), a board independent of the AICPA. Since 1973 the FASB has issued numerous pronouncements in the area of financial accounting. These include the following:


   These statements have the highest level of authority of GAAP. (See II, Hierarchy of Sources of GAAP.) They provide accounting principles and procedures on specific accounting issues. Each statement is issued after extensive research, discussion memoranda, exposure drafts, and public comments.

2. Interpretations

   These pronouncements provide clarification of previously issued statements, including APB Opinions and Accounting Research Bulletins.
3. Technical Bulletins
   The technical bulletins provide guidance on accounting and reporting problems.

   In 1978 the Financial Accounting Standards Board issued the first of a series of Statements of Financial Accounting Concepts. These statements provide a theoretical foundation for generally accepted accounting principles. However, the statements themselves are not considered GAAP.

C. AUTHORITY FOR PROMULGATION OF GAAP
   In 1964, the AICPA included in their rules of conduct that a CPA member would not express an opinion on the financial statements if they were not presented in conformity with generally accepted accounting principles. This rule remains part of the Code of Professional Conduct (Rule 203). Through interpretations to Rule 203, the AICPA is authorized to designate a body to establish accounting principles. The FASB has been so designated to promulgate generally accepted accounting principles. FASB statements, and those Accounting Research Bulletins and APB Opinions that have not been superseded, constitute accounting principles. Other pronouncements of the FASB and AICPA also have status of GAAP.

II. HIERARCHY OF SOURCES OF GAAP
   In 2007, the Hierarchy of Generally Accepted Accounting Principles was issued. This statement supersedes SAS 69, which had previously established the GAAP hierarchy from the auditor perspective. This statement directs the GAAP hierarchy to enterprises, because enterprises, not their auditors, are responsible for selecting the accounting principles used in their financial statements.

A. CATEGORY A
   1. Accounting Research Bulletins (ARBs)
   2. Accounting Principles Board Opinions (APBOs)
   3. FASB Statements of Financial Accounting Standards
   4. FASB Staff Positions
   5. FASB Interpretations
   6. FASB Statement 133 Implementation Issues

B. CATEGORY B
   1. FASB Technical Bulletins
   2. AICPA Industry Audit and Accounting Guides (if cleared by the FASB)
   3. AICPA Statements of Position (if cleared by the FASB)

C. CATEGORY C
   1. AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletins (if cleared by the FASB)
   2. Consensus positions of the FASB Emerging Issues Task Force
   3. Topics discussed in Appendix D of EITF-Abstracts (EITF D Topics)
D. CATEGORY D
1. AICPA Accounting Interpretations
2. FASB Implementation Guides (Q & A)
3. Practices that are widely recognized and prevalent either generally or in the industry
4. AICPA Industry Audit and Accounting Guides (not cleared by the FASB)
5. AICPA Statements of Position (not cleared by the FASB)

III. OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES (SFAC NO. 1)

This first concepts statement defines the objectives of general purpose external financial reporting by business enterprises. It concludes that financial statements are intended to provide information that is useful in making business and economic decisions.

A. USERS OF FINANCIAL REPORTING

SFAC No. 1 identifies the potential users of financial reporting as those who base their decisions on their relationships to and knowledge about the business enterprise. This group includes external users such as investors, creditors, and customers, and those who advise these users.

B. OBJECTIVES OF FINANCIAL REPORTING

The objectives of financial reporting are to provide:

1. Information Useful in Investment and Credit Decisions

   Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.

2. Information Useful in Assessing Cash Flow Prospects

   Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Since investors' and creditors' cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.

3. Information about Enterprise Resources, Claims to Those Resources, and Changes in Them

   Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources.

   In addition, since management knows more about the enterprise and its affairs than investors, creditors, and other outsiders, they can often increase the usefulness of financial information by identifying certain events and circumstances and explaining their financial effects on the enterprise.
IV. QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION (SFAC #2)

This second concept statement sets out a hierarchy of characteristics of accounting information. These characteristics make information useful and are to be considered when accounting alternatives are available.

A. THE CENTRAL ROLE OF DECISION MAKING

The central role of decision making leads to the overriding criterion by which accounting choices must be judged, that is, the choice that produces the most useful information.

B. A HIERARCHY OF ACCOUNTING QUALITIES

The characteristics of information that make it a desirable commodity guide the selection of preferred accounting policies from among available alternatives. They can be viewed as a hierarchy of qualities, with usefulness for decision making the most important.

1. Understandability

Understandability is the quality of information that enables users to perceive its significance. SFAC No. 1 states that financial reporting should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. Thus, understandability is governed by user characteristics and the characteristics inherent in the information. It serves as a link between characteristics of users and decision-specific qualities of information.

2. Decision Usefulness

To be useful in decision making information must possess three qualities:

(i) Relevance,
(ii) Reliability, and
(iii) Comparability.

3. Primary Qualities

a. Relevance

Information is relevant if it has the capacity to make a difference in investors', creditors', or other users' decisions. It is a primary qualitative characteristic. To be relevant, information must have predictive value and/or feedback value and must be timely.

(1) Predictive Value

Predictive value improves the capacity of decision makers to predict or forecast future events.

(2) Feedback Value

Feedback value enables decision makers to confirm prior expectations.

(3) Timeliness

Timeliness is having the information available while it is able to influence decisions.
b. **Reliability**

Information is reliable if it is reasonably free from error and bias and faithfully represents what it purports to represent.

1) **Neutrality**

Neutrality is freedom from bias toward a predetermined result.

Financial accounting information should not be recorded or reported in accordance with the desires of the users, but should be objectively presented in conformity with GAAP and prepared for the common needs of all users. Financial accounting information that is prepared to satisfy a few users to the detriment of others who may have opposing views is a violation of the concept of neutrality.

2) **Representational Faithfulness**

Representational faithfulness is agreement between financial reporting and resources or events represented (validity).

3) **Verifiability**

Verifiability secures a high degree of consensus among independent measures. Verifiable information is usually in the form of arm’s-length transactions.

4. **Secondary Characteristics**

Both comparability and consistency are secondary characteristics of both relevance and reliability.

a. **Comparability**

Comparability is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena. It allows users to compare the information with similar information for other business enterprises.

b. **Consistency**

Consistency is conformity from period to period with unchanging policies and procedures. However, consistent use of accounting principles from one accounting period to another, if pushed too far, can inhibit accounting progress. Therefore, it is the representational faithfulness of the measurements used, rather than simply the unchanging nature of the measurement rules or the classification rules, that results in true comparability over time.

5. **Constraints**

Two pervasive constraints must be considered.

a. **Materiality, the Threshold for Recognition**

Information should be provided if it is material. The more important a judgment item is, the finer the screen should be that will be used to determine whether it is material. Materiality is the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

b. **Costs and Benefits**

Benefits derived from disclosing the information must exceed associated costs.
V. RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES (SFAC NO. 5)

SFAC No. 3 was issued in 1980 and has been superseded by SFAC No. 6, which is covered in detail in the lecture materials. SFAC No. 4 addresses the objectives of financial reporting by nonbusiness organizations and is discussed in the ARE Not-for-Profit Accounting module.

SFAC No. 5 sets forth the recognition criteria and guidance on what and when information should be incorporated into financial statements.

A. FULL SET OF FINANCIAL STATEMENTS

A full set of financial statements for a period should show:

1. Financial Position
   A statement of financial position provides information about an entity's assets, liabilities, and equity and their relationships to each other at a moment in time.

2. Earnings
   The concept of earnings is similar to net income for the period. Earnings is a measure of performance for the period. It is revenue minus expenses plus gains minus losses.

3. Comprehensive Income
   The concept of comprehensive income is a broad measure of the effects of transactions and other events on the entity. Comprehensive income includes all items of income and loss during a reporting period, including cumulative accounting adjustments and other nonowner changes in equity. Comprehensive income comprises all recognized changes in equity of the entity during a period except those resulting from investments by owners and distributions to owners. It is earnings net of cumulative adjustments and other nonowner changes in equity, such as cumulative accounting adjustments and holding gains and losses.

4. Cash Flows
   A statement of cash flows directly or indirectly reflects an entity's cash receipts classified by major sources and its cash payments classified by major uses during a period. It provides useful information about an entity's activities in generating cash through operations, about its financing activities, and about its investing activities.

5. Investments by and Distributions to Owners
   A statement of investments by and distributions to owners reflects the extent to which and in what ways the equity of an entity increased or decreased from transactions with owners as owners during a period.
RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES

All Information Useful for Investment, Credit, and Similar Decisions
(Concepts Statement 1, paragraph 22, partly quoted in footnote 6)

Financial Reporting (Concepts Statement 1, paragraphs 5-8)

Area Directly Affected by Existing FASB Standards

Basic Financial Statements (in AICPA Auditing Standards Literature)

Scope of Recognition and Measurement Concepts Statements

<table>
<thead>
<tr>
<th>Financial Statements</th>
<th>Notes to Financial Statements (and parenthetical disclosures)</th>
<th>Supplementary Information</th>
<th>Other Means of Financial Reporting</th>
<th>Other Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Statement of Financial Position</td>
<td>• Statement of Financial Position</td>
<td>Examples:</td>
<td>Examples:</td>
<td>Examples:</td>
</tr>
<tr>
<td>• Statements of Earnings and Comprehensive Income</td>
<td>• Statements of Earnings and Comprehensive Income</td>
<td>• Changing Prices Disclosures (SFAS #33 as amended)</td>
<td>• Management Discussion and Analysis</td>
<td>• Discussion of Competition and Order Backlog in SEC Form 10-K (under SEC Reg. S-K)</td>
</tr>
<tr>
<td>• Statement of Cash Flows</td>
<td>• Statement of Cash Flows</td>
<td>• Oil and Gas Reserves Information (SFAS #69)</td>
<td>• Letters to Stockholders</td>
<td>• Analysts’ Reports</td>
</tr>
<tr>
<td>• Statement of Investments by and Distributions to Owners</td>
<td>• Statement of Investments by and Distributions to Owners</td>
<td></td>
<td></td>
<td>• Economic Statistics</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• News Articles about Company</td>
</tr>
</tbody>
</table>

Examples:
- Changing Prices Disclosures (SFAS #33 as amended)
- Oil and Gas Reserves Information (SFAS #69)
- Management Discussion and Analysis
- Letters to Stockholders
- Discussion of Competition and Order Backlog in SEC Form 10-K (under SEC Reg. S-K)
- Analysts’ Reports
- Economic Statistics
- News Articles about Company

B. RECOGNITION CRITERIA

Recognition is the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, equity, revenue, or expense.

1. Measurability

Measurability must be considered together with both relevance and reliability. The item has a relevant attribute measurable with sufficient reliability.

a. Historical Cost

Historical cost is usually acquisition cost, adjusted for depreciation and other allocations. Property, plant, and equipment and most inventories are reported at historical cost.

b. Current Cost

Current cost represents the amount of cash required to purchase an equivalent asset today. Some inventories are reported using current cost.

c. Current Market Value

Current market value represents the amount of cash that could be obtained by selling an asset. Trading and available-for-sale securities (bonds and stock) are reported at current market value.
d. **Net Realizable Value**

Net realizable value is the nondiscounted cash into which an asset is expected to be converted in due course of business less direct costs, if necessary, to make that conversion. Some inventories are recorded at net realizable value.

e. **Present Value of Future Cash Flows**

Long-term receivables and payables are reported at their discounted cash flows, that is the present value of future cash inflows less the present value of any cash outflows to obtain the cash inflows. (See further applications in the SFAC No. 7 outline, below.)

f. **Monetary Unit**

The monetary unit is the nominal unit of money. All transactions are measured in terms of a single monetary unit. Additionally, the presumption is made that the value of this monetary unit does not change over time. Thus, the effects of inflation are not reflected in the financial statements. However, an increase in inflation might lead the FASB to select another, more stable measurement scale.

2. **Relevance**

The information about the item is capable of making a difference in user decisions.

3. **Reliability**

The information is representationally faithful, verifiable, and neutral.

C. **GUIDANCE IN APPLYING CRITERIA TO COMPONENTS OF EARNINGS**

Guidance for recognizing components of earnings is concerned with identifying which cycles are substantially complete and with associating particular revenues, gains, expenses, and losses with those cycles. This is simply the matching principle. Costs are matched to related revenues in determining earnings for a specific period. Revenues are recognized using the realization principle.

1. **Revenue and Gains**

   a. **Realized or Realizable**

   Revenue and gains are realized when products, merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash.

   b. **Earned**

   Revenues are not recognized until earned. Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

2. **Expenses and Losses**

   Expenses and losses are generally recognized when an entity's economic benefits are used up in delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations or when previously recognized assets are expected to provide reduced or no further benefits.
D. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Financial statements should include a summary of significant accounting policies. The summary is a compilation of the accounting policies of a business entity. It should include, for example, the basis of consolidation of the entity, the basis of profit recognition on long-term construction contracts, the methods of depreciation or amortization, and the methods of inventory costing used by the company. Items such as lists of plant assets or bond maturity dates are not policies and should not be included in the summary.

E. OTHER DISCLOSURES

Besides the informative classifications and segregation of data, financial statements should disclose all additional information that is necessary for a "fair presentation" in conformity with GAAP. Notes that are necessary for adequate disclosure are considered an integral part of the financial statements. Financial statements are restricted to numbers that are usually described in very few words and are essentially summaries of a large quantity of detailed information, usually requiring amplification by the use of notes to make the information more meaningful and provide additional disclosure.

VI. USING CASH FLOW INFORMATION AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS (SFAC NO. 7)

Before February 2000, some of the pronouncements of the FASB included provisions for certain measurements using present value; however, no consistent approach had been provided for in the foundational concepts on which generally accepted accounting principles are based.

(i) SFAC No. 7 provides this much-needed framework for accountants to employ when using future cash flows as a measurement basis for assets and liabilities (either at initial recognition or when using fresh-start measurements), especially when the factors to consider in the measurement are complex.

(ii) SFAC No. 7 also provides a set of principles that govern the use of present value, especially when the timing and/or amount of future cash flows are uncertain.

This SFAC draws on previously issued SFACs by incorporating that a major objective of financial reporting is to provide investors with information regarding the amounts, timing, and uncertainty of future net cash flows of the company SFAC No. 1). It also ensures that the information presented is relevant, reliable, comparable, consistent, and subject to the constraints of materiality and cost-benefit (SFAC No. 2).

A. MEASUREMENTS BASED ON FUTURE CASH FLOWS ONLY

SFAC No. 7 only applies to measurement issues for assets and liabilities that are determined using future cash flows only. It does not apply to measurements based on fair value determined in the marketplace (i.e., cash or other types of assets received or paid or another type of market observation) because if these existed, measurement on future cash flows would not be necessary.

B. FIVE ELEMENTS OF PRESENT VALUE MEASUREMENT

The use of present value helps to identify the economic differences between sets of future cash flows. It helps to ensure that dissimilar assets or liabilities do not appear to be similar (and vice-versa) to the users of the financial statements. Further, present value measurements that consider the element of uncertainty make the presentation of the asset or liability in the financial statements even more relevant than those that do not consider uncertainty. The FASB identified five elements of present value (or economic value) measurement that were used as the basis for determining the measurement objective of SFAC No. 7.
1. Estimate of Future Cash Flow
2. Expectations about Timing Variations of Future Cash Flows
3. Time Value of Money (the Risk-free Rate of Interest)
4. The Price for Bearing Uncertainty
5. Other Factors (e.g., Liquidity Issues and Market Imperfections)

C. FAIR VALUE OBJECTIVE

Based on the five elements identified above, the FASB determined that the objective of using present value in accounting measurements was to estimate fair value, which is an attribute that includes all of the five elements. As fair value is the measurement objective of assets and liabilities having observable market prices, it reasons that if fair value cannot be determined in the marketplace, an estimate of fair value must be obtained (i.e., a present value of future cash flows).

D. PRESENT VALUE COMPUTATIONS

Prior to SFAC No. 7, most present value computations (if used) were based on fixed (i.e., contractual) cash flows and constant effective interest rates that considered all elements of risk in them. While this is effective for many financial instruments with market interest rates, it is often not the best measure of those assets or liabilities for which cash flows are not certain and for which comparable market interest rates including all inherent risks do no exist. SFAC No. 7 allows the use of two approaches to determine present value (each considering the interest method of allocation), depending on the circumstances.

1. Traditional Approach

The traditional approach (i.e., one discount rate used to take the present value of a future cash flow stream) to present value computations may be used when assets and liabilities have contractual (i.e., fixed) cash flows that are not expected to vary. In this approach, interest rate selection is paramount, as, other than the estimate of future cash flow, all elements of present value measurement (see number 2, above) are included in the discount rate. Therefore, if comparable assets and liabilities can be observed in the marketplace, the traditional method is still acceptable.

2. Expected Cash Flow Approach

When comparable assets and liabilities (including non-financial assets and liabilities) cannot be observed in the marketplace, the traditional approach is not equipped to measure their fair values appropriately. In these more complex cases, the expected cash flow approach is to be used. Rather than focusing on the interest rate selection, this approach uses only the risk-free rate of return as the discount rate and then turns its attention to the expected future cash flows, considering uncertainties (e.g., default risk) as adjustments to the future cash flows.

a. Expected Value vs. Best Estimate

While traditional approaches in accounting have focused on the "most likely" best estimate of cash flows (i.e., the single cash flow with the highest probability of occurring is used), the expected cash flow approach considers a range of possible cash flows. Further, it assigns a (subjective) probability to each cash flow in the range to determine the weighed-average, or "expected," future cash flow.
b. Risk and Uncertainty Adjustments to Cash Flows

The FASB recognized that cash flows used in the present value measurements are estimates, and, as such, there is an element of uncertainty in them. Companies are exposed to risk when there is uncertainty involved in a transaction. In addition, each company has a price, called the risk premium, for accepting uncertainty. While the traditional approach employs a market discount rate that includes adjustment for risk and uncertainty, the complex measurements that must use the expected value approach are not afforded this luxury. Adjustments to the expected cash flows used in those present value computations (not adjustments to the interest rate) are required for uncertainties (e.g., default risk).

E. LIABILITY MEASUREMENT CONSIDERS ADDITIONAL FACTORS

While all of the above measurement rules apply to both assets and liabilities, the measurement of liabilities must consider certain problems that do not exist with the measurement of assets. Some liabilities are relatively easy to measure (e.g., a bond); however others are significantly more complex (e.g., warranty obligations). The FASB determined that, when using present value, the objective of estimating the fair value of a liability must consider other factors.

1. Measurement Must Include Costs to Settle

The measurement of the liability must include an estimate of the costs (i.e., use of assets) required to settle the liability with the holder or to transfer the liability to a third party of comparable credit risk (i.e., the costs of having a third party assume the liability).

2. Credit Standing of the Company

The credit standing of a company is the most relevant measure of its liabilities and must be included in the measure of fair value. The effect that the credit standing has on the fair value of a liability depends on the provisions that may exist to protect holders of those instruments (e.g., sinking funds, collateral, and government guarantees) and on the ability of the company to pay. When a company's credit standing changes, this must be reflected in the fair value of the company's new and existing liabilities.

F. CHANGES IN ESTIMATED CASH FLOWS USE CATCH-UP APPROACH

The catch-up approach has been chosen by the FASB as the technique to use when reporting changes in estimated cash flows. To use this approach, simply adjust the carrying amount of the asset or liability to the present value determined using the revised estimates and discount using the original effective interest rate.
HOMEWORK READING
Segment Reporting

I. SEGMENT DISCLOSURES

A. IDENTIFYING FACTORS
   Factors used to identify the enterprise's reportable segments, including the basis of organization (e.g., products and services, geographic areas, regulatory environments) should be disclosed. Also disclose whether any operation segments have been aggregated.

B. PRODUCTS AND SERVICES
   The types of products and services from which the reportable segment derives its revenues must be disclosed.

C. PROFIT OR LOSS
   The following items must be individually disclosed if the amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker:
   1. Revenues from external customers
   2. Revenues from transactions with other internal operating segments
   3. Interest revenue
   4. Interest expense
   5. Depreciation, depletion, and amortization
   6. Unusual items, including unusual events and transactions
   7. Equity in net income of investees accounted for by the equity method
   8. Income tax expense or benefit
   9. Extraordinary items
   10. Significant noncash items other than depreciation, depletion, and amortization expense

D. ASSETS
   1. The amount of investment in equity method investees
   2. Total expenditures for
      a. Additions to long-lived assets other than financial instruments
      b. Long-term customer relationships of a financial institution
      c. Mortgage and other servicing rights
      d. Deferred policy acquisition costs
      e. Deferred tax assets

E. MEASUREMENT CRITERIA
   1. Basis of accounting for any internal transactions
   2. Nature of any differences between measurements of the reportable segments' profits or losses and the enterprise's consolidated income
   3. Nature of any differences between measurements of the reportable segments' assets and the enterprise's consolidated assets, if not apparent from the reconciliation provided
4. Nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss

5. The nature and effect of any asymmetrical allocations to segments

F. RECONCILIATIONS

1. The total of the reportable segments' revenues to the enterprise's consolidated revenues

2. The total of the reportable segments' measures of profit or loss to the enterprise's consolidated income before income taxes, extraordinary items, discontinued operations, and the cumulative effects of changes in accounting principles

3. The total of the reportable segments' assets to the enterprise's consolidated assets

4. The total of the reportable segments' amounts for every other significant item of information disclosed to the corresponding consolidated amount

II. ENTERPRISE-WIDE INFORMATION

The following disclosures apply to enterprises regardless of the number of reportable segments. They are required disclosures for all public enterprises.

A. PRODUCTS AND SERVICES

Revenues from external customers for each product or service or each group of similar products and services must be disclosed unless it is impracticable to do so, and that fact must be disclosed.

B. GEOGRAPHIC AREAS

1. Revenues

   Disclose the revenues from external customers that are:
   a. Attributable to the enterprise's domicile country.
   b. Attributed to all foreign countries if the amount is material.
   c. Attributed to individual foreign countries if the amount is material.
   d. The basis for attributing revenues from external customers to individual countries.

2. Long-lived Assets

   Disclose the long-lived assets that are:
   a. Located in the enterprise's domicile country.
   b. Located in all foreign countries in total in which the enterprise holds assets.
   c. Located in individual foreign countries if the amount is material.

C. MAJOR CUSTOMERS

An enterprise that generates 10% or more of its revenue from sales to a single customer must disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The identity of the major customer need not be disclosed.
HOMEWORK READING
Enhanced Outline for Interim Financial Reporting

I. GENERAL

Generally accepted accounting principles used in the most recent annual report of an enterprise should be applied to interim financial statements of the current year, unless a change in an accounting principle is adopted in the current year.

The general rule in preparing interim period financial statements is that costs and expenses that clearly benefit more than one period should be properly allocated to the periods affected (matching of revenue and cost principle). Revenues should be recognized in the interim period in which they are earned and realized or realizable. In addition, a total for comprehensive income in condensed financial statements of interim periods issued to shareholders shall be reported.

Timeliness is emphasized over reliability for interim reporting only. Interim financial statements must be viewed as an integral part of the annual financial statements.

II. INTERIM INVENTORY VALUATION

A. INVENTORY ESTIMATION METHODS

Companies using the gross profit method or a retail inventory method to determine interim inventory valuation, or other methods different from those used for annual inventory valuation, should disclose the method used at the interim date and any material difference when reconciled with the annual physical inventory.

B. LIQUIDATION OF A LIFO BASE LAYER

A liquidation of a base-period LIFO inventory layer at an interim date that apparently will be corrected by the end of the annual period should be valued at the expected cost of replacement. Cost of sales for the interim period should include the expected cost of replacement and not the cost of the base-period LIFO inventory.

C. PERMANENT AND TEMPORARY DECLINES IN MARKET VALUE

1. Permanent inventory losses from market declines should be reflected in the interim period in which they occur. Market increases in subsequent interim periods should be recognized in the recovery interim period not to exceed the losses included in prior interim periods.

2. Temporary market declines that are expected to reverse before the end of the annual period should not be recognized in interim period statements.

D. MANUFACTURING VARIANCES

Inventory and product costs computed by the use of standard costs should be determined by the same procedures used at the end of a fiscal year. Variances from standard costs that are expected to reverse by the end of the fiscal year should not be reflected in interim period statements.
III. OTHER COSTS AND EXPENSES

A. SEASONAL REVENUE VARIATIONS

Companies that have material seasonal variations in their businesses should ensure that interim period financial statements do not become misleading. Disclosure of material seasonal variations should be made in interim period financial statements. In addition, if large seasonal changes usually occur, it is desirable to disclose results for the full year, which ends at the interim date.

B. UNUSUAL AND INFREQUENT TRANSACTIONS

Unusual and infrequent transactions that are material and not designated as extraordinary items, such as the effects of a disposal of a segment of business, should be reported separately.

C. INCOME TAXES

Income tax expense is estimated each quarter. The general rule is to multiply the year to date income by the estimated effective tax rate and subtract the result from the provision included in the previous quarter. The estimate of the effective tax rate expected to be applicable for the full fiscal year should reflect all tax planning alternatives including foreign tax rates, percentage depletion, capital gains rate, and anticipated investment tax credits.

D. DISCLOSURE

If the fourth quarter is not reported separately, any significant events and variations for that quarter should be disclosed in the notes.

At a minimum the following needs to be reported:

1. Gross sales or revenues, provision for income taxes, extraordinary items, and net income;
2. Basic and diluted earnings per share;
3. Material seasonal variations of revenues, costs, or expenses;
4. Significant changes in estimates or provisions for income taxes;
5. Disposal of a segment of a business and extraordinary, unusual, or infrequently occurring items;
6. Contingent items;
7. Changes in accounting principles or estimates; and
8. Significant changes in financial position.
IMPORTANT NOTE TO STUDENTS:

Please check the Becker KnowledgeBase (http://www.beckercpa.com/knowledgebase) regularly for supplemental materials, errata postings, software downloads, and other information provided to assist you in the successful preparation for your CPA Examination.

While every effort is made to ensure the accuracy of the material contained in these textbooks, when updates, corrections or clarifications are necessary they are posted within the Course Updates shown above. Below is an example of the Financial Course Updates page. Students are encouraged to sign up for automatic email notification of course updates by clicking on the "Notify Me by Email if this Answer is Updated" button located at the bottom of each answer page.

Unlimited academic support questions including suspected errata items can be submitted using the Ask Becker a Question tab. Please refer to the document "Introducing the New Becker KnowledgeBase!" located under Important Announcements for more detailed instructions on how to use this system.
## FINANCIAL ACCOUNTING & REPORTING 1
### Class Questions Answer Worksheet

<table>
<thead>
<tr>
<th>MC Question Number</th>
<th>First Choice Answer</th>
<th>Correct Answer</th>
<th>NOTES</th>
</tr>
</thead>
<tbody>
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<td>1.</td>
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<td>2.</td>
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<td>3.</td>
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<td>4.</td>
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<td>12.</td>
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<td>14.</td>
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<td>15.</td>
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<td>16.</td>
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</table>

### Grade:

Multiple-choice Questions Correct / 16 = _________% Correct

Detailed explanations to the class questions are located in the back of this textbook.
CLASS QUESTIONS

1. CPA-00005
What is the underlying concept governing the generally accepted accounting principles pertaining to recording gain contingencies?
   a. Conservatism.
   b. Relevance.
   c. Consistency.
   d. Reliability.

2. CPA-00010
According to Statements of Financial Accounting Concepts, neutrality is an ingredient of:

<table>
<thead>
<tr>
<th>Reliability</th>
<th>Relevance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

3. CPA-00020
On December 31, 1992, Brooks Co. decided to end operations and dispose of its assets within three months. At December 31, 1992, the net realizable value of the equipment was below historical cost. What is the appropriate measurement basis for equipment included in Brooks' December 31, 1992, balance sheet?
   a. Historical cost.
   b. Current reproduction cost.
   c. Net realizable value.
   d. Current replacement cost.

4. CPA-00031
Scott Corporation sold a fixed asset used for operations for greater than its carrying amount. Scott should report the transaction in the income statement using the:
   a. Gross concept, showing the proceeds as part of revenues and the carrying amount as part of expenses in the continuing operations section.
   b. Net concept, showing the total amount as an extraordinary item, net of income taxes.
   c. Net concept, showing the total gain as part of discontinued operations, net of income taxes.
   d. Net concept, showing the total gain as part of continuing operations, not net of income taxes.

5. CPA-00052
Which of the following should be included in general and administrative expenses?

<table>
<thead>
<tr>
<th>Interest</th>
<th>Advertising</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
6. CPA-00045
During January 20X3, Doe Corp. agreed to sell the assets and product line of its Hart division. The sale was completed on January 15, 20X4 and resulted in a gain on disposal of $900,000. Hart's operating losses were $600,000 for 20X3 and $50,000 for the period January 1 through January 15, 20X4. Disregarding income taxes, what amount of net gain (loss) should be reported in Doe’s comparative 20X4 and 20X3 income statements?

<table>
<thead>
<tr>
<th></th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$0</td>
<td>$250,000</td>
</tr>
<tr>
<td>b.</td>
<td>$250,000</td>
<td>$0</td>
</tr>
<tr>
<td>c.</td>
<td>$(600,000)</td>
<td>$850,000</td>
</tr>
<tr>
<td>d.</td>
<td>$(650,000)</td>
<td>$900,000</td>
</tr>
</tbody>
</table>

7. CPA-00055
On October 1, 20X4, Host Co. approved a plan to dispose of one of the company's operating segments. Host expected that the sale would occur on April 1, 20X5 at an estimated gain of $350,000. The segment had actual and estimated operating losses as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X4 to 9/30/X4</td>
<td>$(300,000)</td>
</tr>
<tr>
<td>10/1/X4 to 12/31/X4</td>
<td>(200,000)</td>
</tr>
<tr>
<td>1/1/X5 to 3/31/X5</td>
<td>(400,000)</td>
</tr>
</tbody>
</table>

In its 20X4 income statement, what should Host report as a loss from discontinued operations before income taxes?

a. $200,000
b. $550,000
c. $500,000
d. $900,000

8. CPA-00065
On October 1, 20X3, Wand, Inc. committed itself to a formal plan to sell its Kam division's assets early in 20X4. On that date, Wand estimated that the fair value of the component's assets was $25,000 less than the carrying value. Wand also estimated that Kam would incur operating losses of $100,000 for the period of October 1, 20X3 through December 31, 20X3 and $50,000 for the period January 1, 20X4 through February 28, 20X4. All estimates proved to be materially correct. Disregarding income taxes, what should Wand report as loss from discontinued operations in its comparative 20X3 and 20X4 income statements?

<table>
<thead>
<tr>
<th></th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$175,000</td>
<td>$0</td>
</tr>
<tr>
<td>b.</td>
<td>$125,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>c.</td>
<td>$100,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>d.</td>
<td>$0</td>
<td>$175,000</td>
</tr>
</tbody>
</table>
9. CPA-00050
During 1994 both Raim Co. and Cane Co. suffered losses due to the flooding of the Mississippi River. Raim is located two miles from the river and sustains flood losses every two to three years. Cane, which has been located fifty miles from the river for the past twenty years, has never before had flood losses. How should the flood losses be reported in each company’s 1994 income statement?

<table>
<thead>
<tr>
<th>Company</th>
<th>Reporting Category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raim</td>
<td>a. As a component of income from continuing operations</td>
</tr>
<tr>
<td></td>
<td>b. As a component of income from continuing operations</td>
</tr>
<tr>
<td>Cane</td>
<td>c. As an extraordinary item from continuing operations</td>
</tr>
<tr>
<td></td>
<td>d. As an extraordinary item from continuing operations</td>
</tr>
</tbody>
</table>

10. CPA-00098
Midway Co. had the following transactions during 1992:
- $1,200,000 pretax loss on foreign currency exchange due to a major unexpected devaluation by the foreign government.
- $500,000 pretax loss from discontinued operations of a division.
- $800,000 pretax loss on equipment damaged by a hurricane. This was the first hurricane ever to strike in Midway’s area. Midway also received $1,000,000 from its insurance company to replace a building, with a carrying value of $300,000 that had been destroyed by the hurricane.

What amount should Midway report in its 1992 income statement as extraordinary loss before income taxes?
- a. $100,000
- b. $1,300,000
- c. $1,800,000
- d. $2,500,000

11. CPA-00071
Which of the following statements is correct regarding accounting changes that result in financial statements that are, in effect, the statements of a different reporting entity?
- a. Cumulative-effect adjustments should be reported as separate items on the income statement in the year of change.
- b. No restatements or adjustments are required if the changes involve consolidated methods of accounting for subsidiaries.
- c. No restatements or adjustments are required if the changes involve the cost or equity methods of accounting for investments.
- d. The financial statements of all prior periods presented should be restated.

12. CPA-00081
For 1991, Pac Co. estimated its two-year equipment warranty costs based on $100 per unit sold in 1991. Experience during 1992 indicated that the estimate should have been based on $110 per unit. The effect of this $10 difference from the estimate is reported:
- b. As an accounting change, net of tax, below 1992 income from continuing operations.
- c. As an accounting change requiring 1991 financial statements to be restated.
- d. As a correction of an error requiring 1991 financial statements to be restated.
13. CPA-00102
One of the elements of a financial statement is comprehensive income. Comprehensive income excludes changes in equity resulting from which of the following?

a. Loss from discontinued operations.
b. Prior period error correction.
c. Dividends paid to stockholders.
d. Unrealized loss on investments in noncurrent marketable equity securities.

14. CPA-00103
Which of the following information should be disclosed in the summary of significant accounting policies?

a. Refinancing of debt subsequent to the balance sheet date.
b. Guarantees of indebtedness of others.
c. Criteria for determining which investments are treated as cash equivalents.
d. Adequacy of pension plan assets relative to vested benefits.

15. CPA-00107
For interim financial reporting, a company's income tax provision for the second quarter of 1992 should be determined using the:

a. Effective tax rate expected to be applicable for the full year of 1992 as estimated at the end of the first quarter of 1992.
b. Effective tax rate expected to be applicable for the full year of 1992 as estimated at the end of the second quarter of 1992.
c. Effective tax rate expected to be applicable for the second quarter of 1992.

16. CPA-00127
The following information pertains to revenue earned by Timm Co.'s industry segments for the year ended December 31, 1990:

<table>
<thead>
<tr>
<th>Segment</th>
<th>Sales to unaffiliated</th>
<th>Intersegment</th>
<th>Total revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alo</td>
<td>$ 5,000</td>
<td>$3,000</td>
<td>$ 8,000</td>
</tr>
<tr>
<td>Bix</td>
<td>8,000</td>
<td>4,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Cee</td>
<td>4,000</td>
<td>-</td>
<td>4,000</td>
</tr>
<tr>
<td>Dil</td>
<td>43,000</td>
<td>16,000</td>
<td>59,000</td>
</tr>
<tr>
<td>Combined</td>
<td>60,000</td>
<td>23,000</td>
<td>83,000</td>
</tr>
<tr>
<td>Elimination</td>
<td>-</td>
<td>(23,000)</td>
<td>(23,000)</td>
</tr>
<tr>
<td>Consolidated</td>
<td><strong>$60,000</strong></td>
<td>-</td>
<td><strong>$60,000</strong></td>
</tr>
</tbody>
</table>

In conformity with the revenue test, Timm's reportable segments were:

a. Only Dil.
b. Only Bix and Dil.
c. Only Alo, Bix, and Dil.
d. Alo, Bix, Cee, and Dil.