Chapter 4: Statement of Income and Retained Earnings

Learning Objectives
1. Identify the uses and limitations of an income statement.
2. Prepare a single-step income statement.
3. Prepare a multiple-step income statement.
4. Explain how irregular items are reported.
5. Explain intraperiod tax allocation.
6. Explain where earnings per share information is reported.
7. Prepare a statement of retained earnings.
8. Explain how other comprehensive income is reported.

Income Statement Basics
- What is an income statement?
  - Tells what happened;
  - For a STATED PERIOD;
  - Another way to think of it is "retained earnings for this period"
- Transaction based.
  - Something has to actually HAPPEN first
  - Can only purchase goodwill. But do you think that Maybe GM, Xerox, Palm, etc...names have value?
- Important Fact: Inherently relies upon estimates.
  - Valuation of receivables and inventories;
  - Goodwill valuation
  - Completeness of reported impairments
- Quality of earnings

Elements of the Income Statement

NOTE: See textbook for formal definition, which is within the scope of exam possibilities!

Revenue:
Inflow from the entities principal operations.

Expenses:
Costs of earning the revenue.

Gains & Losses:
Other income activities which are not from principal operations and which are presented "net" on the income statement.
**Income Statement Formats**

**Single-Step**
- Concise and simple
- Captions for (1) revenues (2) expenses
- Less detail, consequently less informative

**Multiple-Step**
- More complex, more substantial
- Captions to segregate operating activities from non-operating activities
- More detail, consequently more informative
- Separates operating from non-operating
- Matches costs to revenue generating activities

---

**Examples of Single-Step & Multiple-Step**

KWIC Single step.htm

KWIC multiple step.htm

---

**IRREGULAR ITEMS**

In an attempt to provide financial statement users with the ability to better determine the long-range earning power of an enterprise, certain professional pronouncements require that the following irregular items be highlighted in the income statement.

- Unusual gains and losses, NOT net of tax
- Extraordinary items, Net of tax
- Discontinued Operations, Net of tax

**CHANGES IN ACCOUNTING PRINCIPLE ARE TREATED WITH RETROACTIVE RESTATEMENT OF PRIOR FINANCIAL STATEMENTS.**

**ALL BUT UNUSUAL GAINS AND LOSSES ARE PRESENTED NET OF TAX.**

---

**Unusual Gains & Losses**

Items that are:
- EITHER Unusual or Infrequent, but not both (which is an extraordinary item);
- Material
- Non-Operating

Presentation:
- Separate line-item on income statement
- NOT net of tax
- Not necessarily "special" - can be lumped with other non-operating items such as interest expense.

**EXAMPLES:**

KWIC multiple step.htm
FANCY TERM FOR "NET OF TAX"
Certain items, which we are about to cover, are given specific attention in the income statement. These items, are excluded from the "tax provision" and presented net of tax themselves.

A Company has a 40% tax rate, and an extraordinary loss of $100,000:
- The tax impact is? $40,000
- So the "net of tax" amount is? $60,000

AND THE PRESENTATION IS:
Extraordinary loss, net of $40,000
Tax benefit $60,000

SFAS No. 144 substantially increases the occurrence of discontinued operations in financial reporting by requiring that the operations and gain/loss on disposal of all long-lived assets be reported "for all periods presented" as a discontinued operation.

A Company has a 40% tax rate, and an extraordinary loss of $100,000:
- The tax impact is? $40,000
- So the "net of tax" amount is? $60,000

AND THE PRESENTATION IS:
Extraordinary loss, net of $40,000
Tax benefit $60,000

SFAS No. 144 substantially increases the occurrence of discontinued operations in financial reporting by requiring that the operations and gain/loss on disposal of all long-lived assets be reported "for all periods presented" as a discontinued operation.

A company sells a rental property during the year which generated operating income of $100,000 for the year until it was sold for a $200,000 loss.
- Is this an “operating” item? NO
- Is this presented net of tax? YES
- How would it appear?
Discontinued Operation Presentation

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations</td>
<td>$500,000</td>
</tr>
<tr>
<td>Discontinued operations:</td>
<td></td>
</tr>
<tr>
<td>Income from operation of disc. operation, net of tax provision of $10,000</td>
<td>$70,000</td>
</tr>
<tr>
<td>Loss from sale of disc. Operation, net of tax benefit of $90,000</td>
<td>$(140,000)</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$430,000</td>
</tr>
</tbody>
</table>

Extraordinary Items

Requirements consider two criteria:
- Unusual in nature and
- Infrequent in occurrence, ........

Consider the environment

Are these Extraordinary Items?

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

Yes

Are these Extraordinary Items?

A citrus grower's Florida crop is damaged by frost. Frost damage is normally experienced every three or four years.

No
A large diversified company sells a block of shares from its portfolio of securities which it has acquired for investment purposes. This is the first sale from its portfolio of securities.

No

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

Yes

The Newhall Land & Farming Company (Developer of the town of Valencia) incurred $3.7 million in earthquake damage due to the 1994 Northridge earthquake. The Company experienced earthquake damage from the Sylmar earthquake in the 1970's.

No

NLF ex item.txt
Extraordinary Item Reminders

- If an item is not unusual and infrequent and material, it is disclosed in "Other Revenues and Expenses" section of the income statement.
- Extraordinary items are presented net of tax in the income statement, below discontinued operations.

Change in accounting principle - RETROACTIVE RESTATEMENT

- Calculate the cumulative effect of the accounting change as of the beginning of the period in which the change is made. "Fix" the ending balances by adjustment to retained earnings.
- Adjust the Account for under new method for all years presented.
- Continue accounting for under the new method.

Cumulative effect of accounting change

<table>
<thead>
<tr>
<th>Year</th>
<th>Adjusted (FFAS)</th>
<th>2006 and WW Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>15,300</td>
<td>15,300</td>
</tr>
<tr>
<td>2004</td>
<td>15,300</td>
<td>15,300</td>
</tr>
<tr>
<td>2005</td>
<td>15,300</td>
<td>15,300</td>
</tr>
<tr>
<td>2006</td>
<td>15,300</td>
<td>15,300</td>
</tr>
<tr>
<td>2007</td>
<td>15,300</td>
<td>15,300</td>
</tr>
</tbody>
</table>

Cumulative effect: 81,900

TOTAL THROUGH: 81,900

Adjustments that result from periodic revisions in estimates. THEY ARE TREATED ON A "CURRENT AND FORWARD BASIS." Meaning that you account for it from the beginning of this period forward based on the new estimate.

Examples:
- Bad debt expense;
- Asset impairments;
- Depreciable lives or residual values;
- Contingent losses;
- MANY MANY OTHERS
Required for each year income statement is presented:

- Capital Structure:
  - Simple
  - Complex (diluted)

- Calculation:
  Net Income - Preferred Dividends
  Weighted Average Common Shares Outstanding
Earnings per Share (EPS) required for:

- Income from continuing operations
- Income before extraordinary items
- Net income

Recommended for:
- Discontinued operations
- Extraordinary items

EPS Example

- If net income is $5,000,000 for the year and the weighted average shares outstanding are 10,000,000 shares, what is the net income per share?
  
  \$0.50

- If there was a $500,000 loss (net of tax), due to an extraordinary item, would this be presented as a “per share” amount?
  
  Yes

- How much per share?
  
  \$<.05>

If net income is $5,000,000 for the year and the weighted average shares outstanding are 10,000,000 shares, what is the net income per share?

\$0.50

If there was a $500,000 loss (net of tax), due to an extraordinary item, would this be presented as a “per share” amount?

Yes

How much per share?

\$<.05>

HANDOUT

..\Handouts\CH 4 SUMMARY.xlsx
Before issuing the report for the year ended December 31, 1999, you discover an error that caused the 1998 inventory to be overstated (overstated inventory caused COGS to be lower and thus net income to be higher in 1998). Would this discovery have any impact on the reporting of the Statement of Retained Earnings for 1999?

Turgeon Corporation had retained earnings of $529,000 at January 1, 1999. Net income in 1999 was $1,496,000, and cash dividends of $650,000 were declared and paid. Prepare a 1999 retained earnings statement for Turgeon Corporation.

Also, prepare a retained earnings statement for Turgeon Corporation, assuming that in 1999 Turgeon discovered that it had overstated 1997 depreciation by $125,000 (net of tax).
## Retained Earnings Example

<table>
<thead>
<tr>
<th>Turgeon Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of Retained Earnings</td>
</tr>
<tr>
<td>For the Year Ended December 31, 1999</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, Jan. 1, as reported</td>
<td>$529,000</td>
</tr>
<tr>
<td>Correction of error, net of tax</td>
<td>125,000</td>
</tr>
<tr>
<td>Balance, Jan. 1, as restated</td>
<td>654,000</td>
</tr>
<tr>
<td>Net income</td>
<td>1,496,000</td>
</tr>
<tr>
<td>Dividends declared</td>
<td>650,000</td>
</tr>
<tr>
<td>Balance, Dec. 31</td>
<td>$1,500,000</td>
</tr>
</tbody>
</table>

### Investments/ FAS 115

- **Held to maturity**
  - Current or long-term, depending on maturity;
  - Reported at cost.

- **Trading**
  - Always current;
  - Reported at fair value with gains and losses flowing through the income statement.

- **Available for sale**
  - Current or long-term, depending on circumstances/management intent;
  - Reported at fair value with gains and losses flowing through “other comprehensive income”.

---

### FAS 115 Illustrated

**Purchase Investment for $100,000**

- Entry to record purchase is the same for all three methods:
  - Investments: 100,000
  - Cash: 100,000

**Unrealized Loss of $10K**

- Held to Maturity: No entry
- Trading: No entry

**Trading: Unrealized Loss (P&L)**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized loss</td>
<td>10,000</td>
</tr>
<tr>
<td>Investment</td>
<td>10,000</td>
</tr>
</tbody>
</table>

**Available for Sale: Assuming Tax-Free Entity**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other comprehensive loss</td>
<td>10,000</td>
</tr>
<tr>
<td>Investment</td>
<td>10,000</td>
</tr>
</tbody>
</table>

---

### Dividends

- All three methods report dividends received as a source of income:

**AFS or Trading or Held to Maturity**

- If receive $1,250 dividend, entry is:
  - Cash: $1,250
  - Dividend income: 1,250
All changes in equity during a period except those resulting from investments by owners and distributions to owners. Therefore, includes all revenues and gains, expenses and losses reported in net income, and in addition it includes gains and losses that bypass net income but affect stockholders' equity.

Three approaches to reporting Comprehensive Income (SFAS No. 130, June 1997):
1. A second separate income statement;
2. A combined income statement of comprehensive income;
or
3. As part of the statement of stockholders' equity.

Option 3 above is most common and not allowed after 2012.
Rolls-forward the balance of each of the equity accounts from their opening balance to their ending balance based on current period activity.

Account titles on top row, activity below that.

**EQUITY STATEMENT EXAMPLE**

**BEGINNING EQUITY BALANCES**
- Retained earnings: 100,000
- Accumulated Other Comprehensive Income: 15,000
- Common Stock $1 par: 1,000
- APIC: 96,000
- TOTAL EQUITY: 215,000

**ACTIVITY**
1. Change in accounting principle: COGS in prior periods would be $20,000 less under the new principle than what was recorded (inventory on the balance sheet would be $20,000 higher than it is)
2. Restatement: In a prior period a sale on credit of $10,000 was erroneously
3. Net income: $50,000
4. Available for sale securities increased in value by $5,000
5. Sold 1,000 shares for $10,000
6. Dividends: $25,000
   tax rate is 35%

**INSTRUCTIONS:**
1. For items 1, 2, 4, 5, and 6 above, report the appropriate journal entry
2. Based upon all of the above, prepare the combined statement of stockholders equity and comprehensive income.
XYZ HAD THE FOLLOWING INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2003

Revenue 3,000,000
Cost of goods sold 900,000
Gross Profit 2,100,000

Operating expenses
Selling expense 250,000
General & administrative expense 175,000
Depreciation expense 200,000
For convenience, net operations of sold property 100,000

725,000

Income before income taxes 1,275,000
Income tax provision 412,500
NET INCOME 862,500

Prepare a multiple-step income statement and statement of stockholders equity (including comprehensive income) for XYZ based on the facts on this slide and the previous slide.
### SOLUTION: STATEMENT OF EQUITY

#### XYZ, Inc.

STATEMENT OF CHANGES IN EQUITY AND COMPREHENSIVE INCOME
FOR THE YEAR ENDED DECEMBER 31, 2019

<table>
<thead>
<tr>
<th>Comprehendable</th>
<th>Restricted</th>
<th>Other comp.</th>
<th>Accumulated</th>
<th>Income</th>
<th>Loss</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>Retained</td>
<td>Earnings</td>
<td>Other</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance, January 1, 2019, as previously reported</td>
<td>$40,000</td>
<td>$60,000</td>
<td></td>
<td>$100,000</td>
<td>$100,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Compensation related to stock option</td>
<td>$10,000</td>
<td>$20,000</td>
<td></td>
<td>$30,000</td>
<td>$30,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Translation adjustment under accounting principle</td>
<td>$20,000</td>
<td>$40,000</td>
<td></td>
<td>$60,000</td>
<td>$60,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>Balance, January 1, 2020, as restated</td>
<td>$80,000</td>
<td>$120,000</td>
<td>$20,000</td>
<td>$180,000</td>
<td>$180,000</td>
<td>$360,000</td>
</tr>
</tbody>
</table>

Comprehensive income:
- Net loss: $240,000
- Other comprehensive income: $70,000

Comprehensive income: $210,000

Ending balance: $210,000