# Objectives of Financial Reporting

Financial statements are designed to meet the objectives of financial reporting:

| | | |
|---|---|---|
| Balance Sheet | Direct Information | Financial Position |
| Statement of Earnings and Comprehensive Income | Direct Information | Entity Performance |
| Statement of Cash Flows | Direct Information | Entity Cash Flows |
| Financial Statements Taken As a Whole | Indirect Information | Management & Performance |

# Qualitative Characteristics of Accounting Information

| | | |
|---|---|---|
| | Usefulness | |
| Primary Qualitative Characteristics | <u>Relevance</u> | <u>Reliability</u> |
| Ingredients | Predictive value | Representational faithfulness |
| | Feedback value | Verifiability |
| | Timeliness | Neutrality |
| Secondary Qualitative Characteristics | Consistency & Comparability | |

# Elements of Financial Statements

Assets – Liabilities = Equity

Equity = Contributions by owners – Distributions to owners = Comprehensive Income

Comprehensive Income = Revenues – Expenses + Gains – Losses

Comprehensive Income = Net income ± Adjustments to stockholders' equity

# Basic Rules & Concepts

**C**onsistency

**R**ealization

**C**onservatism

**R**ecognition

**A**llocation

**M**atching

**Full** disclosure

*You'll get more credit (**CR**) if you **CRAM** your essays **FULL** of these rules and concepts*

## Revenue Recognition

| | |
|---|---|
| Accrual method | Collection reasonably assured<br>Degree of uncollectibility estimable |
| Installment sale | Collection not reasonably assured |
| Cost recovery | Collection not reasonably assured<br>No basis for determining whether or not collectible |

## Installment Sales Method

| | |
|---|---|
| Installment receivable balance | Cash collections |
| × Gross profit percentage | × Gross profit percentage |
| = Deferred gross profit (balance sheet) | = Realized gross profit (income statement) |

## Cost Recovery Method

All collections applied to cost before any profit or interest income is recognized

# Converting from Cash Basis to Accrual Basis

## Revenues

| | | |
|---|---|---|
| Cash (amount received) | xx | |
| Increase in accounts receivable (given) | xx | |
| Decrease in accounts receivable (given) | | xx |
| **Revenues** (plug) | | xx |

## Cost of Sales

| | | |
|---|---|---|
| Cost of sales (plug) | xx | |
| Increase in inventory (given) | xx | |
| Decrease in accounts payable (given) | xx | |
| Decrease in inventory (given) | | xx |
| Increase in accounts payable (given) | | xx |
| Cash (payments for merchandise) | | xx |

## Expenses

| | | |
|---|---|---|
| Expense (plug) | xx | |
| Increase in prepaid expenses (given) | xx | |
| Decrease in accrued expenses (given) | xx | |
| Decrease in prepaid expenses (given) | | xx |
| Increase in accrued expenses (given) | | xx |
| Cash (amount paid for expense) | | xx |

# Balance Sheet

| | |
|---|---|
| **Current Assets** | **Current Liabilities** |
| Cash | Short-term debt |
| Trading securities | Accounts payable |
| Current securities available for sale | Accrued expenses |
| Accounts receivable | Current income taxes payable |
| Inventories | Current deferred tax liability |
| Prepaid expenses | Current portion of long-term debt |
| Current deferred tax asset | Unearned revenues |
| **Long-Term Investments** | **Long-Term Debt** |
| Noncurrent securities available for sale | Long-term notes payable |
| Securities held to maturity | Bonds payable |
| Investments at cost or equity | Noncurrent deferred tax liability |
| **Property, Plant, & Equipment** | **Stockholders' Equity** |
| **Intangibles** | Preferred stock |
| **Other Assets** | Common stock |
| Deposits | Additional paid-in capital |
| Deferred charges | Retained earnings |
| Noncurrent deferred tax asset | Accumulated other comprehensive income |

# Current Assets & Liabilities

**Assets**

- Economic resource
- Future benefit
- Control of company
- Past event or transaction

**Current Assets**

- Converted into cash or used up
- Longer of:
  - One year
  - One accounting cycle

**Liabilities**

- Economic obligation
- Future sacrifice
- Beyond control of company
- Past event or transaction

**Current Liabilities**

- Paid or settled
- Longer of:
  - One year
  - One accounting cycle

**OR** Requires use of current assets

# Special Disclosures

## Significant Accounting Policies

Inventory method

Depreciation method

Criteria for classifying investments

Method of accounting for long-term construction contracts

## Related-Party Transactions

Exceptions:

- Salary
- Expense reimbursements
- Ordinary transactions

# Reporting the Results of Operations

## Preparing an Income Statement

*Multiple step*

Revenues
– Cost of sales
= Gross profit
– Operating expenses
    Selling expenses
    G & A expenses
= Operating income
+ Other income
+ Gains
– Other expenses
– Losses
= Income before taxes
– Income tax expense
= Income from continuing operations

*Single step*

Revenues
+ Other income
+ Gains
= Total revenues
– Costs and expenses
    Cost of sales
    Selling expenses
    G & A expenses
    Other expenses
    Losses
    Income tax expense
= Income from continuing operations

## *Computing Net Income*

Income from continuing operations (either approach)

± **D**iscontinued operations

± **E**xtraordinary items

= Net income

(Cumulative changes section was eliminated by SFAS 154)

## *Errors Affecting Income*

| Error (ending balance) | Current stmt | Prior stmt |
| --- | --- | --- |
| Asset overstated | Overstated | No effect |
| Asset understated | Understated | No effect |
| Liability overstated | Understated | No effect |
| Liability understated | Overstated | No effect |
| Error (beginning balance – ending balance is correct) | | |
| Asset overstated | Understated | Overstated |
| Asset understated | Overstated | Understated |
| Liability overstated | Overstated | Understated |
| Liability understated | Understated | Overstated |

## ***Errors Affecting Income (continued)***

| | | |
|---|---|---|
| <u>Error (beginning balance – ending balance is not correct)</u> | | |
| Asset overstated | No effect | Overstated |
| Asset understated | No effect | Understated |
| Liability overstated | No effect | Understated |
| Liability understated | No effect | Overstated |

## Extraordinary Items

Classification as extraordinary – 2 requirements (both must apply)

- Unusual in nature
- Infrequent of occurrence

One or neither applies – component of income from continuing operations

### *Extraordinary*

Negative goodwill on consolidation resulted from purchase (always)

Acts of nature (usually)

### *Not Extraordinary*

Gains or losses on sales of investments or prop, plant, & equip

Gains or losses due to changes in foreign currency exchange rates

Write-offs of inventory or receivables

Effects of major strikes or changes in value of investments

## Change in Accounting Principle

Use **retrospective application** of new principle:

1) Calculate revised balance of asset or liability as of beginning of period as if new principle had always been in use.
2) Compare balance to amount reported under old method.
3) Multiply difference by 100% minus tax rate.
4) Result is treated on books as prior period adjustment to beginning retained earnings.
5) All previous periods being presented in comparative statements restated to new principle.
6) Beginning balance of earliest presented statement of retained earnings adjusted for all effects going back before that date.

## Change in Accounting Principle (continued)

Journal entry:

| | | |
|---|---|---|
| Asset or liability | xxx | |
| Retained earnings | | xxx |
| Current or deferred tax liability (asset) | | xxx |

**Or**

| | | |
|---|---|---|
| Retained earnings | xxx | |
| Current or deferred tax liability (asset) | xxx | |
| Asset or liability | | xxx |

## ***Special Changes***

Changes in accounting principle are handled using the **prospective** method under limited circumstances. No calculation is made of prior period effects and the new principle is simply applied starting at the beginning of the current year when the following changes in principle occur:

- Changes in the method of depreciation, amortization, or depletion
- Changes whose effect on prior periods is impractical to determine (e.g. changes to LIFO when records don't allow computation of earlier LIFO cost bases)

(Note: the method of handling changes in accounting principle described here under SFAS 154 replaces earlier approaches, which applied the **cumulative method** to most changes in accounting principle. SFAS 154 abolished the use of the cumulative method.)

## Change in Estimate

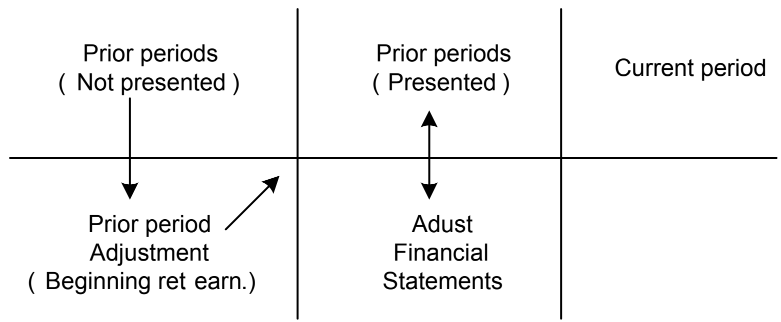
- No retrospective application
- Change applied as of beginning of current period
- Applied in current and future periods

## *Error Corrections*

Applies to:

- Change from unacceptable principle to acceptable principle
- Errors in prior period financial statements

When error occurred:



# Discontinued Operations

When components of a business are disposed of, their results are reported in discontinued operations:

- Component – An asset group whose activities can be distinguished from the remainder of the entity both operationally and for financial reporting purposes.
- Disposal – Either the assets have already been disposed of or they are being held for sale and the entity is actively searching for a buyer and believes a sale is probable at a price that can be reasonably estimated.

All activities related to the component are reported in discontinued operations, including those occurring prior to the commitment to dispose and in prior periods being presented for comparative purposes.

## Reporting Discontinued Operations

Lower section of the income statement:

- After income from continuing operations
- Before extraordinary items

Reported amount each year includes all activities related to the component from operations as well as gains and losses on disposal, net of income tax effects

- Expected gains and losses from operations in future periods are not reported until the future period in which they occur.

Impairment loss is included in the current period when the fair market value of the component is believed to be lower than carrying amount based on the anticipated sales price of the component in future period

## Reporting Comprehensive Income

Statement of Comprehensive Income required as one of financial statements

- May be part of Income statement
- May be separate statement
- Begin with net income
- Add or subtract items of other comprehensive income

Other comprehensive income includes:

- Current year's unrealized gains or losses on securities available for sale
- Current year's foreign currency translation adjustments
- Current year's unrealized gains or losses resulting from changes in market values of certain derivatives being used as cash flow hedges

# Accounting for Changing Prices

## Accounting at Current Cost

Assets & liabilities reported at current amounts

Income statement items adjusted to current amounts

- Inventory reported at replacement cost
- Cost of sales = Number of units sold × Average current cost of units during period
- Differences in inventory & cost of sales treated as holding gains or losses
- Depreciation & amortization – Computed using same method & life based on current cost

## Accounting for Changes in Price Level

Purchasing power gains & losses relate only to **monetary** items

- Monetary assets – money or claim to receive money such as cash & net receivables
- Monetary liabilities – obligations to pay specific amounts of money

Company may be monetary creditor or debtor

- Monetary creditor – monetary assets > monetary liabilities
- Monetary debtor – monetary liabilities > monetary assets

In periods of rising prices

- Monetary creditor will experience purchasing power loss
- Monetary debtor will experience purchasing power gain