CHAPTER 4

Income Statement and Related Information
ANSWERS TO QUESTIONS

1. The income statement is important because it provides investors and creditors with information that helps them predict the amount, timing, and uncertainty of future cash flows. It helps investors and creditors predict future cash flows in a number of different ways. First, investors and creditors can use the information on the income statement to evaluate the past performance of the company. Second, the income statement helps users of the financial statements to determine the risk (level of uncertainty) of income—revenues, expenses, gains, and losses—and highlights the relationship among these various components.

It should be emphasized that the income statement is used by parties other than investors and creditors. For example, customers can use the income statement to determine a company's ability to provide needed goods or services, unions examine earnings closely as a basis for salary discussions, and the government uses the income statements of companies as a basis for formulating tax and economic policy.

LO: 1, Bloom: K, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

2. Information on past transactions can be used to identify important trends that, if continued, provide information about future performance. If a reasonable correlation exists between past and future performance, predictions about future earnings and cash flows can be made. For example, a loan analyst can develop a prediction of future performance by estimating the rate of growth of past income over the past several periods and project this into the next period. Additional information about current economic and industry factors can be used to adjust the trend rate based on historical information.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

3. Some situations in which changes in value are not recorded in income are:
(a) Unrealized gains or losses on available-for-sale debt investments,
(b) Changes in the fair values of long-term liabilities, such as bonds payable,
(c) Changes (increases) in value of property, plant and equipment, such as land, natural resources, or equipment,
(d) Changes (increases) in the values of intangible assets such as customer goodwill, brand value, or intellectual capital.

Note that some of these omissions arise because the items (e.g., brand value) are not recognized in financial statements, while others (value of land) are recorded in financial statements but measurement is at historical cost.

LO: 7, Bloom: K, Difficulty: Moderate, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

4. Some situations in which application of different accounting methods or estimates lead to comparison problems include:
(a) Inventory methods—LIFO vs. FIFO,
(b) Depreciation Methods—straight-line vs. accelerated,
(c) Accounting for long-term contracts—percentage-of-completion vs. completed-contract,
(d) Estimates of useful lives or salvage values for depreciable assets,
(e) Estimates of bad debts,
(f) Estimates of warranty costs.

LO: 3, 4, Bloom: C, Difficulty: Moderate, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

5. The transaction approach focuses on the activities that have occurred during a given period and instead of presenting only a net change, a description of the components that comprise the change is included. In the capital maintenance approach, only the net change (income) is reflected whereas the transaction approach not only provides the net change (income) but the components of income (revenues and expenses, gains and losses). The final net income figure should be the same under either approach given the same valuation base.

LO: 2, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

6. Earnings management is often defined as the planned timing of revenues, expenses, gains and losses to smooth out bumps in earnings. In most cases, earnings management is used to increase income in the current year at the expense of income in future years. For example, companies prematurely recognize sales in order to boost earnings. Earnings management can also be used to decrease current earnings in order to increase income in the future. The classic case is the use of "cookie jar" reserves, which are established by using unrealistic assumptions to estimate liabilities for such items as loan losses, restructuring charges and warranty claims.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

7. Earnings management has a negative effect on the quality of earnings if it distorts the information in a way that is less useful for predicting future cash flows. Within the Conceptual Framework, useful information is both relevant and representationally faithful. However, earnings management reduces the reliability of income, because the income measure is biased (up or down) and/or the reported income is not representationally faithful to that which it is supposed to report (e.g., volatile earnings are made to look more smooth).

LO: 1, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

8. Caution should be exercised because many assumptions and estimates are made in accounting and the net income figure is a reflection of these assumptions. If for any reason the assumptions are not well-founded, distortions will appear in the income reported. The objectives of the application of generally accepted accounting principles to the income statement are to measure and report the results of operations as they occur for a specified period without recognizing any artificial exclusions or modifications.

LO: 2, 3, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

9. The term "quality of earnings" refers to the credibility of the earnings number reported. Companies that use aggressive accounting policies report higher income numbers in the short-run. In such cases, we say that the quality of earnings is low. Similarly, if higher expenses are recorded in the current period, in order to report higher income in the future, then the quality of earnings is also considered low.

LO: 1, Bloom: C, Difficulty: Moderate, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

10. The major distinction between revenues and gains (or expenses and losses) depends on the typical activities of the company. Revenues (expenses) can occur from a variety of different sources, but these sources constitute the entity's ongoing major or central operations. Gains (losses)also can arise from many different sources, but these sources occur from peripheral or incidental transactions of an entity.

LO: 2, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

11. The advantages of the single-step income statement are: (1) simplicity and conciseness, (2) probably better understood by the layperson, (3) emphasis on total costs and expenses, and net income, and (4) does not imply priority of one revenue or expense over another. The disadvantages are that it does not show the relationship between sales revenue and cost of goods sold and it does not show other important relationships and information, such as income from operations, income before income tax, etc.

LO: 3, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

12. Operating items are the expenses and revenues which relate directly to the principal activity of the company; they are the revenue and expenses which contribute to the sale of goods or services for which a company was organized. The nonoperating section of an income statement is a report of the revenues and expenses resulting from secondary or auxiliary activities of the company. In addition, gains and losses that are infrequent or unusual, or both, are normally reported in the section. Generally these breakdown into two main subsections: "Other revenues and gains" and "Other expenses and losses."

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

13. The current operating performance income statement contains only the revenues and usual expenses of the current year, with all unusual gains or losses or material corrections of prior periods' revenues and expenses appearing in the retained earnings statement. The modified all-inclusive income statement includes most items including irregular ones, as part of net income. The retained earnings statement then would include only the beginning balance (adjusted for the effects of errors and changes in accounting principle), the net amount transferred from income summary, dividends, and transfers to and from appropriated retained earnings.

GAAP requires a modified all-inclusive income statement, excluding from the income statement only those items, few in number, which meet the criteria for prior period adjustments and which would thus appear as adjustments to the beginning balance in the retained earnings statement. For example, changes in accounting principle are reported as adjustments to the beginning retained earnings balance.

LO: 3, 4, Bloom: K, Difficulty: Moderate, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

14. Items considered corrections of errors should be charged or credited to the opening balance of retained earnings.

LO: 5, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

15. (a) This transaction will be shown in the income statement in the "Other revenues and gains" section.

(b) The bonus should be shown as an operating expense in the income statement. Although the basis of computation is a percentage of net income, it is an ordinary operating expense to the company and represents a cost of the service received from employees.

(c) If the amount is immaterial, it may be combined with the depreciation expense for the year and included as a part of the depreciation expense appearing in the income statement. If the amount is material, it should be shown in the retained earnings statement as an adjustment to the beginning balance of retained earnings.

(d) This should be shown in the income statement. One treatment would be to show it in the statement as a deduction from the rent expense, as it reduces an operating expense and therefore is directly related to operations. Another treatment is to show it in the other revenues and gains section of the income statement.

(e) Assuming that a provision for the loss had not been made at the time the patent infringement suit was instituted, the loss should be recognized in the current period in computing net income. It should be reported as an unusual loss in the other expenses and losses section.

(f) This should be reported in the income statement in the operating section because it relates to usual business operations of the company.

LO: 5, Bloom: C, Difficulty: Simple, Time: 10-15, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

16. (a) The remaining book value of the equipment should be depreciated over the remainder of the five-year period. The additional depreciation ($425,000) is not a correction of an error and is not shown as an adjustment to retained earnings. The change is considered a change in estimate.

(b) The loss should be shown in the other expenses and losses section of the income statement.

(c) The write-off should be shown as other expenses and losses in the income statement.

(d) A correction of an error should be considered a prior period adjustment and the beginning balance of Retained Earnings should be restated, if material.

(e) The cumulative effect of the change is reported as an adjustment to beginning retained earnings. Prior years' statements are recast on a basis consistent with the new standard.

LO: 5, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

17. (a) Other expenses and losses section.

(b) Other expenses and losses section.

(c) Operating expense section, as a selling expense, but sometimes reflected as an administrative expense.

(d) Separate section after income from continuing operations, entitled discontinued operations.

(e) Other revenues and gains section or in a separate section, appropriately labeled as an unusual item, if unusual or infrequent.

(f) Other revenues and gains section.

(g) Operating expense section, normally administrative. If a manufacturing concern, may be included in cost of goods sold.

(h) Other expenses and losses section.

LO: 3, 4, Bloom: K, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

18. Perlman and Sheehan should not report the sales in a similar manner. This type of transaction appears to be typical of Perlman's central operations. Therefore, Perlman should report revenues of $160,000 and expenses of $100,000 ($70,000 + $30,000). However, Sheehan's transaction appears to be a peripheral or incidental activity not related to its central operations. Thus, Sheehan should report a gain of $60,000 ($160,000 – $100,000). Note that although the classification is different, the effect on net income is the same ($60,000 increase).

LO: 3, 4, Bloom: C, Difficulty: Moderate, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

19. You should tell Greg that a company's reported net income is the same whether the single-step or multiple-step format is used. Either way, the company has the same revenues, gains, expenses, and losses; they are simply organized in a different format.

LO: 3, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

20. Both formats are acceptable. The amount of detail reported in the income statement is left to the judgment of the company whose goal in making this decision should be to present financial statements which are most useful to decision makers. We want to present a simple, understandable statement so that a reader can easily discover the facts of importance; therefore, a single amount for selling expenses might be preferable. However, we also want to fully disclose the results of all activities; thus, a separate listing of expenses may be preferred. Note that if the condensed version is used, it should be accompanied by a supporting schedule of the eight components in the notes to the financial statements.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

21. Intraperiod tax allocation should not affect the reporting of an unusual gain. The FASB specifically prohibits a "net-of-tax" treatment for such items to ensure that users of financial statements can easily differentiate items that are unusual or infrequent. "Net-of-tax" treatment is reserved for discontinued operations, prior period adjustments, and other comprehensive income.

LO: 4, Bloom: K, Difficulty: Complex, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

22. (a) A loss on discontinued operations is reported net of tax in the income statement between income from continuing operations and net income.
(b) Noncontrolling interest allocation is reported in the income statement after the net income.
(c) Earnings per share is shown in the income statement after the noncontrolling interest allocation.
(d) A gain on sale of equipment is shown under other revenues and gains in the income statement.

LO: 4, Bloom: K, Difficulty: Moderate, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

23. Lebron presents the income information as follows:

Net income	$ 124,700
Less: Net income attributed to the noncontrolling interest	30,000
Net income attributable to Lebron Company	$ 94,700

LO: 4, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

24. Intraperiod tax allocation has no effect on reported net income, although it does affect the amounts reported for various components of income. The effects on these components offset each other so net income remains the same. Intraperiod tax allocation merely takes the total income tax expense and allocates it to the various items which affect the tax amount.

LO: 4, Bloom: K, Difficulty: Moderate, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

25. If Neumann has preferred stock outstanding, the numerator in its computation may be incorrect. A better description of "earnings per share" is "earnings per **common** share." The numerator should include only the earnings available to common shareholders. Therefore, the numerator should be net income less preferred dividends.

The denominator is also incorrect if Neumann had any common stock transactions during the year. Since the numerator represents the results for the entire year, the denominator should reflect the weighted-average number of common shares outstanding during the year, not the shares outstanding at one point in time (year-end).

LO: 4, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

26. The earnings per share trend is not favorable. Discontinued items are often one-time occurrences which are not expected to be reported in the future. Therefore, earnings per share on income from continuing operations is more useful because it represents the results of ordinary business activity. Considering this EPS amount, EPS has decreased from $7.21 to $6.40.

LO: 4, Bloom: AN, Difficulty: Simple, Time: 3-5, Analysis, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

27. Tax allocation within a period is the practice of allocating the income tax for a period to such items as income from continuing operations, discontinued items, and prior period adjustments.

The justification for tax allocation within a period is to produce financial statements which disclose an appropriate relationship, for example, between income tax expense and (a) income before from continuing operations, (b) discontinued operations, and (c) prior period adjustments (or of the opening balance of retained earnings).

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

28. Tax allocation within a period (intraperiod) becomes necessary when a firm encounters such items as discontinued operations, or corrections of errors. Such allocation is necessary to bring about an appropriate relationship between income tax expense and income from continuing operations and discontinued operations.

Tax allocation within a period is handled by first computing the tax expense attributable to income before discontinued operations. This is computed by ascertaining the income tax expense related to revenue and expense transactions entering into the determination of such income. Next, the remaining income tax expense attributable to other items is determined by the tax consequences of transactions involving these items. The applicable tax effect of these items should be disclosed separately because of their materiality.

LO: 4, Bloom: K, Difficulty: Moderate, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

29.

LISELOTTE COMPANY
Partial Income Statement
For the Year Ended December 31, 2020

Income before income tax		$1,500,000
Income tax ($1,500,000 x 34%)		510,000
Income continuing operations		990,000
Discontinued operations—gain on disposal of assets	$450,000	
Less: Applicable income tax ($450,000 x 30%)	135,000	315,000
Net income		$1,305,000

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

30. The damages are reported in Frazier Corporation's financial statements in the other expenses and losses section. The damages would not be reported as a correction of an error (prior period adjustment).

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

31. No, these sales would not be reported as discontinued operations after income from continuing operations. A discontinued operation occurs when two things happen: (1) A company eliminates the results of operations of a component or group of components of the business. A component comprises operations and cash flows that can be clearly distinguished operationally and for financial reporting purposes. (2) The elimination represents a strategic shift, having a major effect on the company's operations and financial results.

LO: 4, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

32. The major items reported in the retained earnings statement are: (1) adjustments of the beginning balance for corrections of errors or changes in accounting principle, (2) the net income or loss for the period, (3) dividends for the year, and (4) restrictions (appropriations) of retained earnings. It should be noted that the retained earnings statement is sometimes composed of two parts, unappropriated and appropriated.

LO: 6, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

33. Generally accepted accounting principles are ordinarily concerned only with a "fair presentation" of business income. In contrast, taxable income is a statutory concept which defines the base for raising tax revenues by the government, and any method of accounting which meets the statutory definition will "clearly reflect" taxable income as defined by the Internal Revenue Code. It should be noted that the Code prohibits use of the cash receipts and disbursements method as a method which will clearly reflect income in accounting for purchases and sales if inventories are involved.

The cash receipts and disbursements method will not usually fairly present income because:
(1) The completed transaction, not receipt or disbursement of cash, increases or diminishes income. Thus, a sale on account produces revenue and increases income, and the incurrence of expense reduces income without regard to the time of payment of cash.
(2) The expense recognition principle generally results in costs being matched against related revenues produced. In most situations the cash receipts and disbursements method will violate this principle.
(3) Consistency requires that accountable events receive the same accounting treatment from accounting period to accounting period. The cash receipts and disbursements method permits manipulation of the timing of revenues and expenses and may result in treatments which are not consistent, detracting from the usefulness of comparative statements.

LO: 4, Bloom: K, Difficulty: Moderate, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

34. From the revenue side, there are many types of revenue transactions which require estimation. For example, it is difficult to estimate the amount of revenue to recognize for a long-term contract in a given period. Other estimation situations also prevalent such as high rates of return on products sold, net versus gross sales issues, sales with buyback options, estimating revenues in licensing arrangements and so on. During a single fiscal period it often is difficult to determine the expiration of certain costs which may benefit several periods. Business is continuous and estimates have to be made of the future if we are to systematically apportion costs to fiscal periods. Examples of items which present serious obstacles include such items as institutional advertising costs.

Accountants have established certain rules for handling revenues and costs which are applied consistently and in a systematic manner. From period to period, application of these rules generally results in a satisfactory matching of costs and revenues unless there are large changes from one period to another. These rules, influenced by conservatism in the face of the uncertainties involved, tend to charge costs to expense earlier than might be ideally desirable if we had more knowledge of the future.

Costs or expenses of the types mentioned above, by their very nature, defy any attempt to relate them to revenues of a specific period or periods. Although it is known that advertising will yield benefits beyond the present, both the amount of such benefits and when they will be enjoyed are shrouded in uncertainty. The degree of certainty with which their time distribution can be forecast is so small and the results, therefore, so unreliable that the accountant writes them off as applicable to the period or periods in which the expense was incurred.

LO: 7, Bloom: C, Difficulty: Moderate, Time: 5-10, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

35. Elements are the basic ingredients which comprise the income statement; that is, revenues, gains, expenses, and losses. Items are descriptions of the elements such as rent revenue, rent expense, etc.

In order to predict the future, the amounts of individual items may have to be reported. For example, if "income from continuing operations" is significantly lower this year and is reported as a single amount, users would not know whether to attribute the decrease to a temporary increase in an expense item (for example, an unusually large bad debt), a structural change (for example, a change in the relationship between variable and fixed expenses), or some other factor. Another example is income data that are distorted because of large discretionary expenses.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

36. Other comprehensive income must be displayed (reported) in one of two ways: (1) a single continuous income statement (one statement approach) or (2) two separate but consecutive statements of net income and other comprehensive income (two statement approach).

LO: 7, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

37. The results of continuing operations should be reported separately from discontinued operations, and any gain or loss from disposal of a component of a business should be reported with the related results of discontinued operations. The following format illustrates the proper disclosure:

Income from continuing operations before income tax		$XXX
Income tax		XXX
Income from continuing operations		XXX
Discontinued operations		
Income (loss) from operations of discontinued Division X, less applicable income tax of $--..............................	XXX	
Gain (loss) on disposal of Division X less applicable income tax of $–		XXX
Net income		$XXX

LO: 3, 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 4.1

STARR CO.
Income Statement
For the Year 2020

Revenues		
Sales revenue		$540,000
Expenses		
Cost of goods sold	$330,000	
Salaries and wages expense	120,000	
Other operating expenses	10,000	
Income tax expense	25,000	
Total expenses		485,000
Net income		$ 55,000
Earnings per share		$0.55*

*$55,000 ÷ 100,000 shares.

Note: The increase in value of the company reputation and the unrealized gain on the value of patents are not reported.

LO: 3, Bloom: AP, Difficulty: Simple, Time: 5-7, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

BRIEF EXERCISE 4.2

BRISKY CORPORATION
Income Statement
For the Year Ended December 31, 2020

Revenues		
Net sales		$2,400,000
Interest revenue		31,000
Total revenues		2,431,000
Expenses		
Cost of goods sold	$1,450,000	
Selling expenses	280,000	
Administrative expenses	212,000	
Interest expense	45,000	
Income tax expense*	133,200	
Total expenses		2,120,200
Net income		$ 310,800
Earnings per share**		$4.44

*($2,431,000 – $1,450,000 – $280,000 – $212,000 – $45,000) X 30% = $133,200.

**$310,800 ÷ 70,000 shares.

LO: 3, Bloom: AP, Difficulty: Simple, Time: 5-7, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

BRIEF EXERCISE 4.3

BRISKY CORPORATION
Income Statement
For the Year Ended December 31, 2020

Net sales		$2,400,000
Cost of goods sold		1,450,000
Gross profit		950,000
Selling expenses	$280,000	
Administrative expenses	212,000	492,000
Income from operations		458,000
Other revenue and gains		
Interest revenue	$31,000	
Other expenses and losses		
Interest expense	45,000	14,000
Income before income tax		444,000
Income tax expense ($444,000 x 30%)		133,200
Net income		$ 310,800
Earnings per share		$4.44*

*$310,800 ÷ 70,000 shares.

LO: 3, Bloom: AP, Difficulty: Simple, Time: 5-7, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

BRIEF EXERCISE 4.4

Income from continuing operations		$10,600,000
Discontinued operations		
Loss from operation of discontinued restaurant division net of tax	$315,000	
Loss from disposal of restaurant division net of tax	189,000	504,000
Net income		$10,096,000
Earnings per share		
Income from continuing operations		$1.06*
Discontinued operations, net of tax		(0.05)**
Net income		$1.01

*$10,600,000 ÷ 10,000,000 shares **$504,000 ÷ 10,000,000 shares

LO: 2, 3, 4, Bloom: AP, Difficulty: Simple, Time: 5-7, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

BRIEF EXERCISE 4.5

Income from operations		$7,200,000
Other Revenues and Gains		
Interest revenue		17,000
		7,217,000
Other Expenses and Losses		
Loss due to volcano eruption	770,000	
Impairment loss - building	53,000	823,000
Income before income tax		6,394,000
Income tax ($6,394,000 X .30)........................		1,918,200
Net income		$4,475,800
Per share of common stock:		
Net income ($4,475,800 ÷ 5,000,000).................		$ .90

*Rounded

LO: 2, 3, 4, Bloom: AP, Difficulty: Simple, Time: 5-7, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

BRIEF EXERCISE 4.6

	2020	2019	2018
Income before income tax	$180,000	$145,000	$170,000
Income tax (30%)	54,000	43,500	51,000
Net Income	$126,000	$101,500	$119,000

Note: The company must report income under the weighted average method for all three years.

LO: 5, Bloom: AP, Difficulty: Simple, Time: 5-7, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

BRIEF EXERCISE 4.7

Vandross would not report any cumulative effect because a change in estimate is not handled retrospectively. Vandross would report bad debt expense of $120,000 in 2020.

LO: 5, Bloom: AP, Difficulty: Simple, Time: 3-5, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

BRIEF EXERCISE 4.8

$$\frac{\$1{,}000{,}000 - \$250{,}000}{190{,}000} = \underline{\underline{\$3.95}} \text{ per share}$$

LO: 4, Bloom: AP, Difficulty: Simple, Time: 3-5, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

BRIEF EXERCISE 4.9

PORTMAN CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2020

Retained earnings, January 1	$ 675,000
Add: Net income	1,400,000
Less: Cash dividends	75,000
Retained earnings, December 31	$2,000,000

LO: 6, Bloom: AP, Difficulty: Simple, Time: 3-5, AACSB: Analytic, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

BRIEF EXERCISE 4.10

PORTMAN CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2020

Retained earnings, January 1, as reported	$ 675,000
Correction for overstatement of expenses in prior period (net of tax)	80,000
Retained earnings, January 1, as adjusted	755,000
Add: Net income	1,400,000
	2,155,000
Less: Cash dividends	75,000
Retained earnings, December 31	$2,080,000

LO: 5, 6, Bloom: AP, Difficulty: Simple, Time: 3-5, AACSB: Analytic, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

BRIEF EXERCISE 4.11

(a)	**Net income (Interest revenue)...............................**	**$3,000**
(b)	**Net income ....**	**$3,000**
	Unrealized holding gain (net of tax).....................	**4,000**
	Comprehensive income.......................................	**$7,000**
(c)	**Unrealized holding gain (net of tax)**	
	Other comprehensive income..............................	**$4,000**
(d)	**Accumulated other comprehensive income,**	
	January 1, 2020	**$ 0**
	Unrealized holding gain (net of tax).....................	**4,000**
	Accumulated other comprehensive income,	
	December 31, 2020...	**$4,000**

LO: 7, Bloom: AP, Difficulty: Moderate, Time: 5-7, AACSB: Analytic, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

SOLUTIONS TO EXERCISES

EXERCISE 4.1 (18–20 minutes)

Computation of net income

Change in assets	**\$204,000**	**Increase (a)**
Change in liabilities	**31,000**	**Increase (b)**
Change in stockholders' equity	**\$173,000**	**Increase**

(a) \$79,000 + \$45,000 + \$127,000 – \$47,000
(b) \$ 82,000 – \$51,000

Change in stockholders' equity accounted for as follows:

Net increase		**\$ 173,000**
Increase in common stock	**\$125,000**	
Increase in paid-in capital in excess of par	**13,000**	
Decrease in retained earnings due to dividend declaration	**(19,000)**	
Net increase accounted for		**(119,000)**
Increase in retained earnings due to net income		**\$ 54,000**

LO: 2, Bloom: AP, Difficulty: Simple, Time: 15-20, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

EXERCISE 4.2 (10–15 minutes)

Sales revenue	$310,000
Cost of goods sold	140,000
Gross profit	170,000
Selling and administrative expenses	50,000
Income from operations	120,000(a)
Other revenues and gains	
Gain on sale of plant assets	30,000
Other expenses and losses	
Interest expense	6,000
Income from continuing operations	144,000
Loss on discontinued operations	(12,000)
Net income	$ 132,000(b)

Net income	$132,000
Unrealized gain on available-for-sale debt investments	10,000
Comprehensive income	$142,000(c)

Net income	$132,000
Dividends	(5,000)
12/31/20 Retained earnings	$127,000(d)

(a)	Income from operations	$120,000
(b)	Net income	$132,000
(c)	Comprehensive income	$142,000
(d)	Retained earnings balance	$127,000

LO: 2, 4, Bloom: AP, Difficulty: Simple, Time: 10-15, AACSB: Analytic, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

EXERCISE 4.3 (25–35 minutes)

(a) **Total net revenue:**

Sales revenue		$390,000
Less: Sales discounts	$ 7,800	
Sales returns and allowances	12,400	20,200
Net sales		369,800
Dividend revenue		71,000
Rent revenue		6,500
Total net revenue		$447,300

(b) **Net income:**

Total net revenue (from a)		$447,300
Expenses:		
Cost of goods sold	$184,400	
Selling expenses	99,400	
Administrative expenses	82,500	
Interest expense	12,700	
Total expenses		379,000
Income before income tax		68,300
Income tax		31,000
Net income		$ 37,300

EXERCISE 4.3 (Continued)

(c) Income attributed to controlling stockholders = (Net income – allocation to noncontrolling interest):

Net income [from (b)]	**$37,300**
Allocation to noncontrolling interest	**17,000**
Income attributable to controlling interest	**$20,300**

LO: 2, 4, Bloom: AP, Difficulty: Simple, Time: 25-35, AACSB: Analytic, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

EXERCISE 4.4 (20–25 minutes)

LEROI JONES INC.
Income Statement
For Year Ended December 31, 2020

Revenues		
Net sales ($1,250,000[b] – $17,000)............		$1,233,000
Expenses		
Cost of goods sold....................................	$500,000	
Selling expenses.......................................	400,000[c]	
Administrative expenses...........................	100,000[a]	
Interest expense..	20,000	
Total expenses..................................		1,020,000
Income before income tax...................................		213,000
Income tax ($213,000 X 30%).....................		63,900
Net income		$ 149,100
Earnings per share[d]		$ 7.46*

*Rounded

EXERCISE 4.4 (Continued)

Determination of amounts

(a)	**Administrative expenses**	**=**	**20% of cost of good sold**
		=	**20% of $500,000**
		=	**$100,000**
(b)	**Gross sales X 8%**	**=**	**administrative expenses**
		=	**$100,000 ÷ .08**
		=	**$1,250,000**
(c)	**Selling expenses**	**=**	**four times administrative expenses. (operating expenses consist of selling and administrative expenses; since selling expenses are 4/5 of operating expenses, selling expenses are 4 times administrative expenses.)**
		=	**4 X $100,000**
		=	**$400,000**

(d) Earnings per share $7.46 ($149,100 ÷ 20,000)

<u>Note:</u> An alternative income statement format is to show income tax as part of expenses, and not as a separate item. In this case, total expenses are $1,083,900.

LO: 2, 3, Bloom: AP, Difficulty: Moderate, Time: 20-25, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

EXERCISE 4.5 (30–35 minutes)

(a)

Multiple-Step Form
P. BRIDE COMPANY
Income Statement
For the Year Ended December 31, 2020
(In thousands, except earnings per share)

Sales revenue			$96,500
Cost of goods sold			60,570
Gross profit			35,930
Operating Expenses:			
Selling expenses			
Sales commissions	$7,980		
Depr. of sales equipment	6,480		
Delivery expense	2,690	$17,150	
Administrative expenses			
Officers' salaries	4,900		
Depr. of office furn. and equip.	3,960	8,860	26,010
Income from operations			9,920
Other Revenues and Gains:			
Rent revenue			17,230
Other Expenses and Losses:			
Interest expense			1,860
Income before income tax			25,290
Income tax			9,070
Net income			$16,220
Earnings per share ($16,220 ÷ 40,550)			$.40

EXERCISE 4.5 (Continued)

(b)

Single-Step Form
P. BRIDE COMPANY
Income Statement
For the Year Ended December 31, 2020
(In thousands, except earnings per share)

Revenues	
Net sales	$ 96,500
Rental revenue	17,230
Total revenues	113,730
Expenses	
Cost of goods sold	60,570
Selling expenses	17,150
Administrative expenses	8,860
Interest expense	1,860
Total expenses	88,440
Income before income tax	25,290
Income tax	9,070
Net income	$ 16,220
Earnings per share	$.40

Note: An alternative income statement format for the single-step form is to show income tax a part of expenses, and not as a separate item.

(c) Single-step:

1. Simplicity and conciseness.
2. Probably better understood by users.
3. Emphasis on total costs and expenses and net income.
4. Does not imply priority of one revenue or expense over another.

EXERCISE 4.5 (Continued)

Multiple-step:

1. **Provides more information through segregation of operating and nonoperating items.**
2. **Expenses are matched with related revenue.**

Note to instructor: **Students' answers will vary due to the nature of the question; i.e., it asks for an opinion. However, the discussion supporting the answer should include the previous points.**

LO: 2, 3, Bloom: AP, Difficulty: Simple, Time: 30-35, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

EXERCISE 4.6 (30–35 minutes)

ALONZO CORP.
Income Statement
For the Year Ended December 31, 2020

Sales Revenue		
Sales revenue		$1,380,000
Less: Sales returns and allowances	$150,000	
Sales discounts	45,000	195,000
Net sales		1,185,000
Cost of goods sold		621,000
Gross profit on sales		564,000
Operating Expenses		
Selling expenses	194,000	
Administrative and general expenses	97,000	291,000
Income from operations		273,000

EXERCISE 4.6 (Continued)

Other Revenues and Gains	
Interest revenue	**86,000**
	359,000
Other Expenses and Losses	
Loss from earthquake damage	**150,000**
Interest expense	**60,000**
Income before income tax	**149,000**
Income tax ($149,000 X .20)	**29,800**
Net income	**$119,200**
Per share of common stock:	
Net income ($119,200 ÷ 100,000)	**$ 1.19***

***Rounded**

LO: 2, 3, 4, Bloom: AP, Difficulty: Moderate, Time: 30-35, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

EXERCISE 4.7 (30–40 minutes)

(a) **Multiple-Step Form**

LATIFA SHOE CO.
Income Statement
For the Year Ended December 31, 2020

Net sales			$980,000
Cost of goods sold			496,000
Gross profit on sales			484,000
Operating Expenses			
Selling expenses			
Salaries and wages expense	$114,800		
Depreciation exp. (70% X $65,000).	45,500		
Supplies	17,600	$177,900	
Administrative expenses			
Salaries and wages expense	135,900		
Other admin. expenses	51,700		
Depreciation exp. (30% X $65,000).	19,500	207,100	385,000
Income from operations			99,000
Other Revenues and Gains			
Rent revenue			29,000
			128,000
Other Expenses and Losses			
Interest expense			18,000
Income before income tax			110,000
Income tax			23,100
Net income			$ 86,900
Earnings per share ($86,900 ÷ 20,000)			$4.35*

*Rounded

EXERCISE 4.7 (Continued)

(b)

Single-Step Form
LATIFA SHOE CO.
Income Statement
For the Year Ended December 31, 2020

Revenues	
Net sales	$ 980,000
Rent revenue	29,000
Total revenues	1,009,000
Expenses	
Cost of goods sold	496,000
Selling expenses(**)	177,900
Administrative expenses(***)	207,100
Interest expense	18,000
Total expenses	899,000
Income before income tax	110,000
Income tax	23,100
Net income	$ 86,900
Earnings per share ($86,900 ÷ 20,000)	$4.35(*)

*Rounded

** $114,800 + (70% x $65,000) + $17,600 = $177,900

*** $135,900 + $51,700 + (30% x $65,000) = $207,100

Note: An alternative income statement format for the single-step form is to show income tax as part of expenses, and not as a separate item.

(c) Single-step:

1. Simplicity and conciseness.
2. Probably better understood by users.

3. Emphasis on total costs and expenses and net income.
4. Does not imply priority of one revenue or expense over another.

Multiple-step:
1. Provides more information through segregation of operating and nonoperating items.
2. Expenses are matched with related revenue.

Note to instructor: Students' answers will vary due to the nature of the question, i.e., it asks for an opinion. However, the discussion supporting the answer should include the above points.

LO: 2, 3, 4, Bloom: AP, Difficulty: Moderate, Time: 30-40, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

EXERCISE 4.8 (15–20 minutes)

(a)	Net sales	$ 540,000
	Cost of goods sold	(210,000)
	Administrative expenses	(100,000)
	Selling expenses	(80,000)
	Discontinued operations-loss	(40,000)
	Income before income tax	110,000
	Income tax ($110,000 X .20)	22,000
	Net income	$ 88,000

(b)	Income from continuing operations before income tax	$150,000*
	Income tax ($150,000 X .20)	30,000
	Income from continuing operations	120,000
	Discontinued operations, less applicable income tax of $8,000	(32,000)
	Net income	$ 88,000

*Income before income tax	$110,000
Discontinued operations	40,000
	$150,000

EXERCISE 4.8 (Continued)

Earnings per share:	
Income from continuing operations ($120,000 ÷ 10,000)	$12.00
Loss on discontinued operations, net of tax ($32,000 ÷ 10,000)	(3.20)
Net Income ($88,000 ÷ 10,000)	$ 8.80

LO: 3, 4, Bloom: AP, Difficulty: Simple, Time: 15-20, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

EXERCISE 4.9 (30–35 minutes)

(a)

IVAN CALDERON CORP.
Income Statement
For the Year Ended December 31, 2020

Sales Revenue		
Net sales		$1,300,000
Cost of goods sold		780,000
Gross profit		520,000
Operating Expenses		
Selling expenses	$65,000	
Administrative expenses	48,000	113,000
Income from operations		407,000
Other Revenues and Gains		
Dividend revenue	20,000	
Interest revenue	7,000	27,000
		434,000
Other Expenses and Losses		
Casualty loss	50,000	
Write-off of inventory due to obsolescence	80,000	130,000
Income before income tax		304,000
Income tax ($304,000 X .20)		60,800
Net income		$ 243,200
Per share of common stock:		
Net income ($243,200 ÷ 60,000)		$4.05*

*Rounded

EXERCISE 4.9 (Continued)

(b)

IVAN CALDERON CORP.
Retained Earnings Statement
For the Year Ended December 31, 2020

Retained earnings, Jan. 1, as reported	$ 980,000
Correction for overstatement of net income in prior period (depreciation error) (net of $11,000 tax)	(44,000)
Retained earnings, Jan. 1, as adjusted	936,000
Add: Net income	243,200
	1,179,200
Less: Dividends declared	45,000
Retained earnings, Dec. 31	$1,134,200

LO: 3, 4, 6, Bloom: AP, Difficulty: Simple, Time: 30-35, AACSB: Analytic, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

EXERCISE 4.10 (20–25 minutes)

Net income	$33,000,000
Less: Provision for preferred dividends (.08 X $4,500,000)	360,000
Income available to common stockholders	32,640,000
Common stock shares	÷10,000,000
Earnings per share	$3.26*

Income statement presentation
Per share of common stock:
Net income $3.26

*Rounded

LO: 4, Bloom: AP, Difficulty: Simple, Time: 20-25, AACSB: Analytic, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

EXERCISE 4.11 (20–25 minutes)

SPOCK CORPORATION
Income Statement
For the Year Ended December 31, 2020

Net sales[a]		$4,162,000
Cost of goods sold[b]		2,665,000
Gross profit		1,497,000
Selling expenses[c]	$636,000	
Administrative expenses[d]	491,000	1,127,000
Income from operations		370,000
Rent revenue	240,000	
Casualty loss	(70,000)	
Interest expense	(176,000)	(6,000)
Income before income tax		364,000
Income tax ($364,000 X .20)		72,800
Net income		$ 291,200

Earnings per share ($900,000 ÷ $10 par value = 90,000 shares)
Net income ($291,000 ÷ 90,000) $3.24*

*Rounded

Supporting computations

(a) Net sales:
$4,275,000 – $34,000 – $79,000 = $4,162,000

(b) Cost of goods sold:
$535,000 + ($2,786,000 + $72,000 – $27,000 – $15,000) – $686,000 = $2,665,000

(c) Selling expenses:
$284,000 + $83,000 + $69,000 + $54,000 + $93,000 + $36,000 + $17,000 = $636,000

(d) Administrative expenses:
$346,000 + $33,000 + $24,000 + $48,000 + $32,000 + $8,000 = $491,000

LO: 3, 4, Bloom: AP, Difficulty: Moderate, Time: 20-25, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

EXERCISE 4.12 (20–25 minutes)

(a)

EDDIE ZAMBRANO CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2020

Balance, January 1, as reported	$225,000*
Correction for depreciation error (net of $5,000 tax)	(20,000)
Cumulative decrease in income from change in inventory methods (net of $7,000 tax)	(28,000)
Balance, January 1, as adjusted	177,000
Add: Net income	192,000**
	369,000
Less: Dividends declared	100,000
Balance, December 31	$269,000

*($40,000 + $125,000 + $160,000) – ($50,000 + $50,000)
**[$240,000 – (20% X $240,000)]

(b) Total retained earnings would still be reported as $269,000. A restriction does not affect total retained earnings; it merely labels part of the retained earnings as being unavailable for dividend distribution. Retained earnings would be reported as follows:

Retained earnings:	
Appropriated	$ 70,000
Unappropriated	199,000
Total	$269,000

LO: 6, Bloom: AP, Difficulty: Simple, Time: 20-25, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

EXERCISE 4.13 (15–20 minutes)

Net income:		
Income from continuing operations before income tax		**$23,650,000**
Income tax (17% X $23,650,000)		**4,020,500**
Income from continuing operations		**19,629,500**
Discontinued operations		
Loss before income tax	**$3,225,000**	
Less: Applicable income tax (17%)	**548,250**	**(2,676,750)**
Net income		**$16,952,750**
Preferred dividends declared:		**$ 1,075,000**
Weighted average common shares outstanding		**4,000,000**
Earnings per share		
Income from continuing operations		**$4.64***
Discontinued operations, net of tax		**(.67)****
Net income		**$3.97*****

***($19,629,500 – $1,075,000) ÷ 4,000,000. (Rounded)**
****$2,676,750 ÷ 4,000,000. (Rounded)**
*****($16,952,750 – $1,075,000) ÷ 4,000,000.**

LO: 4, Bloom: AP, Difficulty: Moderate, Time: 15-20, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

EXERCISE 4.14 (15–20 minutes)

(a)

	2020
Income before income tax	$450,000
Income tax (.20 X $450,000)	90,000
Net Income	$360,000

(b) Cumulative effect for years prior to 2020.

Year	Weighted-Average	FIFO	Difference	Tax Rate (20%)	Net Effect
2018	$370,000	$395,000	$25,000		
2019	390,000	430,000	40,000		
		Total	$65,000	$13,000	$52,000

(c)

	2020	2019	2018
Income before income tax	$450,000	$430,000	$395,000
Income tax (20%)	90,000	86,000	79,000
Net income	$360,000	$344,000	$316,000

LO: 5, Bloom: AP, Difficulty: Moderate, Time: 15-20, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

EXERCISE 4.15 (15–20 minutes)

(a)

ROXANNE CARTER CORPORATION
Statement of Comprehensive Income
For the Year Ended December 31, 2020

Sales revenue	$1,200,000
Cost of goods sold	750,000
Gross profit	450,000
Selling and administrative expenses	320,000
Net income	130,000
Other comprehensive income unrealized holding gain	18,000
Comprehensive income	$ 148,000

EXERCISE 4.15 (Continued)

(b)

ROXANNE CARTER CORPORATION
Income Statement
For the Year Ended December 31, 2020

Sales	$1,200,000
Cost of goods sold..	750,000
Gross profit	450,000
Selling and administrative expenses..................................	320,000
Net income..	$ 130,000
Net income..	$ 130,000
Other comprehensive income unrealized holding gain	18,000
Comprehensive income...	$ 148,000

LO: 3, 7, Bloom: AP, Difficulty: Simple, Time: 15-20, AACSB: Analytic, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

EXERCISE 4.16 (15–20 minutes)

C. REITHER CO.
Statement of Stockholders' Equity
For the Year Ended December 31, 2020

	Total	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock
Beginning balance	$520,000	$ 90,000	$80,000	$350,000
Net income*	120,000	120,000		
Other comprehensive income				
Unrealized holding loss	(60,000)		(60,000)	
Dividends	(10,000)	(10,000)		
Ending balance	$570,000	$200,000	$20,000	$350,000

***($700,000 – $500,000 – $80,000).**

LO: 6, 7, Bloom: AP, Difficulty: Moderate, Time: 15-20, AACSB: Analytic, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

EXERCISE 4.17 (30–35 minutes)

(a)

ROLAND CARLSON INC.
Income Statement
For the Year Ended December 31, 2020

Revenues		
Sales revenue	$1,900,000	
....		
....		
....		
Rent revenue	40,000	
Total revenues		$1,940,00
Expenses		
Cost of goods sold	850,000	
Selling expenses	300,000	
Administrative expenses	240,000	
Total expenses		1,390,00
Income from operations		550,00
Other revenues and gains		
Gain on sale of equipment		95,00
....		
Other expenses and losses		
Inventory loss		60,00
Income from continuing operations before income tax		585,00
Income tax		187,00
Income from continuing operations		398,00
Discontinued operations		
Loss on discontinued operations	75,000	
Less: Applicable income tax reduction	25,500	(49,50
Net income		$ 348,50

Per share of common stock:

Income from continuing operations ($398,000 ÷ 100,000)	$3.98
Loss on discontinued operations, net of tax	(.50)*
Net income ($348,500 ÷ 100,000)	$3.48

***$49,500 ÷ 100,000**

EXERCISE 4.17 (Continued)

(b)

ROLAND CARLSON INC.
Comprehensive Income Statement
For the Year Ended December 31, 2020

Net income	$348,500
Other comprehensive income	
Unrealized holding gain, net of tax	15,000
Comprehensive income	$363,500

(c)

ROLAND CARLSON INC.
Retained Earnings Statement
For the Year Ended December 31, 2020

Retained earnings, January 1	$600,000
Add: Net income	348,500
	948,500
Less: Dividends declared	150,000
Retained earnings, December 31	$798,500

LO: 3, 4, 6, 7, Bloom: AP, Difficulty: Moderate, Time: 30-35, AACSB: Analytic, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

SOLUTIONS TO PROBLEMS

PROBLEM 4.1

DICKINSON COMPANY
Income Statement
For the Year Ended December 31, 2020

Sales revenue		$25,000,000
Cost of goods sold		16,000,000
Gross profit		9,000,000
Selling and administrative expenses		4,700,000
Income from operations		4,300,000
Other revenues and gains		
Interest revenue	$ 70,000	
Gain on the sale of investments	110,000	180,000
Other expenses and losses		
Loss from flood damage	390,000	
Write-off of goodwill	820,000	1,210,000
Income from continuing operations before income tax		3,270,000
Income tax		1,244,000
Income from continuing operations		2,026,000
Discontinued operations		
Loss on operations, net of applicable tax	90,000	
Loss on disposal, net of applicable tax	440,000	(530,000)
Net income		$ 1,496,000

Earnings per share:		
Income from continuing operations		$ 3.89[a]
Discontinued operations		
Loss on operations, net of tax	$0.18	
Loss on disposal, net of tax	0.88	(1.06)
Net income		$ 2.83[b]

$$^{a}\frac{\$2{,}026{,}000 - \$80{,}000}{500{,}000 \text{ shares}} = \$3.89$$

$$^{b}\frac{\$1{,}496{,}000 - \$80{,}000}{500{,}000 \text{ shares}} = \$2.83$$

PROBLEM 4.1 (Continued)

DICKINSON COMPANY
Retained Earnings Statement
For the Year Ended December 31, 2020

Retained earnings, January 1		$ 980,000
Add: Net income..		1,496,000
		2,476,000
Less Dividends declared on:		
Preferred stock	$ 80,000	
Common stock...	250,000	330,000
Retained earnings, December 31.........................		$2,146,000

LO: 3, 4, 6, Bloom: AP, Difficulty: Moderate, Time: 30-35, AACSB: Analytic, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

PROBLEM 4.2

THOMPSON CORPORATION
Income Statement
For the Year Ended December 31, 2020

Revenues		
Net sales ($1,100,000 – $14,500 – $17,500)....	$1,068,000	
Gain on disposal of land................................	30,000	
Rent revenue...	18,000	
Total revenues		$1,116,000
Expenses		
Cost of goods sold*......................................	645,000	
Selling expenses	232,000	
Administrative expenses	99,000	
Total expenses......................................		976,000
Income before income tax		140,000
Income tax..		53,900
Net income		$ 86,100
Earnings per share ($86,100 ÷ 30,000)....................		$2.87

*Cost of goods sold: Can be verified as follows:

Inventory, Jan. 1..		$ 89,000
Purchases..	$610,000	
Less: Purchase discounts.................................	10,000	
Net purchases	600,000	
Add: Freight-in	20,000	620,000
Inventory available for sale		709,000
Less: Inventory, Dec. 31		64,000
Cost of goods sold...		$645,000

PROBLEM 4.2 (Continued)

THOMPSON CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2020

Retained earnings, January 1	$160,000
Add: Net income	86,100
	246,100
Less: Cash dividends	45,000
Retained earnings, December 31	$201,100

LO: 3, 4, 6, Bloom: AP, Difficulty: Simple, Time: 25-30, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

PROBLEM 4.3

MAHER INC.
Income Statement (Partial)
For the Year Ended December 31, 2020

Income from continuing operations before income tax			**$748,500[a]**
Income tax...			**193,350[b]**
Income from continuing operations			**555,150**
Discontinued operations			
Loss from disposal of recreational division...	**$115,000**		
Less: Applicable income tax reduction.....	**34,500**	**(1)**	**(80,500)**
Net income..			**$474,650**

(1) $115,000 × 30%

Per share of common stock:	
Income from continuing operations ($555,150 ÷ 120,000)	**$4.63***
Discontinued operations, net of tax...........	**(0.67)***
Net income ($474,650 ÷ 120,000)	**$3.96**

***Rounded**

[a]Computation of income from cont. operations before taxes:

As previously stated		**$790,000**
Loss on sale of securities....................................		**57,000**
Gain on proceeds of life insurance policy ($150,000 – $46,000)..............................		**104,000**
Flood Loss		**90,000**
Error in computation of depreciation		
As computed ($54,000 ÷ 6).......................................	**$9,000**	
Corrected ($54,000 – $9,000) ÷ 6..............................	**(7,500)**	**1,500**
As restated		**$748,500**

PROBLEM 4.3 (Continued)

(b) **Computation of income tax:**

Income from continuing operations before taxes	**$748,500**
Nontaxable income (gain on life insurance)	**(104,000)**
Taxable income	**644,500**
Tax rate	**X .30**
Income tax	**$193,350**

Note: No adjustment is needed for the inventory method change, since the new method is reported in 2020 income. The cumulative effect on prior years of retroactive application of the new inventory method will be recorded in retained earnings.

LO: 3, 4, Bloom: AP, Difficulty: Moderate, Time: 30-40, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

PROBLEM 4.4

(a)

TWAIN CORPORATION
Income Statement
For the Year Ended June 30, 2020

Sales		
Sales revenue		$1,578,500
Less: Sales discounts	$31,150	
Sales returns and allowances	62,300	93,450
Net sales		1,485,050
Cost of goods sold		896,770
Gross profit		588,280
Operating Expenses		
Selling expenses		
Sales commissions	97,600	
Salaries and wages expense	56,260	
Travel expense	28,930	
Delivery expense	21,400	
Entertainment expense	14,820	
Telephone and Internet expense	9,030	
Maintenance and repairs expense	6,200	
Depreciation expense	4,980	
Bad debt expense	4,850	
Miscellaneous selling expenses	4,715	248,785
Administrative Expenses		
Maintenance and repairs expense	9,130	
Property tax expense	7,320	
Depreciation expense	7,250	
Supplies expense	3,450	
Telephone and Internet expense	2,820	
Office expenses	6,000	35,970
Income from operations		303,525

PROBLEM 4.4 (Continued)

Other Revenues and Gains	
Dividend revenue	38,000
Other Expenses and Losses	
Interest expense	18,000
Income before income tax.................................	323,525
Income tax expense.......................................	102,000
Net income	$221,525
Earnings per common share	
[($221,525 – $9,000) ÷ 80,000]	$2.66*

*Rounded

TWAIN CORPORATION
Retained Earnings Statement
For the Year Ended June 30, 2020

Retained earnings, July 1, 2019, as reported		$337,000
Correction of depreciation understatement, net of tax		(17,700)
Retained earnings, July 1, 2019, as adjusted.....		319,300
Add: Net income..		221,525
		540,825
Less:		
Dividends declared on preferred stock.....	$ 9,000	
Dividends declared on common stock	37,000	46,000
Retained earnings, June 30, 2020		$494,825

(b)

TWAIN CORPORATION
Income Statement
For the Year Ended June 30, 2020

Revenues	
Net sales	$1,485,050
Dividend revenue	38,000
Total revenues	1,523,050
Expenses	
Cost of goods sold	896,770
Selling expenses	248,785
Administrative expenses	35,970
Interest expense	18,000
Total expenses	1,199,525
Income before income tax	323,525
Income tax	102,000
Net income	$ 221,525
Earnings per common share [($221,525 - $9,000) ÷ 80,000]	$2.66*

* Rounded

TWAIN CORPORATION
Retained Earnings Statement
For the Year Ended June 30, 2020

Retained earnings, July 1, 2019, as reported		$337,000
Correction of depreciation understatement, net of tax		(17,700)
Retained earnings, July 1, 2019 as adjusted		319,300
Add: Net income		221,525
		540,825
Less:		
Dividends declared on preferred stock	$ 9,000	
Dividends declared on common stock	37,000	46,000
Retained earnings, June 30, 2020		$494,825

LO: 3, 4, 5, 6, Bloom: AP, Difficulty: Moderate, Time: 45-55, AACSB: Analytic, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

PROBLEM 4.5

1. **The usual but infrequently occurring charge of $8,500,000 should be disclosed separately, assuming it is material. This charge is shown above income before income tax and would not be reported net of tax. This item should be separately disclosed to inform the users of the financial statements that this item is nonrecurring and therefore may not impact next year's results.**

2. **The loss on sale of equipment of $6,000,000 should be reported as an "Other expense or loss", included in income from operations. It should not be reported net of tax. As with the first item, if material, it should be separately reported.**

3. **The adjustment required for correction of an error is inappropriately labeled. It also should not be reported in the retained earnings statement. Changes in estimate should be handled in current and future periods through the income statement. Catch-up adjustments are not permitted. To restate financial statements every time a change in estimate occurred would be extremely costly. In addition, adjusting the beginning balance of retained earnings is inappropriate as the increased charge in this case affects current and future income statements.**

4. **Earnings per share should be reported on the face of the income statement and not in the notes to the financial statements. Because such importance is ascribed to this statistic, the profession believes it necessary to highlight the earnings per share figure.**

LO: 3, 4, 5, 6, Bloom: AP, Difficulty: Moderate, Time: 20-25, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

PROBLEM 4.6

(a)

ACADIAN CORP.
Retained Earnings Statement
For the Year Ended December 31, 2020

Retained earnings, January 1, as reported	$257,600
Correction of error from prior period (net of tax)	25,400
Adjustment for change in accounting principle (net of tax)	(23,200)
Retained earnings, January 1, as adjusted	259,800
Add: Net income	52,300*
Less: Cash dividends declared	32,000
Retained earnings, December 31	$280,100

*$52,300 = ($84,500 + $41,200 + $21,600 – $35,000 – $60,000)

(b)

1. Gain on sale of investments—body of income statement. This gain should not be shown net of tax on the income statement.
2. Refund on litigation with government—body of income statement, possibly unusual item. This refund should not be shown net of tax on the income statement.
3. Loss on discontinued operations—body of the income statement, following the caption, "Income from continuing operations."
4. Write-off of goodwill—body of income statement, possibly unusual item. The write-off should not be shown net of tax on the income statement.

LO: 4, 5, 6, Bloom: AP, Difficulty: Moderate, Time: 25-35, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

PROBLEM 4.7

WADE CORP.
Income Statement (Partial)
For the Year Ended December 31, 2020

Income from continuing operations before income tax			$1,200,000*
Income tax			228,000**
Income from continuing operations			972,000
Discontinued operations			
Loss from operations of discontinued subsidiary	$ 90,000		
Less: Applicable income tax reduction ($90,000 × .19)	17,100	$ 72,900	
Loss from disposal of subsidiary	100,000		
Less: Applicable income tax reduction ($100,000 × .19)	19,000	81,000	(153,900)
Net income			$ 818,100

Per share of common stock:	
Income from continuing operations ($972,000 ÷ 150,000)	$6.48
Discontinued operations, net of tax	(1.03)
Net income ($818,100 ÷ 150,000)	$5.45

*Computation of income from continuing operations before income tax:

As previously stated	$1,210,000
Loss on sale of equipment [$40,000 – ($80,000 – $30,000)]	(10,000)
Restated	$1,200,000

**Computation of income tax:

$1,200,000 X .19 = $228,000

Note: The gain on condemnation is appropriately included in income from continuing operations (and is taxed at 19%). The error related to the intangible asset was correctly charged to retained earnings.

LO: 3, 4, 5, Bloom: AP, Difficulty: Moderate, Time: 25-35, AACSB: Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

SOLUTIONS TO CONCEPTS FOR ANALYSIS

CA 4.1

The deficiencies of O'Malley Corporation's income statement are as follows:

1. The heading is inappropriate. The heading should include the period of time for which the income statement is presented.

2. Gain on recovery of insurance proceeds is properly classified in a single-step income statement.

3. Cost of goods sold is usually listed as the first expense, followed by selling, administrative, and other expenses.

4. Advertising expense is a selling expense and should usually be classified as such, unless this expense is unusually different from previous periods.

5. Loss on obsolescence of inventories is properly classified in a single step income statement.

6. Loss on discontinued operations requires a separate classification after income from continuing operations.

7. Intraperiod income tax allocation is required to relate income tax expense to income from continuing operations and loss on discontinued operations.

8. Per share data is a required presentation for income from continuing operations, discontinued operations, and net income.

LO: 2, 3, 4, Bloom: C, Difficulty: Simple, Time: 20-25, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 4.2

(a) Earnings management is often defined as the planned timing of revenues, expenses, gains and losses to smooth out bumps in earnings. In most cases, earnings management is used to increase income in the current year at the expense of income in future years. For example, companies prematurely recognize sales in order to boost earnings. Earnings management can also be used to decrease current earnings in order to increase income in the future. The classic case is the use of "cookie jar" reserves, which are established, by using unrealistic assumptions to estimate liabilities for such items as loan losses, restructuring charges and warranty returns.

(b)

Proposed Accounting	2017	2018	2019	2020	2021
Income before warranty expense				$43,000	$43,000
Warranty expense				7,000	3,000
Income	$20,000	$25,000	$30,000	$36,000	$40,000

Assuming the same income before warranty expense for both 2020 and 2021 and total warranty expense over the 2-year period of $10,000, this proposed accounting results in steadily increasing income over the two-year period.

CA 4.2 (Continued)

(c)

Appropriate Accounting	2017	2018	2019	2020	2021
Income before warranty expense				$43,000	$43,000
Warranty expense				5,000	5,000
Income	$20,000	$25,000	$30,000	$38,000	$38,000

The appropriate accounting would be to record $5,000 of warranty expense in 2020, resulting in income of $38,000. However, with the same amount of warranty expense in 2021, Bobek no longer shows an increasing trend in income. Thus, by taking more expense in 2020, Bobek can save some income (a classic case of "cookie-jar" reserves) and maintain growth in income.

LO: 1, 5, Bloom: AP, Difficulty: Moderate, Time: 20-25, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

CA 4.3

(a) The ethical issues involved are integrity and honesty in financial reporting, full disclosure, accountant's professionalism, and job security for Charlie.

(b) If Charlie believes the losses are relevant information important to users of the income statement, he should disclose the losses separately. If they are considered incidental to the company's normal activities—i.e., the major activities of the Kelly Corporation do not include selling equipment—the transactions should be reported among any gains and losses that occurred during the year.

LO: 1, Bloom: AN, Difficulty: Simple, Time: 15-20, AACSB: Analytic, Communication, AICPA BB: Professional Demeanor, Problem Solving, AICPA FC: Reporting, AICPA PC: Communication

CA 4.4

(a) It appears that the sale of the Casino Knights Division would qualify as a discontinued operation. The operation of gambling facilities appears to meet the criteria for discontinued operations for Simpson Corp. and, therefore, the accounting requirements related to discontinued operations should be followed. Although the financial vice-president might be correct theoretically, professional pronouncements require that such segregation be made. A separate classification is required for disposals meeting the requirements of discontinued operations. If this disposal did not meet the requirements for disposal of a component of a business, treatment as "other gain or loss" might be considered appropriate.

(b) The "walkout" or strike generally does not get special reporting. Events of this nature are a general risk that any business enterprise takes and should not warrant special treatment. Such events may call for expanded disclosure if the effects are significant.

(c) The financial vice-president is incorrect in his/her observations concerning the materiality of irregular items. The materiality of each item must be considered individually. It is not appropriate to consider only the materiality of the net effect. Each irregular item must be reported separately on the income statement.

(d) Earnings per share for income from continuing operations and discontinued operations, and net income, must be reported on the face of the income statement.

LO: 4, Bloom: AP, Difficulty: Moderate, Time: 30-35, AACSB: Communication, AICPA BB: Problem Solving, AICPA FC: Reporting, AICPA PC: Communication

CA 4.5

The income statement of Walters Corporation contains the following weaknesses in classification and disclosure:

1. **Sales taxes.** Sales taxes have been erroneously included in both gross sales and cost of goods sold on the income statement of Walters Corporation. Failure to deduct these taxes directly from customer billings results in a deceptive inflation of the amount of sales. These taxes should be deducted from gross sales because the corporation acts as an agent in collecting and remitting such taxes to the state government.

2. **Purchase discounts.** Purchase discounts should not be treated as revenue by being lumped with other revenues such as dividends and interest. A purchase discount is more logically a reduction of the cost of purchases because revenue is not created by purchasing goods and paying for them. In a cash transaction, cost is measured by the amount of the cash consideration. In a credit transaction, however, cost is measured by the amount of cash required to settle immediately the obligation incurred. The discount should reduce the cost of goods sold to the amount of cash that would be required to settle the obligation immediately.

3. **Recoveries of accounts written off in prior years.** These collections should be credited to the allowance for doubtful accounts unless the direct write-off method was used in accounting for bad debt expense. Generally, the direct write-off method is not allowed.

4. **Delivery expense.** Although delivery expense (sometimes referred to as freight-out) is an expense of selling and is therefore reported properly in the statement, freight-in is an inventoriable cost and should have been included in the computation of cost of goods sold. The value assigned to inventory should represent the value of the economic resources given up in obtaining goods and readying them for sale.

5. **Loss on discontinued styles.** This type of loss, though often substantial, should not be treated as discontinued operation unless it eliminates a component of the business of the corporation and/or represents a strategic shift. Otherwise it should be reported “other expenses and losses” before Income before taxes.

6. **Loss on sale of marketable securities.** This item should be reported as a separate component of income from continuing operations as an "Other expense or loss."

7. **Loss on sale of warehouse.** This type of item does not get special treatment, even if the loss is the direct result of a major casualty, an expropriation, or a prohibition under a newly enacted law or regulation. This item should be separately disclosed as an unusual item, if either unusual in nature and/or infrequent in occurrence. Note that as a result of a recent FASB ASU, special extraordinary item treatment of unusual and infrequent items is no longer allowed.

8. **Federal Income taxes.** The provision for federal income taxes and intraperiod tax allocation are not presented in the income statement. This omission implies that the federal income tax is a distribution of net income instead of an operating expense and a determinant of net income. This assumption is not as relevant to the majority of financial statement users as the concept of net income to investors, stockholders, or residual equity holders. Also, by law the corporation must pay federal income taxes whether the benefits it receives from the government are direct or indirect. Finally, those who base their decisions upon financial statements are thought to look to net income as being a more relevant measure of income than income before taxes.

LO: 2, 3, 4, Bloom: C, Difficulty: Moderate, Time: 30-40, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

CA 4.6

	Classification	Rationale
1.	No disclosure.	Error has “reversed out”; that is, subsequent income statement compensated for the error. However, prior year income statements should be restated if the amount of the error is material.
2.	Reported in body of the income statement, as Other revenues and gains.	While unusual in nature, and infrequent in occurrence, GAAP requires reporting in income from continuing operations.
3.	Depreciation expense in body of income statement, based on new useful life.	Material item, but change in estimated useful life is considered part of normal business activity.
4.	No separate disclosure unless material.	Change in estimate, considered part of normal business activity.
5.	Reported in body of the income statement, possibly as an unusual item.	Sale does not meet criteria for the disposal of a component of the business.
6.	Adjustment to the beginning balance of retained earnings.	A change in inventory methods is a change in accounting principle and prior periods are adjusted.
7.	Reported in body of the income statement, as Other Expenses and losses.	Loss on preparation of such proposals does not get special reporting.
8.	Reported in body of the income statement, as Other Expenses and losses.	Strikes are the result of general business risk and do not receive special reporting.
9.	Prior period adjustment, adjust beginning retained earnings.	Corrections of errors are shown as prior period adjustments.
10.	Reported in body of the income statement, possibly as an unusual item (other gains).	While unusual in nature, and infrequent in occurrence, GAAP requires reporting in income from continuing operations.
11.	Discontinued operations section.	Division’s assets, results of operations, and activities are clearly distinguishable physically, operationally, and for financial reporting purposes. As indicated the charge reflects a strategic shift for the company.

LO: 2, 3, 4, 5, 6, Bloom: C, Difficulty: Moderate, Time: 20-25, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

CA 4.7

(a) **Separate Statement**

	Current Year	Prior Year
. . . income components . . .		
Net income	$400,000	$410,000

Comprehensive Income Statement

	Current Year	Prior Year
Net income	$400,000	$410,000
Unrealized gains	15,000	
Comprehensive income	$415,000	$410,000

(b) **Combined Format**

	Current Year	Prior Year
. . . income components . . .		
Net income	$400,000	$410,000
Other comprehensive income		
Unrealized gains	15,000	
Comprehensive income	$415,000	$410,000

(c) Nelson can choose either approach, according to FASB ASC 220-10-45. The method chosen should be based on which one provides the most useful information. For example, Nelson should not choose the combined format because the gains result in an increasing trend in comprehensive income, while net income is declining.

LO: 7, Bloom: AP, Difficulty: Simple, Time: 10-15, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

