

EXERCISE 4-5 (30–35 minutes)

PARNEVIK CORP.
Income Statement
For the Year Ended December 31, 2010

Sales Revenue

Sales		\$1,280,000
Less: Sales returns and allowances.....	\$150,000	
 Sales discounts	45,000	195,000
Net sales revenue		1,085,000
Cost of goods sold		621,000
Gross profit		464,000

Operating Expenses

Selling expenses.....	194,000	
Admin. and general expenses	97,000	291,000
Income from operations		173,000

EXERCISE 4-5 (Continued)

Other Revenues and Gains

Interest revenue	<u>86,000</u>
	259,000

Other Expenses and Losses

Interest expense.....	<u>60,000</u>
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Income before tax and extraordinary item	199,000
Income tax (\$199,000 X .34).....	<u>67,660</u>
Income before extraordinary item	131,340
Extraordinary item—loss from earthquake damage	120,000
Less: Applicable tax reduction (\$120,000 X .34)....	<u>40,800</u>
Net income	<u>\$ 52,140</u>

Per share of common stock:

Income before extraordinary item	
(\$131,340 ÷ 100,000)	\$1.31*
Extraordinary item (net of tax)	<u>(0.79)</u>
Net income (\$52,140 ÷ 100,000).....	<u>\$0.52</u>

*Rounded

EXERCISE 4-7 (15–20 minutes)

(a) Net sales	\$ 540,000
Less: Cost of goods sold	(260,000)
Administrative expenses	(100,000)
Selling expenses	(80,000)
Discontinued operations-loss	<u>(40,000)</u>
Income before income tax.....	60,000
Income tax (\$60,000 X .30).....	<u>18,000</u>
Net income	<u>\$ 42,000</u>

(b) Income from continuing operations	
before income tax	\$100,000*
Income tax (\$100,000 X .30).....	<u>30,000</u>
Income from continuing operations	70,000
Discontinued operations, less applicable income	
tax of \$12,000	<u>(28,000)</u>
Net income	<u>\$ 42,000</u>

***\$60,000 + \$40,000**

Earnings per share:

Income from continuing operations	
(\$70,000 ÷ 20,000)	\$ 3.50
Loss on discontinued operations, net of tax.....	<u>(1.40)</u>
Net Income (\$42,000 ÷ 20,000)	<u>\$ 2.10</u>

EXERCISE 4-13 (15–20 minutes)

(a)

2010

Income before income tax.....	\$460,000
Income tax (35%)	<u>161,000</u>
Net Income	<u>\$299,000</u>

(b) Cumulative effect for years prior to 2010:

<u>Year</u>	<u>Weighted Average</u>	<u>FIFO</u>	<u>Difference</u>	<u>Tax Rate (35%)</u>	<u>Net Effect</u>
2008	\$370,000	\$395,000	\$25,000		
2009	390,000	420,000	<u>30,000</u>		
		Total	\$55,000	\$19,250	\$35,750

(c)

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Income before income tax	\$460,000	\$420,000	\$395,000
Income tax (35%)	<u>161,000</u>	<u>147,000</u>	<u>138,250</u>
Net income	<u>\$299,000</u>	<u>\$273,000</u>	<u>\$256,750</u>

EXERCISE 4-14 (15–20 minutes)

ARMSTRONG CORPORATION
Income Statement and Comprehensive Income Statement
For the Year Ended December 31, 2010

Sales	\$1,200,000
Cost of goods sold	<u>720,000</u>
Gross profit	480,000
Selling and administrative expenses	<u>320,000</u>
Net income	<u>\$ 160,000</u>
Net income	\$ 160,000

Unrealized holding gain	<u>15,000</u>
Comprehensive income	<u>\$ 175,000</u>

EXERCISE 4-15 (15–20 minutes)

BRYANT CO.
Statement of Stockholders' Equity
For the Year Ended December 31, 2010

	<u>Total</u>	<u>Compre- hensive Income</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Common Stock</u>
Beginning balance	\$520,000		\$ 90,000	\$80,000	\$350,000
Comprehensive income					
Net income*	170,000	\$170,000	170,000		
Other comprehensive income					
Unrealized holding loss	(50,000)	<u>(50,000)</u>		(50,000)	
Comprehensive income		<u>\$120,000</u>			
Dividends	<u>(10,000)</u>		<u>(10,000)</u>		
Ending balance	<u>\$630,000</u>		<u>\$250,000</u>	<u>\$30,000</u>	<u>\$350,000</u>

*($\$750,000 - \$500,000 - \$80,000$).

PROBLEM 4-4

(a)

TWAIN CORPORATION
Income Statement
For the Year Ended June 30, 2010

Sales Revenue

Sales		\$1,578,500
Less: Sales discounts	\$31,150	
Sales returns	<u>62,300</u>	<u>93,450</u>
Net sales.....		1,485,050
Cost of goods sold		<u>896,770</u>
Gross profit.....		588,280

Operating Expenses

Selling expenses

Sales commissions	\$97,600	
Sales salaries	56,260	
Travel expense.....	28,930	
Freight-out.....	21,400	
Entertainment expense	14,820	
Telephone and internet	9,030	
exp.		
Building expense	6,200	
Depr. of sales equipment	4,980	
Bad debt expense	4,850	
Misc. selling expenses	<u>4,715</u>	248,785

PROBLEM 4-4 (Continued)

Administrative Expenses

Building expense	9,130		
Real estate and other local taxes	7,320		
Depreciation of office furniture and equipment.....	7,250		
Office supplies used.....	3,450		
Telephone and internet expense	2,820		
Miscellaneous office expenses	<u>6,000</u>	<u>35,970</u>	<u>284,755</u>
Income from operations.....			303,525

Other Revenues and Gains

Dividend revenue.....			<u>38,000</u>
			341,525

Other Expenses and Losses

Bond interest expense			<u>18,000</u>
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Income before income tax			323,525
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Income tax.....			<u>102,000</u>
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Net income			<u>\$ 221,525</u>
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Earnings per common share

[($\$221,525 - \$9,000$) \div 80,000]			<u>\$2.66*</u>
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*Rounded

PROBLEM 4-4 (Continued)

TWAIN CORPORATION
Retained Earnings Statement
For the Year Ended June 30, 2010

Retained earnings, July 1, 2009, as reported		\$337,000
Correction of depreciation understatement, net of tax		<u>(17,700)</u>
Retained earnings, July 1, 2009, as adjusted		319,300
Add: Net income		<u>221,525</u>
		540,825
Less:		
Dividends declared on preferred stock	9,000	
Dividends declared on common stock	<u>37,000</u>	<u>46,000</u>
Retained earnings, June 30, 2010		<u>\$494,825</u>

PROBLEM 4-4 (Continued)

(b)

TWAIN CORPORATION
Income Statement
For the Year Ended June 30, 2010

<u>Revenues</u>	
Net sales	\$1,485,050
Dividend revenue	<u> 38,000</u>
Total revenues	<u>1,523,050</u>
<u>Expenses</u>	
Cost of goods sold	896,770
Selling expenses	248,785
Administrative expenses	35,970
Bond interest expense	<u> 18,000</u>
Total expenses	<u>1,199,525</u>
Income before income tax	323,525
Income tax	<u> 102,000</u>
Net income	<u>\$ 221,525</u>
Earnings per common share	<u>\$2.66</u>

PROBLEM 4-4 (Continued)

TWAIN CORPORATION
Retained Earnings Statement
For the Year Ended June 30, 2010

Retained earnings, July 1, 2009, as reported		\$337,000
Correction of depreciation understatement, net of tax		<u>(17,700)</u>
Retained earnings, July 1, 2009 as adjusted		\$319,300
Add: Net income		<u>221,525</u>
		540,825
Less:		
Dividends declared on preferred stock....	9,000	
Dividends declared on common stock.....	<u>37,000</u>	<u>46,000</u>
Retained earnings, June 30, 2010		<u>\$494,825</u>

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 extraordinary items 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. Furthermore, trend comparisons may be misleading if such an item is not highlighted and adjustments made. The item should not be considered extraordinary because it is usual in nature.
2. The extraordinary item of \$6,000,000 should be reported net of tax in a separate section for extraordinary items. An adjustment should be made to income taxes to report this amount at \$21,400,000. The \$2,000,000 tax effect of this extraordinary item should be reported with the extraordinary item. The reason for the separate disclosure is much the same as that given above for the separate disclosure of the usual, but infrequently occurring item. Readers must be informed that certain revenue and expense items may be unusual and infrequent, and that their likelihood for affecting operations again in the future is unlikely.
3. The adjustment required for correction of an error is inappropriately labeled and 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.

PROBLEM 4-5 (Continued)

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. In this case the company should report both income before extraordinary item and net income on a per share basis.

PROBLEM 4-7

WADE CORP.
Income Statement (Partial)
For the Year Ended December 31, 2010

Income from continuing operations			
before income tax.....			\$1,200,000*
Income tax.....			<u>456,000**</u>
Income from continuing operations			744,000
Discontinued operations			
Loss from operations of			
discontinued subsidiary.....	\$ 90,000		
Less: Applicable income tax			
reduction	<u>34,200</u>	\$ 55,800	
Loss from disposal of subsidiary	100,000		
Less: Applicable income tax			
reduction.....	<u>38,000</u>	<u>62,000</u>	<u>117,800</u>
Income before extraordinary item			626,200
Extraordinary item:			
Gain on condemnation		125,000	

Less: Applicable income tax.....	<u>50,000</u>	<u>75,000</u>
Net income		<u>\$ 701,200</u>

Per share of common stock:

Income from continuing operations	\$4.96
Discontinued operations, net of tax	<u>(0.79)</u>
Income before extraordinary item	4.17
Extraordinary item, net of tax	<u>0.50</u>
Net income (\$701,200 ÷ 150,000)	<u>\$4.67</u>

***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)]	<u>(10,000)</u>
Restated	<u>\$1,200,000</u>

****Computation of income tax expense:**

$$\underline{\$1,200,000} \times .38 = \underline{\$456,000}$$

Note: The error related to the intangible asset was correctly charged to retained earnings.

CA 4-4

- (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 before they are complete 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 sales returns, loan losses, and warranty costs.

(b) Proposed Accounting	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Income before warranty expense				\$43,000	\$43,000
Warranty expense				<u>7,000</u>	<u>3,000</u>
Income	<u>\$20,000</u>	<u>\$25,000</u>	<u>\$30,000</u>	<u>\$36,000</u>	<u>\$40,000</u>

Assuming the same income before warranty expense for both 2010 and 2011 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.

(c) Appropriate Accounting	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Income before warranty expense				\$43,000	\$43,000
Warranty expense				<u>5,000</u>	<u>5,000</u>
Income	<u>\$20,000</u>	<u>\$25,000</u>	<u>\$30,000</u>	<u>\$38,000</u>	<u>\$38,000</u>

The appropriate accounting would be to record \$5,000 of warranty expense in 2010, resulting in income of \$38,000. However, with the same amount of warranty expense in 2011, Bobek no longer shows an increasing trend in income. Thus, by taking more expense in 2010, Bobek can save some income (a classic case of “cookie-jar” reserves) and maintain growth in income.

CA 4-5

- (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.

CA 4-8

<u>Classification</u>	<u>Rationale</u>
1. No disclosure.	Error has "washed out"; that is, subsequent income statement compensated for the error. However, prior year income statements should be restated.
2. Extraordinary item section.	Material, unusual in nature, and infrequent in occurrence.
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 either the disposal of a component of the business or an extraordinary item.
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, possibly as an unusual item.	Loss on preparation of such proposals is not considered extraordinary in nature.
8. Reported in body of the income statement, possibly as an unusual item.	Strikes are not considered extraordinary in nature.
9. Prior period adjustment, adjust beginning retained earnings.	Corrections of errors are shown as prior period adjustments.
10. Extraordinary item section.	Material, unusual in nature, and infrequent in occurrence.
11. Discontinued operations section.	Division's assets, results of operations, and activities are clearly distinguishable physically, operationally, and for financial reporting purposes.