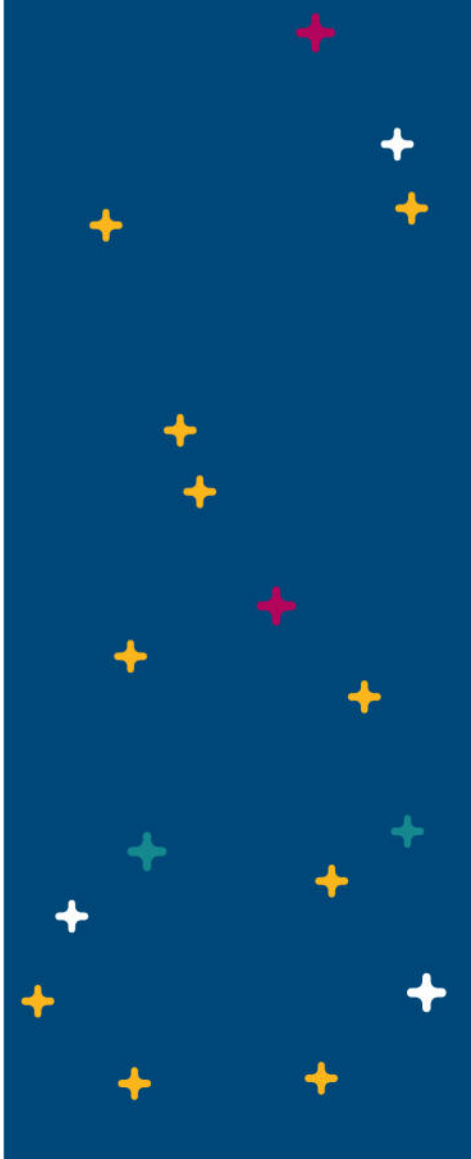
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1

Financial Reporting

Module

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MODULE

1 Balance Sheet, Income Statement, and Comprehensive Income

FAR 1

1 Balance Sheet

Under U.S. GAAP, general purpose financial reporting is defined as a full set of financial statements and notes to the financial statements. A full set of financial statements typically includes:

- Statement of financial position (balance sheet)
- Statement of earnings (income statement)
- Statement of comprehensive income
- Statement of cash flows
- Statement of owners' equity

Entities may present a classified balance sheet that distinguishes current and non-current assets and liabilities. When appropriate, a balance sheet presentation based on liquidity is also permissible. The following is an example of a classified balance sheet.

Company Name
Balance Sheet
As of December 31, Year 1

Assets	*Liabilities and Stockholders' Equity*
Current assets	**Current liabilities**
Cash and cash equivalents	Current portion of long-term debt
Trading securities, at fair value	Accounts payable
Accounts receivable, net of allowance	Notes payable
Notes receivable	Interest payable
Inventory	Salaries payable
Prepaid expenses	Unearned revenue
Investments	**Long-term liabilities**
Available-for-sale securities, at fair value	Bonds payable
Held-to-maturity securities	Deferred income tax liability
Investments in affiliates	Pension and other postretirement benefit liabilities

(continued)

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(continued)

Assets	*Liabilities and Stockholders' Equity*
Property, plant, and equipment	**Total liabilities**
Land	
Building	**Stockholders' equity**
Equipment	Capital stock
Less: accumulated depreciation	Preferred stock, $10 par, 8% cumulative and nonparticipating, 10,000 shares authorized, 5,000 shares issued and outstanding
Intangible assets	Common stock, $0.01 par, 600,000,000 shares authorized, 57,598,000 shares issued and 57,178,485 shares outstanding
Goodwill	Paid-in capital in excess of par
Patents, net of amortization	Retained earnings
Other assets	Accumulated other comprehensive income
Pension and other postretirement benefit assets	(Treasury stock at cost) (419,515 shares)
Deferred income tax asset	**Total stockholders' equity**
Total assets	**Total liabilities and stockholders' equity**

2 Uses of the Income Statement and Terminology

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

2.1 Uses of the Income Statement

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

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2.2 Terminology

2.2.1 Cost and Unexpired Costs

- **Cost** is an amount (measured in money) expended for items such as capital assets, services (e.g., payroll), and merchandise received. Cost is the amount actually paid for something.
- **Unexpired costs** are costs that will expire in future periods and be charged (allocated in a systematic and rational manner or matched) against revenues from future periods.

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

2.2.2 Gross Concept (Revenues and Expenses)

- **Revenues** are reported in the gross amount of consideration to which the entity expects to be entitled in exchange for the specified goods or services transferred.
- **Expenses** (costs that benefit only the current period or the allocation of unexpired costs to the current period for the benefit received) are reported at their gross amounts.

2.2.3 Net Concept (Gains and Losses)

- **Gains** are reported at their net amounts (i.e., proceeds less net book value). A gain is the recognition of an asset either not in the ordinary course of business (e.g., gains on the sale of a fixed asset) or without the incurrence of an expense (e.g., finding gold on the company's property).
- **Losses** are reported at their net amounts (i.e., proceeds less net book value). A loss is cost expiration either not in the ordinary course of business (e.g., loss on the sale of investment assets) or without the generation of revenue (e.g., abandonment).

Note: Items of income or loss that are unusual or infrequent (or both) should be reported separately as part of income from continuing operations. The nature of the item and the financial statement effects should be disclosed on the face of the income statement or in the footnotes.

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3 Income From Continuing Operations

3.1 Multiple-Step Income Statement

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

Example 1 Multiple-Step Income Statement

Facts: The following trial balance contains a list of income statement accounts for the year ended December 31, Year 1.

Trial Balance: Income Statement Accounts *Only*
For the Year Ended December 31, Year 1

4000	Sales revenue		$380
4050	Sales returns	$ 25	
4060	Sales discounts	5	
4100	Service revenue		200
4200	Rental revenue		100
5000	Cost of goods sold	200	
5100	Cost of services sold	150	
5200	Cost of rental income	60	
5250	Salaries expense*	70	
5300	Freight out	25	
5400	Commissions	40	
5500	Advertising	15	
5600	Insurance expense	20	
5800	Depreciation expense	80	
5900	Income tax expense	100	
6000	Interest revenue		170
6200	Other revenue		130
6500	Gain on sale of available-for-sale securities		50
7000	Interest expense	50	
7500	Loss on sale of fixed assets	40	
7550	Restructuring expense**	100	
8000	Loss on discontinued operations (net of tax)	25	

*Salaries expense: $20 relates to salaries for salespeople and $50 relates to salaries for officers of the company.
**Restructuring expense relates to an infrequent restructuring of service division.

(continued)

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(continued)

Note: The trial balance does not balance, as the balance sheet accounts are excluded.

Required: Prepare a multiple-step income statement prepared from the trial balance information above.

Solution:

Radon Industries Inc.
Income Statement
For the Year Ended December 31, Year 1
(in thousands)

Net sales (including goods, services, and rentals), less discounts and returns		$650
Cost of sales (including goods, services, and rentals):		(410)
Gross margin		$240
Selling expenses	$100	
General and administrative expenses	70	
Depreciation expense	80	(250)
Income (loss) from operations		$ (10)
Other revenues and gains:		
Interest revenue	170	
Gain on sale of available-for-sale securities	50	
Other revenue	130	350
Other expenses and losses:		
Interest expense	50	
Loss on sale of fixed assets	40	
Restructuring expense	100	(190)
Income before income tax		150
Income tax expense		(100)
Income from continuing operations		$ 50
Discontinued operations (net of tax)		(25)
Net income		**$ 25**

Selling expenses include freight out, salaries for salespeople, commissions, and advertising. General and administrative expenses include officers' salaries and insurance. Nonoperating revenues and gains include auxiliary activities.

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3.2 Single-Step Income Statement

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

Example 2 Single-Step Income Statement

Facts: Same as Example 1.

Required: Using the trial balance from Example 1, prepare a single-step income statement.

Solution:

Radon Industries Inc.
Income Statement
For the Year Ended December 31, Year 1
(in thousands)

Revenues and other items:	
Sales revenue	$ 350
Service revenue	200
Interest revenue	170
Rental revenue	100
Gain on sale of available-for-sale securities	50
Other revenue	130
Total revenues and other items	**$1,000**
Expenses and other items:	
Cost of goods sold	$ 200
Cost of services sold	150
Cost of rental income	60
Selling expenses	100
General and administrative expenses	70
Interest expense	50
Depreciation expense	80
Loss on sale of fixed assets	40
Restructuring expense	100
Income tax expense	100
Total expenses and other items	**$ 950**
Income from continuing operations	$ 50
Discontinued operations (net of tax)	25
Net income	**$ 25**

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4 Income From Discontinued Operations

Discontinued operations are reported separately from continuing operations in the income statement, net of tax. A discontinued operation may include a component of an entity, a group of components of an entity, or a business or nonprofit activity. Items reported within discontinued operations can consist of an impairment loss, a gain or loss from actual operations, and a gain or loss on disposal. All of these amounts are included in discontinued operations in the period in which they occur.

4.1 Types of Entities to Be Considered

The results of operations of a component of an entity or a group of components of an entity, or a business or nonprofit activity, will be reported in discontinued operations if it:

- has been disposed of; or
- is classified as held for sale.

4.2 Conditions That Must Be Present

4.2.1 Held-for-sale criteria

For a business activity to be classified as held for sale, all of the following criteria must be met:

1. Management commits to a plan to sell the activity.
2. The activity is available for immediate sale in its present condition.
3. An active program to locate a buyer has been initiated.
4. The sale of the activity is probable, and completion of the sale is expected to occur within a year.
5. The activity is being actively marketed at a reasonable sale price relative to its current fair value.
6. Significant changes in the plan to sell are not expected.

If any of the criteria are no longer met, the activity should be reclassified as held and used. The held and used classification is the default for property, plant, and equipment and simply means that a company uses the assets and they are not actively for sale.

All related costs shall be recognized when the obligations to others exist, not necessarily in the period of commitment to a plan. A disposal of a component or group of components is reported in discontinued operations if the disposal represents a strategic shift that has or will have a major effect on an entity's operations and financial results.

Examples of a strategic shift that could have a major effect on operations and financial results may include, among others:

- Disposal of a major geographical area
- Disposal of a major equity method investment
- Disposal of a major line of business

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A business or nonprofit activity that, on acquisition, meets the criteria to be classified as held for sale is a discontinued operation.

Illustration 1 Discontinued Operation

Am-Serv Inc. is a food service company that delivers frozen food products to food service providers. Its clients include fast-food restaurants, high-end steak houses, home-delivery diet food companies, and institutions such as schools and hospitals. Historically, the fast-food restaurants have been the largest segment of Am-Serv's business in terms of revenue and operating profit. However, that division is now forecast to begin to decline in revenues because the public is looking for healthier options. Am-Serv has decided to sell its fast-food operation and, instead, focus on selling to locally operated restaurants offering a healthier fare. Such restaurants will generally show lower revenue per unit, but higher operating profit per unit. Because the fast-food division is the largest component in terms of revenue and operating profit, the disposal represents a major strategic shift, and will be reported as a discontinued operation.

4.3 Discontinued Operations Calculation

4.3.1 Types of Items Included in Results of Discontinued Operations

- Results of operations of the component.
- Gain or loss on disposal of the component.
- Impairment loss (and subsequent increases in fair value) of the component.
  - **Initial and Subsequent Impairment Losses**

    A loss is recognized for recording the impairment of the component (i.e., any initial or subsequent write-down to fair value less costs to sell).
  - **Subsequent Increases in Fair Value**

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

4.3.2 Report in the Period Disposed of or Held for Sale

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

4.3.3 Depreciation and Amortization

Once management decides to dispose of the component, assets within the component are no longer depreciated or amortized.

4.4 Measurement and Valuation

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

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4.5 Presentation and Disclosure

- **Present as a Separate Component of Income:** The results of discontinued operations, net of tax, are reported as a separate component of income, below income from continuing operations.
- **Disclose in Face or in Notes:** A gain or loss recognized on the disposal shall be disclosed either on the face of the income statement or in the notes to the financial statements.

Example 3 Discontinued Operations Calculations and Income Statement Presentation

Facts: The trial balance below presents the income statement accounts for Year 1 from All Sports Company's trial balance. The golf division of All Sports has been losing money on a monthly basis. The golf division's income statement accounts are also presented below. The board of directors decides on April 30, Year 1, to dispose of the golf division. The carrying value of the golf division on April 30, Year 1, is $4,000,000, and its fair value less costs to sell is $2,200,000. After months of negotiations, the division's net assets are sold on June 30, Year 2, for $2,000,000. The golf division has continuing losses in Year 2 of $200,000 per month. All Sports' income tax rate is 40 percent for Years 1 and 2. Assume that All Sports' income from continuing operations is $4,875,000 in Year 1 and $5,200,000 in Year 2.

All Sports Company Trial Balance
Year 1

		All Components		Golf Division	
4000	Sales revenue		$21,000,000		$2,500,000
5000	Cost of goods sold	$9,500,000		$1,850,000	
5300	Freight out	155,000		135,000	
5400	Commissions	900,000		220,000	
5500	Advertising	1,200,000		600,000	
5600	Insurance expense	1,400,000		750,000	
5700	Salaries expense	2,500,000		850,000	
5800	Depreciation expense	950,000		495,000	
6000	Interest revenue		750,000		
6200	Other revenue		300,000		
6500	Gain on sale of assets		400,000		
7000	Interest expense	120,000			
7500	Impairment loss	1,800,000		1,800,000	

Required: How should the disposal of the golf division be reported on All Sports Company's Year 1 and Year 2 financial statements?

(continued)

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(continued)

Solution:

Reporting for Year 1:

The golf division was not disposed of until Year 2 and would be reported as held for sale in the Year 1 financial statements.

The continuing loss from the golf division would be included in discontinued operations in Year 1.

Loss from operations = $2,500,000 − ($1,850,000 + $135,000 + $220,000 + $600,000 + $750,000 + $850,000 + $495,000) = ($2,400,000).

Loss from operations, net of tax = ($2,400,000) × (1 − 40%) = ($1,440,000)

Impairment loss = $2,200,000 − $4,000,000 = ($1,800,000)

Impairment loss, net of tax = ($1,800,000) × (1 − 40%) = ($1,080,000)

Income Statement Presentation Year 1:

Income from continuing operations	$4,875,000
Discontinued operations	
Loss from operations of discontinued component, net of tax	(1,440,000)
Loss from impairment of discontinued operations, net of tax	(1,080,000)
Net income	$2,355,000

Reporting for Year 2:

In Year 2, discontinued operations would include the continuing losses incurred before the sale and the loss on disposal.

Loss from operations (Jan 1 − June 30) = ($200,000) × 6 = ($1,200,000)

Loss from operations, net of tax = ($1,200,000) × (1 − 40%) = ($720,000)

Loss on disposal = $2,000,000 − $2,200,000 = ($200,000)

Loss on disposal, net of tax = ($200,000) × (1 − 40%) = ($120,000)

Income Statement Presentation Year 2:

Income from continuing operations	$5,200,000
Discontinued operations	
Loss from operations of discontinued component, net of tax	(720,000)
Loss from sale (disposal) of discontinued operations, net of tax	(120,000)
Net income	$4,360,000

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5 Foreign Currency Transactions

Foreign currency transaction gains and losses occur when a company buys from or sells to a foreign company with whom it has no ownership interest and agrees to pay or accept payment in a foreign currency. Transactions between subsidiary and parent of a permanent financing nature are not considered foreign currency transactions.

5.1 Foreign Currency Terminology

- **Exchange Rate:** Exchange rate is the price of one unit of a currency expressed in units of another currency; the rate at which two currencies will be exchanged at equal value. The exchange rate may be expressed as:
  - **Direct Method:** The direct method is the domestic price of one unit of another currency. For example, one euro costs $1.47.
  - **Indirect Method:** The indirect method is the foreign price of one unit of the domestic currency. For example, 0.68 euro buys $1.00.
- **Current Exchange Rate:** Current exchange rate is the exchange rate at the current date, or for immediate delivery of currency, often referred to as the spot rate.
- **Denominated or Fixed in a Currency:** A transaction is denominated or fixed in the currency used to negotiate and settle the transaction, either in U.S. dollars or a foreign currency.

5.2 Changes in Exchange Rate

A foreign exchange transaction gain or loss will result if the exchange rate changes between the time a purchase or sale in foreign currency is contracted for and the time actual payment is made.

5.3 Transaction Not Settled at Balance Sheet Date

A foreign exchange transaction gain or loss that is recognized in current net income must be computed at each balance sheet date on all recorded transactions denominated in foreign currencies that have not been settled. The difference between the exchange rate used in recording the transaction in dollars and the exchange rate at the balance sheet date (current exchange rate) is an unrealized gain or loss on the foreign currency transaction.

5.4 Valuation of Assets and Liabilities

The assets or liabilities resulting from foreign currency transactions should be recorded in the U.S. company's books using the exchange rate in effect at the date of the transaction.

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Example 4 Foreign Currency Transaction

Facts: On 12/1/Yr 1, Millinio Company purchased goods on credit for 100,000 pesos. Millinio Company paid for the goods on 2/1/Yr 2. The exchange rates were:

Date	Rate
12/1/Yr 1	$0.10
12/31/Yr 1	$0.08
2/1/Yr 2	$0.09

Required: Prepare the journal entries related to this foreign currency transaction.

Solution:

12/1/Yr 1

DR	Purchases (100,000 pesos × $0.10 exchange rate)	$10,000	
CR	Accounts payable		$10,000

12/31/Yr 1

DR	Accounts payable [100,000 pesos × ($0.10 – $0.08)]	$2,000	
CR	Foreign exchange transaction gain		$2,000

100,000 pesos can be purchased for $8,000 at 12/31/Yr 1. The difference between the $8,000 and the original recorded liability of $10,000 is a foreign exchange transaction gain that increases net income for Year 1.

2/1/Yr 2

DR	Accounts payable	$8,000	
DR	Foreign exchange transaction loss [100,000 × ($0.08 – $0.09)]	1,000	
CR	Cash (100,000 pesos × $0.09)		$9,000

6 Statement of Comprehensive Income

6.1 Definitions

6.1.1 Comprehensive Income

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

	Net income
+	**Other comprehensive income**
	Comprehensive income

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6.1.2 Net Income

Net income includes the following items:

1. Income from continuing operations
2. Discontinued operations

6.1.3 Other Comprehensive Income

Other comprehensive income items are revenues, expenses, gains, and losses that are included in comprehensive income but excluded from net income under U.S. GAAP.

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

- **Pension Adjustments**

  Under U.S. GAAP, certain gains and losses from defined benefit pension plan accounting must be recognized in other comprehensive income in the year the changes occur. These gains and losses are included in other comprehensive income until recognized as pension expense on the income statement.

  Note: Defined benefit pension plan accounting is no longer tested on the CPA Exam.

- **Unrealized Gains and Losses (Available-for-Sale Debt Securities and Hedges)**

  The following types of unrealized gains and losses on certain investments in debt securities and hedges are reported as components of other comprehensive income until the securities are sold or until the cash flows associated with the hedged item are realized.

  - Unrealized holding gains and losses on "available-for-sale debt securities."
  - Unrealized holding gains and losses that result from a debt security being transferred into the "available-for-sale" category from "held to maturity."
  - Subsequent decreases or increases in the fair value of "available-for-sale" debt securities previously written down as impaired.
  - Gains or losses on derivative instruments that are designated as, and qualify as, cash flow hedges.
  - For derivatives that are designated in qualifying hedging relationships (both fair value and cash flow) with an excluded component (a component excluded from the assessment of hedge effectiveness), an entity is permitted to recognize, as a component of other comprehensive income, differences between the changes in fair value of the excluded component and initial amounts recognized under a systematic and rational method in earnings.

- **Foreign Currency Items**

  Foreign currency translation adjustments and gains and losses on foreign currency transactions that are designated as (and are effective as) economic hedges of a net investment in a foreign entity are reported as a component of other comprehensive income. Foreign currency translation adjustments remain in other comprehensive income until the sale or liquidation of the investment in the foreign entity. Also, gains and losses on intra-entity foreign currency transactions that are of a long-term investment nature, when the entities to the transaction are consolidated, are combined or accounted for by the equity method.

- **Instrument-Specific Credit Risk**

  For liabilities for which the fair value option is elected, changes in fair value that are attributable to instrument-specific credit risk are included in comprehensive income.

6.1.4 Reclassification Adjustments

Reclassification adjustments move other comprehensive income items from accumulated other comprehensive income to the income statement.

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6.1.5 Accumulated Other Comprehensive Income

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

Pass Key

At the end of each accounting period, all components of comprehensive income are closed to the balance sheet. Net income is closed to retained earnings, and other comprehensive income is closed to accumulated other comprehensive income.

6.2 Financial Statement Reporting

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

Under U.S. GAAP, comprehensive income may be presented in:

- a single statement of comprehensive income (single-statement approach); or
- an income statement followed by a separate statement of comprehensive income that begins with net income (two-statement approach).

6.2.1 Single-Statement Approach

The single-statement approach displays other comprehensive income items individually and in total, below the net income amount, and totals them for comprehensive income.

Example 5 Single-Statement Approach

Facts: The following other comprehensive income items were noted in the Year 1 trial balance of Sydney Technologies Inc. The tax rate for other comprehensive income items is 25 percent for Year 1.

Unrealized holding gains	$400,000
Foreign currency translation gains	50,000
Unrealized holding losses	120,000
Foreign currency translation losses	120,000

Required: Compute the net of tax amounts to be reported in the statement of comprehensive income and complete the following statement of comprehensive income using the single-statement approach.

(continued)

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(continued)

Solution:

The net of tax amounts to be reported in the statement of comprehensive income for each other comprehensive income item is as follows:

Unrealized holding net gains	$280,000 × (1 − 25%) = 210,000
Foreign currency items	$70,000 × (1 − 25%) = (52,500)

Sydney Technologies Inc.
Statement of Comprehensive Income
For the Year Ended December 31, Year 1

Revenues	$ 20,000,000
Expenses	(18,400,000)
Income before income taxes	$ 1,600,000
Income tax (25%)	(400,000)
Net income	$ 1,200,000
Other comprehensive income, net of income tax:	
Unrealized holding gains (available-for-sale securities)	$ 210,000
Foreign currency items	(52,500)
Other comprehensive income	157,500
Comprehensive income	$ 1,357,500

6.2.2 Two-Statement Approach

The two-statement approach displays comprehensive income as a separate statement that immediately follows the income statement.

Sydney Technologies Inc.
Statement of Comprehensive Income
For the Year Ended December 31, Year 1

Net income	$1,200,000
Other comprehensive income, net of income tax:	
Unrealized holding gains (available-for-sale securities)	$ 210,000
Foreign currency items	(52,500)
Other comprehensive income	157,500
Comprehensive income	$1,357,500

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6.3 Other Reporting Issues

6.3.1 Other Comprehensive Income

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

6.3.2 Income Tax Expense or Benefit

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

6.3.3 Interim Period Reporting

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

6.3.4 Required Disclosures

All formats must disclose:

- The tax effects of each component included in (current) other comprehensive income, either as part of the statement presentation or in the notes to the financial statements.
- The changes in the accumulated balances of each component of other comprehensive income (e.g., pension adjustments, unrealized holding gains and losses on available-for-sale debt securities and hedges, foreign currency items, and interest-specific credit risk).
  - The changes in the accumulated balances by component may be shown on the face of the financial statements or in the notes to the financial statements.
- Total accumulated other comprehensive income in the balance sheet as an item of equity.
- The reclassification adjustments, which are made to avoid double counting in other comprehensive income items that are displayed in net income for the current year (e.g., previously reported unrealized gains on available-for-sale securities that were realized during the current year).
  - Disclosure is required for:
    - —Changes in AOCI balances by component of other comprehensive income. The entity must separately disclose (i) reclassification adjustments; and (ii) current-period OCI.
    - —Significant items reclassified out of AOCI must be disclosed either on the face of the statement where net income is presented, or as a separate disclosure in the notes to the financial statements.
  - Amounts by OCI component may be presented either before-tax or net-of-tax, as long as the tax effect is shown in either the financial statements or the notes.

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1 SEC Reporting Requirements

The Securities and Exchange Commission (SEC) requires that more than 50 forms be filed to comply with reporting requirements. These forms are filed electronically through the *electronic data gathering, analysis, and retrieval system* (EDGAR) and are available online to the public.

1.1 Form 10-K

Form 10-K is the annual report that must be filed by U.S. registered companies (issuers). The report provides details to current and prospective investors about the business of a company and the relevant risk factors it faces, its financial and operating results for the year, and the perspective of its executive leadership. The filing deadlines relative to fiscal year-end are as follows:

- 60 days for large accelerated filers;
- 75 days for accelerated filers; and
- 90 days for all other registrants.



Pass Key

A large accelerated filer is defined by the SEC as an issuer with a worldwide market value of outstanding common equity held by nonaffiliates of $700 million or more as of the last business day of the issuer's most recently completed second fiscal quarter. An accelerated filer is defined as an issuer with a worldwide market value of outstanding common equity held by nonaffiliates of $75 million to less than $700 million and annual revenue of $100 million or more. Smaller reporting companies, which are entities with annual revenues of less than $100 million, are excluded from the definition of large accelerated filers or accelerated filers.

Specific items of importance contained in the 10-K report are as follows:

- **Part II, Item 7: "Management's Discussion and Analysis of Financial Condition and Results of Operations" (MD&A)**

  The objective of this section is to provide perspective on the business results of the company in management's own words. The MD&A will include the following components:

  - Material information that is relevant to an assessment of the financial condition and results of operations of the registrant, including information on liquidity and capital resources, as well as material impacts of cybersecurity incidents.
  - Summarized financial and operating results, trends, risks, and uncertainties.
  - Material changes and uncertainties relative to the prior period.
  - Critical accounting estimates and assumptions.

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- **Part II, Item 7A: "Quantitative and Qualitative Disclosures about Market Risk"**

  Market risk includes the risk of potential loss in value of financial instruments due to changes in interest rates, exchange rates, cybersecurity threats, and other market-related factors. The disclosures required in this item include:

  - Quantitative information as of the end of the latest fiscal year, presented in one of the following three disclosure alternatives:
    - —Tabular presentation of information related to market risk sensitive instruments
    - —Sensitivity analysis disclosures expressing potential loss in future earnings, fair value, or cash flows of market risk sensitive instruments
    - —Value-at-risk disclosures expressing potential loss in future earnings, fair value, or cash flows or market risk sensitive instruments
  - Qualitative information regarding primary market risk exposures, the management of these exposures, and changes relative to the most recently completed fiscal year and expectations for future periods.

- **Part II, Item 8: "Financial Statements and Supplementary Data"**
  - Audited financial statements (income statement, balance sheets, statement of cash flows, and statement of stockholders' equity) and accompanying notes presented using generally accepted accounting principles (GAAP). Time periods covered include the following:
    - —Balance sheets for the two most recent fiscal years.
    - —Income statements (and statement of comprehensive income) for each of the three fiscal years preceding the date of the most recent audited balance sheet.
    - —Statement of cash flows for each of the three fiscal years preceding the date of the most recent audited balance sheet.
    - —Changes in owners' equity for each of the three fiscal years preceding the date of the most recent audited balance sheet.
  - The auditor's report.
  - Certifications from the company's CEO and CFO regarding the accuracy and completeness of the 10-K.

1.2 Form 10-Q

Form 10-Q is the quarterly report that must be filed by U.S. registered companies for each of the first three quarters of every fiscal year. The report provides an overview of business operations, financial statements, nonfinancial information (e.g., legal items, risk factors, recent equity sales), and relevant disclosures. The filing deadlines relative to fiscal quarter-end are as follows:

- 40 days for large accelerated and accelerated filers; and
- 45 days for all other registrants.

Specific items of importance contained in the 10-Q report are as follows:

- **Part I, Item 1: "Financial Statements"**

  Requirements are similar to Form 10-K, Part II, Item 8, with the following notable differences:

  - They are generally unaudited financial statements.
  - They must be filed for each of the first three fiscal quarters of the entity's fiscal year.

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- They may be presented in a condensed format and should reflect adjustments necessary to fairly state the results of the interim period, with a statement to that effect included in the notes to the financial statements. If all such adjustments are of a normal recurring nature, a statement should be made to that effect. The financial statements should include a detailed description of the nature and amounts of adjustments that are not normal recurring adjustments.
- Balance sheet presentations:
  - —As of the end of the most recent fiscal quarter and as of the end of the preceding fiscal year.
  - —May also include balance sheet as of the end of the corresponding fiscal quarter for the preceding fiscal year if necessary to understand the impact of seasonal fluctuations.
- Income statements and comprehensive income presentations:
  - —For the most recent fiscal quarter, for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year.
  - —May also include income statements for the cumulative 12-month period ended during the most recent fiscal quarter and for the corresponding preceding period.
- Statement of cash flows presentations:
  - —For the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and the corresponding period for the preceding fiscal year.
  - —May also include statements of cash flows for the cumulative 12-month period ended during the most recent fiscal quarter and for the corresponding preceding period.

- **Part I, Item 2: "Management's Discussion and Analysis of Financial Condition and Results of Operations"**

  Requirements are similar to Form 10-K, Part II, Item 7, along with the following additional disclosures related to any material changes in:

  - Financial condition from the end of the preceding fiscal year to the date of the most recent interim balance sheet. If an interim balance sheet as of the corresponding interim date of the preceding fiscal year is included, management should disclose any material changes in financial condition from that date to the date of the most recent interim balance sheet.
  - Operational results with respect to the most recent fiscal year-to-date period where a statement of comprehensive income is provided, and the corresponding year-to-date period of the preceding fiscal year.
  - Operational results with respect to the most recent quarter for which a statement of comprehensive income is provided and either the corresponding quarter for the preceding fiscal year or the immediately preceding sequential quarter.

- **Part I, Item 3: "Quantitative and Qualitative Disclosures About Market Risk"**

  Requirements are similar to Form 10-K, Part II, Item 7A. Discussion and analysis should help the reader understand changes in market risk from the end of the preceding fiscal year to the date of the most recent interim balance sheet.

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1.3 Form 8-K

This form is filed by U.S. registered companies to disclose changes whenever a material event occurs. Examples of material events are as follows:

- Bankruptcy
- Acquisition or disposition of assets
- Material cybersecurity incidents
- New material financial obligations
- Costs associated with exit or disposal activities
- Material asset impairments
- Changes in the public accounting firm used to audit the company
- Changes in securities and trading markets
- Changes in or election of directors and officers
- Amendments to bylaws or articles of incorporation
- Changes in fiscal year
- Financial statement changes
- Material definitive agreements

Companies generally have four business days to file the form for any event that triggers a filing requirement.

2 Earnings per Share Overview

Under U.S. GAAP, all public entities (or entities that have made a filing for a public offering) are required to present earnings per share on the face of the income statement. An entity's capital structure determines the manner in which earnings per share are disclosed.

An entity has a simple capital structure if it has only common stock outstanding. The entity presents basic per-share amounts for income from continuing operations and for net income on the face of the income statement.

All other entities must present basic and diluted per-share amounts for income from continuing operations and for net income on the face of the income statement (or statement of income and comprehensive income if the entity is using the one-statement approach).

If the entity reports a discontinued operation, the entity must present the basic and diluted (if applicable) per-share amounts for that item either on the face of the income statement or in the notes to the financial statements.

3 Simple Capital Structure (Report Basic EPS Only)

An entity that issues only common stock (or no other securities that can become common stock, such as noncovertible preferred stock) is said to have a simple capital structure. This organization will present EPS for income from continuing operations and for net income on the face of the income statement. The number of common shares outstanding (the denominator) used in the EPS calculation is arrived at by the weighted average method.

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3.1 Basic EPS Formula

For an organization with a simple capital structure, the formula for earnings per share is as follows:

$$\text{Basic EPS} = \frac{\text{Income available to common shareholders}}{\text{Weighted average number of common shares outstanding}}$$

3.2 Income Available to the Common Shareholders

Income available to common shareholders is determined by deducting from the line item income from continuing operations and net income (1) dividends declared in the period on noncumulative preferred stock (regardless of whether they have been paid) and (2) dividends accumulated in the period on cumulative preferred stock (regardless of whether they have been declared).

If there is a loss from continuing operations (or a net loss), the amount of the loss should be increased by the preferred shareholders' dividends or claims to determine income available to the common shareholders.

3.3 Weighted Average Number of Common Shares Outstanding

The weighted average number of common shares outstanding during the period is the mean (average) of shares outstanding and assumed to be outstanding for EPS calculations. Shares sold or reacquired during the period (including treasury stock) should be weighted for the portion of the period they were outstanding.

Shares outstanding at the beginning of the period
+ Shares sold during the period (on a time-weighted basis)
− Shares reacquired during the period (on a time-weighted basis)
+ Stock dividends and stock splits (retroactively adjusted)
− Reverse stock splits (retroactively adjusted)

Weighted average number of common shares outstanding

3.3.1 Stock Dividends and Stock Splits

Stock dividends and stock splits (to the same class of shareholders in the same company) must be treated as though they occurred at the *beginning* of the period. The shares outstanding before the stock dividend or stock split must be restated for the portion of the period before the stock dividend/split. If prior periods are presented, the effects of stock dividends and stock splits must be retroactively adjusted for those periods.

- If a stock dividend or stock split occurs after the end of the period but before the financial statements are issued, those shares should enter into the shares outstanding for the EPS calculation for all periods presented.
- Reverse stock splits would retroactively reduce shares outstanding for all periods presented.

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3.3.2 Rules for Stock Issued in a Business Combination

If the acquisition method is used, the weighted average is measured from the date of the combination.

Example 1 **Weighted Average Number of Shares Outstanding Computation**

Facts:

Date	Transaction	Change in Shares	Total Shares
1/1	Shares outstanding		1,000,000
3/31	2-for-1 stock split	1,000,000	2,000,000
4/1	Additional shares sold	3,000,000	5,000,000
12/1	Reacquired shares (treasury)	(500,000)	4,500,000

Required: Calculate the weighted average number of shares outstanding.

Solution:

Total Shares	×	Period Outstanding	×	Adjustment for Split	=	Weighted Average
1,000,000		3/12 (Jan–Mar)		2		500,000
5,000,000		8/12 (April–Nov)				3,333,333
4,500,000		1/12 (Dec)				375,000
				Weighted average shares outstanding		4,208,333

Alternative Solution:

Date	Transaction	Gross Change in Shares	Adjustment to Weighted Average Shares	
1/1	Shares outstanding	(beginning number)	1,000,000	
3/31	2-for-1 stock split	1,000,000	1,000,000	[effective 1/1]
4/1	Additional shares sold	3,000,000	2,250,000	[3,000,000 × 9/12]
12/1	Reacquired shares	(500,000)	(41,667)	[500,000 × 1/12]
	Weighted average shares outstanding		4,208,333	

4 Complex Capital Structure (Report Basic and Diluted EPS)

An entity has a complex capital structure when it has securities that can potentially be converted to common stock and would therefore dilute (reduce) EPS (of common stock). Both basic and diluted EPS must be presented. The basic EPS calculation ignores potentially dilutive securities in the weighted average number of shares outstanding calculation. The objective of diluted EPS is to measure the performance of an entity over the reporting period while giving effect to all potentially dilutive common shares outstanding during the period. Potentially dilutive securities include:

- convertible securities (e.g., convertible preferred stock, convertible bonds, etc.);
- warrants and other options;
- contracts that may be settled in cash or stock; and
- contingent shares.

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4.1 Diluted EPS Formula

$$\text{Diluted EPS} = \frac{\text{Income available to the common stock shareholder} + \text{Interest on dilutive securities}}{\text{Weighted average number of common shares (assuming all dilutive securities are converted to common stock)}}$$

4.2 Dilution From Options, Warrants, and Their Equivalents

The dilutive effect of options and warrants and their equivalents is applied using the treasury stock method. The treasury stock method assumes that the proceeds from the exercise of stock options, warrants, and their equivalents will be used by the company to repurchase treasury shares at the prevailing market price, resulting in an incremental increase in shares outstanding, but not the full amount of shares that are issued on exercise of the common stock equivalents. The equivalents of options and warrants include nonvested stock granted to employees, stock purchase contracts, and partially paid stock subscriptions. Any canceled or issued options or warrants during the period shall be included in the denominator of diluted EPS for the period they were outstanding.

4.2.1 Dilutive vs. Antidilutive

Options and similar instruments are only dilutive when the average market price of the underlying common stock exceeds the exercise price of the options or warrants because it is unlikely they would be exercised if the exercise price were higher than the market price. These options or warrants would be "out of the money" and antidilutive. Previously reported EPS should not be adjusted retroactively in the case of options or similar instruments to reflect subsequent changes in market prices of the common stock.

4.2.2 Treasury Stock Method

The treasury stock method is applied as follows:

- If the average market price of the stock is greater than the exercise price (called "in the money"), assume that the warrants or other options are exercised at the beginning of the period (or at the time of issue, if later).
- Also assume that the proceeds received (the option or exercise price) are used to purchase common shares at the average market price during the period.
- When the option/warrant is in the money (average market price > exercise price), the proceeds (assumed to be) received will not be sufficient to buy back an (assumed) equal number of shares. This will always result in dilution.
- The difference between the number of shares assumed issued to satisfy the options or warrants and the number of shares assumed to be purchased with the proceeds should be included in the number of shares (denominator) for diluted EPS.
- Previously reported EPS data should not be retroactively adjusted for changes in market price.

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The formula to compute additional shares for options and similar instruments is:

$$\text{Additional shares outstanding} = \text{Number of shares} - \left(\frac{\text{Number of shares} \times \text{Exercise price}}{\text{Average market price}} \right)$$

Example 2 Options and Warrants Treasury Stock Method

Facts:

1,000 options to purchase 1,000 common stock shares
$15.00 exercise price per share
$20.00 average market price
$25.00 period-end market price

Required: Compute the incremental shares to be added to WACSO when computing diluted EPS using the treasury stock method.

Solution:

		Diluted
Options/common stock shares	1,000 →	1,000
Exercise price per share	× $ 15.00	
Cash corp. received (hypothetically)	$15,000	
Diluted "repurchase price"	÷ $ 20.00	
Repurchase shares (hypothetically)		<750>
Common shares added to WACSO when computing diluted EPS		250 shares

Formula Approach

$$1{,}000 - \frac{1{,}000 \times \$15.00}{\$20.00} = 250 \text{ shares}$$

4.3 Dilution From Convertible Securities: Bonds or Preferred Stock

The "if-converted" method should be used to determine the dilutive effects of the convertible securities. The if-converted method assumes that the securities were converted to common stock at the *beginning* of the period (or at the time of issue, if later).

4.3.1 Convertible Bonds

Use the following steps to apply the if-converted method to convertible bonds:

1. Add to the numerator (i.e., income available to common shareholders) the interest expense, net of tax, due to the assumed conversion of bonds to common stock.

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2. Add to the denominator (i.e., weighted average number of shares outstanding) the number of common shares associated with the assumed conversion.
3. If the convertible bonds were issued during the period, assume that the stock was issued at that date for the weighted average calculation.

Illustration 1 Convertible Bonds: If-Converted Method

Actual		Pretend
$100	Income	$100
<20>	Bond interest	<0>
80	Income before taxes	100
<32>	Taxes (40%)	<40>
$ 48	N.I. available to common stockholders	$ 60

4.3.2 Antidilution

Use the results of each assumed conversion only if it results in dilution (i.e., reduces EPS). Do not include the results of the *assumed* conversion if it is antidilutive (i.e., increases EPS). In determining whether potential common shares are dilutive or antidilutive, each issue will be considered separately in sequence from most to least dilutive, with options and warrants generally included first. The tests for dilutive or antidilutive effects should be based on income from continuing operations.

Example 3 Application of the If-Converted Method (Convertible Bonds)

Facts: X Company has outstanding 100,000 shares of common stock and $500,000 in 6 percent bonds convertible into 10 shares for each $1,000 bond. Net income for the year is $100,000.

Required: Compute the diluted EPS assuming a 34 percent tax rate.

Solution:

Diluted net income:	
Net income	$100,000
Add: Interest on bonds, less tax effects [0.06 × $500,000 × (1 − 0.34)]	19,800
Total net income	$119,800
Diluted shares outstanding:	
Common stock	100,000
Convertible bonds [($500,000 / $1,000 face value) × 10 shares]	5,000
Total common shares outstanding	105,000
Diluted EPS ($119,800 / 105,000 shares)	$ 1.14

(continued)

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(continued)

Compare basic EPS computed with the bonds to diluted EPS computed without the bonds to determine whether the inclusion of the convertible bonds in the computation of diluted EPS is antidilutive:

Basic EPS (without conversion) ($100,000 ÷ 100,000 shares)	$ 1.00

Diluted EPS with conversion of the convertible bonds ($1.14) is more than basic EPS without the conversion ($1.00). The convertible bonds are antidilutive and would be excluded.

4.3.3 Convertible Preferred Stock

Use the following steps to apply the if-converted method to convertible preferred stock:

1. Adjust the numerator (as preferred stock dividends do not affect net income).
2. Add to the denominator the number of shares associated with the assumed conversion.

Antidilution rules apply to convertible preferred stock.

Example 4 — Application of the If-Converted Method (Convertible Preferred Stock)

Facts: Carlin Company has outstanding 100,000 shares of common stock and 10,000 shares of convertible preferred stock, convertible into five shares of common stock for each share of preferred. Net income for the year is $100,000. Dividends declared during the year were $20,000 on the preferred, and $30,000 on the common.

Required: Compute the diluted EPS assuming a 34 percent tax rate.

Solution:

Diluted shares outstanding:	
Common stock	100,000
Convertible preferred stock (10,000 × 5)	50,000
Total common shares outstanding	150,000
Diluted net income:	$100,000
Diluted EPS ($100,000 ÷ 150,000)	$ 0.67

Note: The preferred stock dividends are not subtracted from net income. We assume that since the preferred stock was converted into common stock, the preferred stock dividends were not paid.

Antidilution is checked by comparing basic EPS with the calculated diluted EPS:

$$\text{Basic EPS: } \frac{\$100{,}000 - \$20{,}000}{100{,}000} = \$0.80$$

Since diluted EPS is less than basic EPS (without conversion), the preferred stock is dilutive, and diluted EPS is $0.67.

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4.4 Dilution From Contracts That May Be Settled in Cash or in Stock

If a contract could be settled in either stock or cash at the election of either the entity or the holder, the facts available each period determine whether it is reflected in the computation of EPS. It is presumed that the contract will be settled in common stock and the resulting shares included in diluted EPS if the effect is more dilutive.

4.5 Dilution From Contingent Shares

Contingent issuable shares do not require cash consideration and depend on some future event or on certain conditions being met. Contingent shares (that are dilutive) are also included in the calculation of *basic* EPS if (and as of the date) all conditions for issuance are met.

Issuable shares contingent on the attainment of a certain level of earnings are treated as follows, if dilutive:

- If the necessary conditions have been satisfied by the end of the period, those shares are included in basic EPS as of the beginning of the period in which the conditions were satisfied.
- If the necessary conditions have not been satisfied by the end of the period, the number of contingently issuable shares included in diluted EPS is based on the number of shares that would be issuable, if any, if the end of the reporting period were the end of the contingency period. These shares are included as of the beginning of the period (or as of the date of the contingent stock agreement, if later). If the contingency is due to attainment of future earnings and/or future prices of the shares, both earnings to date and current market price, as they exist at the end of the reporting period, are used.

5 Earnings per Share Disclosures

Cash flow per share should not be reported. In addition to reporting basic EPS and diluted EPS for both income from continuing operations and net income and the effects of discontinued operations, the following disclosure requirements must be met:

- A reconciliation of the numerators and the denominators of the basic and diluted per-share computations for income from continuing operations.
- The effect that has been given to preferred dividends in arriving at income available to common stockholders in computing basic EPS.
- Securities that could potentially dilute basic EPS in the future that were not included in the computation of diluted EPS because the effect was antidilutive for the period(s) presented.
- Description of any transaction that occurred after the period end that would have materially affected the number of actual and/or potential common shares outstanding.

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Pass Key

	Weighted Average	Options and Warrants	Convertible Bond	Convertible P/S	Contingent Issues
Basic	Yes	N/A	N/A	N/A	Conditions have been fully satisfied
Diluted	Yes	Average market value > Exercise price **Treasury stock method** Repurchase common stock at the *average* price	Any dilutive **If-converted method** Adjust net income for interest expense (not incurred) reduced by taxes	Any dilutive **If-converted method** Do *not* reduce income available to common shareholders by the preferred stock dividend (pretend they were converted)	Based upon conditions having been met to date

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