Study Unit One

Introduction to Financial Statements

1.1	*Concepts of Financial Accounting*	*2*
1.2	*Balance Sheet (Statement of Financial Position)*	*6*
1.3	*Income Statement and Statement of Comprehensive Income*	*12*

This study unit is the **first of seven** on **external financial reporting decisions**. The relative weight assigned to this major topic in Part 1 of the exam is **15%**. The seven study units are

- **Study Unit 1: Introduction to Financial Statements**
- Study Unit 2: Advanced Financial Statements and Consolidations
- Study Unit 3: Measurement, Valuation, and Disclosure: Assets -- Short-Term Items
- Study Unit 4: Measurement, Valuation, and Disclosure: Assets -- Long-Term Items
- Study Unit 5: Measurement, Valuation, and Disclosure: Liabilities
- Study Unit 6: Revenue, Impairment Recognition, and IFRS
- Study Unit 7: Integrated Reporting

This study unit discusses the basic concepts underlying financial accounting, which are important to understand before moving on to Study Units 2 through 7. Topics covered in this study unit include

- Users of accounting
- Accrual accounting
- Basic financial statements
- The accounting equation and transaction analysis

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

1.1 Concepts of Financial Accounting



Author's Note

The terms "company," "organization," "firm," and "entity" are used interchangeably in this study unit.

The Objective of General-Purpose Financial Reporting

The objective of general-purpose financial reporting is to report financial information that is **useful in making decisions** about providing resources to the reporting entity.

- A reporting entity is an organization that prepares financial information for external users.
- Financial reporting is the process of preparing financial statements.

The information reported in the financial statements relates to the entity's economic resources and claims to those resources. Those resources and claims are summarized in the balance sheet, otherwise known as the statement of financial position. Information about economic resources and claims helps to evaluate liquidity, solvency, financing needs, and the probability of obtaining financing.

- Liquidity is the ability to quickly convert an asset into cash.
- Solvency is the ability to pay debts.
- Financing refers to the ability to obtain funds for business activities.

Users of financial statements need to differentiate between changes in economic resources and claims arising from the entity's performance and other events and transactions. The performance of an entity is summarized in the income statement. Information about financial performance is useful for

- Understanding the return on economic resources, its variability, and its components
- Evaluating management
- Predicting future returns

For financial statements to be useful to external parties, they must be prepared in conformity with accounting principles that are generally accepted in the United States (U.S. GAAP).



Success Tip

The CMA exam also tests some knowledge of International Financial Reporting Standards (IFRS). Significant differences between IFRS and U.S. GAAP are detailed in Study Unit 6, Subunit 4. If an exam question does not distinguish between U.S. GAAP and IFRS, use U.S. GAAP.

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Financial accounting differs from management accounting. Management accounting assists management decision making, planning, and control. Management accounting information is primarily directed to specific internal users. Management accounting topics are covered in Study Units 8 through 16.

Users of Financial Statements

External users are the primary users of financial statements. External users use financial statements to determine whether doing business with the firm will be beneficial.

- Investors, including current and potential stockholders, need information to decide whether to increase, decrease, or obtain an investment in a firm.
- Creditors, such as banks and suppliers, need information to determine whether to extend credit and under what terms.
- Financial advisors and analysts need financial statements to help investors evaluate particular investments.
- Stock exchanges need financial statements to evaluate whether to accept a firm's stock for listing or whether to suspend the stock's trading.
- Regulatory agencies may need financial statements to evaluate the firm's conformity with regulations and to determine price levels in regulated industries.

Internal users also use financial statements to make decisions affecting the operations of the business. These users include management, employees, and the board of directors.

Features of Financial Statements

Financial statements are the primary means of communicating financial information to external parties. Additional information is provided by financial statement notes, supplementary information (such as management's discussion and analysis), and other disclosures. Information typically disclosed in notes is essential to understanding the financial statements.

- The notes are considered part of the basic financial statements. They amplify or explain information recognized in the statements and are a fundamental part of statements prepared in accordance with U.S. GAAP.
  - The first footnote accompanying any set of complete financial statements is generally one describing significant accounting policies, such as the use of estimates and assumptions, and policies relating to revenue recognition and allocation of asset costs to current and future periods.

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

A full set of financial statements includes the following statements:

- Balance sheet (also called the statement of financial position)
- Income statement
- Statement of comprehensive income
- Statement of changes in equity
- Statement of cash flows

To be useful, information presented in the financial statements must be relevant, faithfully represented, and consistent.

- Usefulness is enhanced when the information is comparable with similar information for other entities and the same entity for another period or date. **Comparability** allows users to understand similarities and differences. For example, if two companies both follow the same accounting principles and use the same accounting methods, a creditor or investor can evaluate them based on the comparability of the information and results presented.
- **Consistency** is necessary so that users can rely on the information presented and compare results from period to period. Consistency means that a company applies the same accounting method in the periods presented for evaluation.
- To be recognized in the financial statements, an item must be measurable, relevant, faithfully represented, verifiable, and neutral.

Financial statements are prepared under the **going-concern assumption**, which means that the entity is assumed to continue operating indefinitely and that it will not be liquidated in the near future.

Financial Statement Relationships

Financial statements complement each other. They describe different aspects of the same transactions, and more than one statement is necessary to provide information for a specific economic decision.

The components of one statement relate to those of other statements. Among the relationships are the following:

- Net income or loss from the income statement is reported and accumulated in the retained earnings account, a component of the equity section of the statement of financial position.
- The components of cash and cash equivalents from the statement of financial position are reconciled with the corresponding items in the statement of cash flows.
- Items of equity from the statement of financial position are reconciled with the balances on the statement of changes in equity.
- Ending inventories are reported in current assets on the statement of financial position and are reflected in the calculation of cost of goods sold on the income statement.
- Amortization and depreciation reported in the income statement also are reflected in asset and liability balances in the statement of financial position.

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Accrual Basis of Accounting

Financial statements are prepared under the accrual basis of accounting. Accrual accounting records the financial effects of transactions and other events and circumstances when they occur rather than when their associated cash is paid or received.

- Revenues are recognized in the period in which they were earned, even if the cash will be received in a future period. This is referred to as the **revenue recognition principle**.
- Expenses are recognized in the period in which they were incurred, even if the cash will be paid in a future period.
  - Under the **matching principle**, expenses are recognized in the same period as the related revenue.
  - Expense recognition principles associate cause and effect, systematic and rational allocation, and immediate recognition.

Example 1-1 Revenue Recognition

Ann owns a lawn care business. She mows Greg's lawn on May 25 and sends Greg an invoice. Greg pays Ann on June 3. Under the revenue recognition principle, Ann recognizes the revenue in May, the month the work was performed.

Ann purchases fuel for the lawnmower on May 24 with a credit card. She uses that fuel to mow Greg's lawn on May 25. She receives the credit card bill in the mail in June and pays for the fuel June 8. Ann recognizes the fuel expense in May, the month the expense was incurred, even though she pays for the fuel in June.



Author's Note

Under the **cash basis**, revenues are recognized when cash is received and expenses are recognized when cash is paid. Under U.S. GAAP, financial statements cannot be prepared under the cash basis of accounting.

The value at which financial statement elements are measured depends on the type of transaction and the relevant accounting standard. For example, the value of an asset could be the historical cost or the current fair value. Measurement and valuation are covered in Study Units 3-5.

An **accounting period** is a period of time for which financial results are summarized and communicated. It may be annual, quarterly, monthly, or another time period. A calendar year refers to the period January 1-December 31. A fiscal year refers to any 12-month period, such as July 1, Year 1, to June 30, Year 2.

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

1.2 Balance Sheet (Statement of Financial Position)

The balance sheet, also called the statement of financial position, reports the amounts of assets, liabilities (debt), and equity and their relationships at a moment in time, such as at the end of the fiscal year. It helps users assess liquidity, financial flexibility, the efficiency with which assets are used, capital structure, and risk.

- Liquidity is the ability to convert assets, such as inventory, to cash.
- Financial flexibility is the ability to restructure finances to react quickly to new opportunities or unexpected expenses.
- Capital structure refers to the company's mix of debt and equity financing.

The **basic accounting equation** presents a perfect balance between the entity's resources and its capital structure.

- The entity's resources consist of the assets used in its attempts to earn a profit.
- The capital structure consists of the amounts contributed by creditors (liabilities) and investors (stockholders' equity). Stockholders' equity may also be referred to as shareholders' equity.

Assets = Liabilities + Stockholders' equity

Transaction Analysis

Using the basic accounting equation, all transactions of the entity can be illustrated based on the impact of the transaction to the accounting equation. Every transaction will have a dual effect, impacting at least two accounts of the equation. The elements of the accounting equation are assets, liabilities, and stockholders' equity.

- The accounting equation must remain in balance with each accounting transaction.

An **account** is a record that tracks the increases and decreases in specific assets, liabilities, or stockholders' equity items. For example, accounts payable is a liability account. That account is used to keep track of the amounts owed to creditors and suppliers on account.



Author's Note

Although financial accounting typically uses debits and credits to record transactions in journal entries, the CMA exam has traditionally used increases and decreases to refer to a transaction's impact on the elements of the accounting equation. This text therefore presents transactions with increases and decreases.

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Example 1-2 Transaction Analysis

Examples of transaction analysis include the following:

- Borrowing cash from a bank with a note payable

Assets	=	Liabilities	+	Stockholders' Equity
Cash ↑		Notes payable ↑		

- Receiving cash when providing services for customers

Assets	=	Liabilities	+	Stockholders' Equity
Cash ↑				Service revenue ↑

- Paying a supplier an amount owed on account

Assets	=	Liabilities	+	Stockholders' Equity
Cash ↓		Accounts payable ↓		

- Purchasing inventory on account from a supplier

Assets	=	Liabilities	+	Stockholders' Equity
Inventory ↑		Accounts payable ↑		

- Purchasing equipment with cash

Assets	=	Liabilities	+	Stockholders' Equity
Cash ↓ Equipment ↑				

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Elements of the Balance Sheet

Assets are resources owned by the entity as a result of past events. They represent probable future economic benefits to the entity.

- Examples include inventory; accounts receivable; investments; and property, plant, and equipment.

Liabilities are present obligations of the entity arising from past events. Liabilities represent amounts owed. Their settlement is expected to result in an outflow of economic benefits from the entity.

- Examples include loans payable, bonds payable, and accounts payable.

Equity is the owner's residual interest in the assets of the entity after subtracting all its liabilities.

- Examples include a company's common stock, preferred stock, and retained earnings.
- Equity is affected not only by operations but also by transactions with owners, such as dividends and contributions.

Assets and liabilities are separated in the balance sheet into **current** and **noncurrent** categories. Assets are generally reported in order of liquidity, which means the order in which the assets are expected to be converted to cash.

Some variation of the following classifications is used by most entities. The subunit references below refer to the locations where topics are covered in more detail.

Assets
Current assets:
  Cash
  Certain investments (4.1-4.3)
  Accounts receivable (3.1)
  Inventories (3.2-3.3)
  Prepaid expenses
Noncurrent assets:
  Certain investments and funds (4.1-4.3)
  Property, plant, and equipment (PPE) (4.4)
  Intangible assets (4.5)
  Other noncurrent assets

Liabilities
Current liabilities:
  Accounts payable
  Current notes payable
  Current maturities of noncurrent liabilities
Noncurrent liabilities:
  Noncurrent notes payable
  Bonds payable (5.4)

Equity
Common stock (2.1)
Retained earnings (2.1)

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Current and Noncurrent Assets

An asset is classified as **current** on the balance sheet if it is expected to be realized in cash or sold or consumed within the entity's operating cycle or 1 year, **whichever period is longer**. The operating cycle is the number of days it takes to purchase inventory, sell it on account, and collect the cash on the sale. The following are the major categories of current assets:

- **Cash and cash equivalents**
  - Cash and cash equivalents are the most liquid assets. Cash equivalents are securities that can be quickly converted into cash.
- **Certain debt securities**
  - Certain debt securities classified as trading are treated as current assets. Debt securities that are available-for-sale or held-to-maturity may be treated as current assets. These classifications of debt security investments are covered in Study Unit 4, Subunit 3.
- **Receivables**
  - Accounts receivable arise from making a sale to a customer on account. They represent amounts due to the company. Accounts receivable is covered in Study Unit 3, Subunit 1.
- **Inventories**
  - Inventory is the goods a company owns that are available to sell to customers. Inventory is covered in Study Unit 3.
- **Prepaid expenses**
  - Prepaid expenses are expenses that are paid in advance and benefit more than one accounting period. Insurance is an example. Expenses expire with time, and until then, they are assets.

Noncurrent assets (long-term assets) are those not qualifying as current. The following are the major categories of noncurrent assets:

- **Investments and funds** include nonoperating items intended to be held beyond the longer of 1 year or the operating cycle. The following assets are typically included:
  - Investments in equity securities made to control or influence another entity and other noncurrent securities. Equity securities are covered in Study Unit 4, Subunits 1 and 2.
  - Certain available-for-sale and held-to-maturity debt securities may be noncurrent. Debt securities are covered in Study Unit 4, Subunit 3.
- **Property, plant, and equipment (PPE)** are tangible operating items recorded at cost and reported net of any accumulated depreciation. PPE is covered in Study Unit 4, Subunit 4. It includes the following:
  - Land and natural resources subject to depletion, e.g., oil and gas. Depletion refers to the allocation of cost as the resource is used.
  - Buildings, equipment, furniture, fixtures, leasehold improvements, land improvements, a lessee's right-of-use assets held under finance and operating leases, noncurrent assets under construction, and other depreciable assets. Depreciation is the cost allocation of the asset over its useful life.
- **Intangible assets** are nonfinancial assets without physical substance. Examples are patents and goodwill. Intangible assets are covered in Study Unit 4, Subunit 5.

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Current and Noncurrent Liabilities

Current liabilities are expected to be settled or liquidated in the ordinary course of business during the longer of the next year or the operating cycle. Generally speaking, current liabilities are expected to be settled or liquidated within 1 year from the balance sheet date. The following are the major categories of current liabilities:

- **Accounts (or trade) payables** for materials and supplies used in producing goods or services for sale.
- **Other payables** arising from operations, such as wages, salaries, rentals, royalties, interest, and taxes. The term “accrued expenses” is used for many of these types of current liabilities.
- **Unearned revenues** arising from collections in advance of delivering goods or performing services, e.g., ticket sales revenue.
- **Other obligations** expected to be liquidated in the ordinary course of business during the longer of the next year or the operating cycle. These include
  - Short-term notes
  - Payments on the current portion of bonds or other noncurrent debt
  - Long-term obligations that are or will become callable by the creditor because of the debtor’s violation of a provision of the debt agreement at the balance sheet date
  - Possible obligations for warranties (guarantees) and estimated returns

Current liabilities **do not include** short-term debt if an entity intends to refinance them on a noncurrent basis and demonstrates an ability to do so.

- The ability to refinance may be demonstrated by entering into a **refinancing agreement** before the balance sheet is issued.

Noncurrent liabilities (long-term liabilities) are those not qualifying as current. The noncurrent portions of the following items are reported in this section of the balance sheet.

- **Noncurrent notes and bonds**
- **A lessee’s liabilities** under finance and operating leases
  - These lease classifications are covered in Study Unit 5, Subunit 2.
- **Deferred tax liabilities** arising from interperiod tax allocation
  - Deferred income taxes result from the different treatment of certain transactions for financial reporting compared to income tax reporting. This subject is covered in Study Unit 5, Subunit 3.
- **Obligations under product or service warranty agreements**
  - A warranty is a written guarantee of the condition of a product or performance of a service. Accounting for warranties is covered in Study Unit 5, Subunit 1.
- **Deferred revenue**
  - Deferred revenue (unearned revenue) is recognized when a customer pays for a product or service that has not yet been delivered.

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Equity

Equity represents ownership interest in a firm. Owners of corporations are referred to as stockholders or shareholders. The following are the major items of equity:

- **Capital contributions by owners** refers to the funds invested in the company by its owners, which include the par value of common and preferred stock issued and additional paid-in capital.
  - Additional paid-in capital (APIC) is the amount received in excess of par value at the time stock was sold. This topic is covered in more detail in Study Unit 2, Subunit 1.
- **Retained earnings** is the accumulated net income not yet distributed to owners.
- **Treasury stock** is the firm's own stock that has been repurchased by the firm.
  - It is reflected in shareholders' equity as a contra account. A contra account is an account that reduces the balance of a related account.
- **Accumulated other comprehensive income** refers to all comprehensive income items not included in net income. This topic is covered in Subunit 1.3.

Detailed equity transactions are covered in Study Unit 2, Subunit 1.

Limitations of the Balance Sheet

Limitations of using the balance sheet for decision making include the following:

- The balance sheet shows a company's financial position at a single point in time. Accounts may vary significantly a few days before or after the publication of the balance sheet.
- Many balance sheet items, such as property, plant, and equipment, are recorded at historical cost, which may not equal their fair value.
- The preparation of the balance sheet requires estimates and management judgment. For example, depreciation of property, plant, and equipment requires estimates of useful lives and salvage value.
- The balance sheet omits many items that cannot be recorded objectively but have financial value to the company. An example would be a company's brand value.

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

1.3 Income Statement and Statement of Comprehensive Income

Income Statement Elements

While the balance sheet is a snapshot of a company's financial position as of a specific date, the income statement reports the results of an entity's operations over a period of time, such as a year. The income statement is sometimes called the statement of income. An entity's financial performance is calculated in the following income equation.

The Income Equation

Income (Loss) = Revenues + Gains – Expenses – Losses

The following are the elements of an income statement:

- **Revenues** are inflows or other enhancements of assets and/or settlements of liabilities from delivering or producing goods or providing services.
- **Gains** are increases in equity other than from revenues or investments by owners. For example, if the company sells a factory for more than its carrying value, the transaction would be reported as a gain.
- **Expenses** are outflows or other usage of assets and/or incurrences of liabilities from delivering or producing goods or providing services.
- **Losses** are decreases in equity other than from expenses or distributions to owners. For example, if a company sells a factory for an amount less than its carrying value, the transaction would be reported as a loss.

The sale of PPE is covered in detail in Study Unit 6, Subunit 3, including the calculation of gain or loss on the sale of an asset.

All transactions affecting the net change in equity during the period are included in income except transactions with owners, prior-period adjustments (such as error corrections or a change in accounting principle), items reported initially in other comprehensive income, and transfers to and from appropriated retained earnings.



Author's Note

Sometimes revenue is shown on the income statement as "sales" or "sales revenue."

As explained in Subunit 1.1, U.S. GAAP require the **accrual basis of accounting**. Revenues are recognized in the period in which they were earned, even if the cash will be received in a future period. Expenses are recognized in the period in which they were incurred, even if the cash will be paid in a future period.

One of the most significant expense categories in the income statement is the cost of goods sold, which is subtracted from revenue to yield gross profit.

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Income Statement Formats

The income statement can be presented in two primary formats: single-step and multiple-step. Both calculate net income, but they differ in structure and the level of detail provided.

The **single-step** income statement provides one grouping for revenue items and one for expense items. The single step is the one subtraction necessary to arrive at net income.

Example 1-3 Single-Step Income Statement

XYZ Company
Income Statement
For the Year Ended December 31, Year 1

Revenues:		
Net sales		$93,150
Expenses:		
Cost of goods sold	$27,500	
Depreciation	12,500	
Rent expense	1,950	
Utilities expense	400	
Supplies expense	450	
Salaries expense	18,750	
Interest expense	5,250	
Total expenses		66,800
Net income		**$26,350**

The **multiple-step** income statement presents operating revenues and expenses in a section separate from nonoperating items.

- The most common way to present the income statement is the condensed format of the multiple-step income statement, which includes only the section totals.

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Example 1-4 Multiple-Step Income Statement

XYZ Company
Income Statement
For the Year Ended December 31, Year 1

Revenues:			
Gross sales			$160,000
Minus: Sales discounts		$(30,000)	
Sales returns		(36,850)	(66,850)
Net sales			$ 93,150
Cost of goods sold:			
Beginning inventory		$ 35,000	
Purchases	$20,000		
Minus: Purchase returns	(5,000)		
Net purchases	$15,000		
Transportation-in	7,500	22,500	
Goods available for sale		$ 57,500	
Minus: Ending inventory		(30,000)	
Cost of goods sold			(27,500)
Gross profit			$ 65,650
Operating expenses:			
Selling expenses:			
Sales salaries	$ 8,000		
Office supplies	200	$ 8,200	
General and administrative expenses:			
Executive salaries	$ 6,750		
Office staff salaries	4,000		
Utilities expense	400		
Depreciation	12,500		
Office supplies	250		
Rent expense	1,950	25,850	
Total operating expenses			(34,050)
Income from operations			$ 31,600
Other revenues and gains:			
Other expenses and losses:			
Interest expense		$ 5,250	$ (5,250)
Net income before taxes			$ 26,350
Income tax expense			(2,635)
Net income after taxes			**$ 23,715**

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Another example of a multiple-step income statement is shown below.

Example 1-5 Multiple-Step Income Statement

Net sales	$ 200,000
Cost of goods sold	(150,000)
Gross profit	$ 50,000
Selling expenses	(6,000)
Administrative expenses	(5,000)
Income from operations	$ 39,000
Other revenues and gains	3,500
Other expenses and losses	(2,500)
Income before taxes	$ 40,000
Income taxes	(16,000)
Net income	**$ 24,000**

Cost of Goods Sold and Cost of Goods Manufactured

Cost of goods sold is an expense account reported on the income statement.

For a **retailer**, cost of goods sold represents the cost of the items being sold to customers and is calculated based on changes in inventory:

$$\text{Cost of goods sold for retailers} = \text{Beginning inventory} + \text{Cost of goods purchased} - \text{Ending inventory}$$

An example calculation is shown below. Freight-in is the transportation cost of shipping the goods.

Beginning inventory	$10,000
Plus: Net purchases	14,000
Plus: Freight-in	1,000
Goods available for sale	$25,000
Minus: Ending inventory	(5,000)
Cost of goods sold	**$20,000**

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

For a **manufacturer**, cost of goods sold represents the cost of items that were produced (manufactured) by the firm and are being sold to customers. Manufacturing costs include direct materials, direct labor, and manufacturing overhead.

Manufacturers must calculate the cost of goods manufactured in order to calculate the cost of goods sold. The **cost of goods manufactured** is the cost of goods completed during the current year. It represents the cost of goods transferred out of work-in-process inventory to finished goods inventory.

Cost of goods sold for manufacturers = Beginning finished goods inventory + Cost of goods manufactured – Ending finished goods inventory

Cost of goods manufactured = Beginning work-in-process inventory + Total manufacturing costs – Ending work-in-process inventory

Manufacturers calculate cost of goods sold as follows:

Beginning direct materials inventory	$3,000		
Purchases during the period	3,000		
Ending direct materials inventory	(1,000)		
Direct materials used in production		$5,000	
Direct labor costs		5,000	
Manufacturing overhead costs* (Fixed + Variable)		4,000	
Total manufacturing costs			$14,000
Beginning work-in-process inventory			5,000
Ending work-in-process inventory			(4,000)
Cost of goods manufactured			$15,000
Beginning finished goods inventory			6,000
Ending finished goods inventory			(11,000)
Cost of goods sold			**$10,000**

*Study Unit 8, Subunit 1, has details about what is included in manufacturing overhead.

- Cost of goods sold is recognized at the time the goods are sold, which follows the matching principle.

Gross profit is the net difference between sales revenue and cost of goods sold.

- Gross profit margin as a percentage of sales is calculated as follows:

Gross profit margin (%) = Gross profit ÷ Sales

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Example 1-6 Cost of Goods Sold and Cost of Goods Manufactured

The following information was taken from the accounting records of Amy's Manufacturing.

Inventory	January 1	December 31
Raw materials	$ 65,000	$ 58,000
Work-in-process (WIP)	100,000	120,000
Finished goods	30,000	26,000

Other Information	
Purchase of raw materials	$240,000
Direct labor	300,000
Factory rent	80,000
Factory utilities	25,000
Advertising expense	40,000
Administrative salaries	200,000

1. **Find the direct materials used in production.**

Beginning raw materials		$ 65,000
Add: Purchases during the period		240,000
Materials available		$305,000
Less: Ending raw materials		(58,000)
Materials used in production		**$247,000**

2. **Find the total manufacturing cost.**

Materials used in production		$247,000
Direct labor		300,000
Manufacturing overhead		
Factory rent	$80,000	
Factory utilities	25,000	
Total manufacturing overhead		105,000
Total manufacturing costs		**$652,000**

3. **Calculate the cost of goods manufactured.**

Total manufacturing costs	$652,000
Add: Beginning WIP inventory	100,000
Less: Ending WIP inventory	(120,000)
Cost of goods manufactured	**$632,000**

4. **Calculate the cost of goods sold.**

Cost of goods manufactured	$632,000
Add: Beginning finished goods inventory	30,000
Less: Ending finished goods inventory	(26,000)
Cost of goods sold	**$636,000**

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Other Expenses

General and administrative expenses are incurred for the benefit of the enterprise as a whole and are not related wholly to a specific function, e.g., selling or manufacturing.

- They include accounting, legal, and other fees for professional services; officers' salaries; insurance; wages of office staff; miscellaneous supplies; and office occupancy costs.

Selling expenses are those incurred in selling or marketing.

- Examples include sales representatives' salaries, commissions, and traveling expenses; sales department salaries and expenses, including rent; advertising; and credit and collection costs.
- Shipping costs are also often classified as selling expenses.

Interest expense is recognized based on the passage of time.

Discontinued Operations

Discontinuing an operation is the sale, abandonment, or disposal of a significant component of a business, such as a line of business, geographical area, or subsidiary. The associated cost is reported separately on the financial statements.

- The purpose of separate reporting is to give users of the financial statements a clear view of ongoing operations and to isolate the financial effects of activities that are not expected to continue in the future.

When an entity reports a **discontinued operation**, it must be presented in a separate section between **income from continuing operations and net income**.

- Because these items are reported after the presentation of income taxes, they must be shown net of tax.
- The term "continuing operations" is used only when a discontinued operation is reported.

Discontinued operations, if reported, may have two components:

1. Gain or loss from operations of the component that has been disposed of or is classified as held for sale
    - The gain or loss is measured from the first day of the reporting period until the date of disposal (or the end of the reporting period if it is classified as held for sale).
2. Gain or loss on the disposal of this component

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Example 1-7 Discontinued Operations

Net sales		$ 200,000
Cost of goods sold		(150,000)
Gross profit		$ 50,000
Selling expenses		(6,000)
Administrative expenses		(5,000)
Income from operations		$ 39,000
Other revenues and gains		3,500
Other expenses and losses		(2,500)
Income before taxes		$ 40,000
Income taxes		(16,000)
Income from continuing operations		$ 24,000
Discontinued operations		
Gain from operations of component (including loss on disposal of $5,000)	$10,000	
Income taxes	(4,000)	
Gain from discontinued operations		$ 6,000
Net income		**$ 30,000**

Statement of Comprehensive Income

The statement of comprehensive income goes beyond net income or loss generated from the operations of the firm and improves financial disclosure by ensuring that all significant financial activities and their effects on a business's equity are disclosed. This enhanced visibility supports more accurate valuations and more informed decision making by investors, analysts, and other stakeholders.

Comprehensive income includes all of the changes in equity of a business during a period, except those from investments by and distributions to owners. It provides a broader view of a company's financial performance than net income alone. It consists of

- **Net income or loss** (the bottom line of the income statement)
- **Other comprehensive income (OCI)**

OCI is a concept used in accounting to represent certain gains and losses that are not realized or included in net income or profit for a period but are nonetheless important for understanding a company's overall financial health.

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Certain income items are excluded from the calculation of net income and instead are included in other comprehensive income. The following are the major items included in other comprehensive income:

- The effective portion of a gain or loss on a hedging instrument in a cash flow hedge.
- Unrealized holding gains and losses due to changes in the fair value of available-for-sale debt securities.
- Foreign currency translation gains and losses for financial statements of foreign operations.
- Certain amounts associated with pension plans. A pension plan is a retirement benefit for employees when they retire that is funded by the employer.

All items of comprehensive income are recognized for the period in either

- **One continuous financial statement** that has two sections, net income and OCI, or
- **Two separate but consecutive statements**.
  - The first statement (the income statement) presents the components of net income and total net income.
  - The second statement (the statement of OCI) is presented immediately after the first. It presents a total of OCI with its components and a total of comprehensive income.

Example 1-8 Separate Statement of Comprehensive Income

Net income		**$70,000**
Other comprehensive income (net of tax):		
Loss on defined benefit postretirement plans	$(15,000)	
Gains on foreign currency translation	6,000	
Gains on remeasuring available-for-sale securities	4,000	
Effective portion of losses on cash flow hedges	(3,000)	
Other comprehensive income (loss)		**(8,000)**
Total comprehensive income		**$62,000**

Accumulated other comprehensive income is reported in the equity section of the balance sheet.

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.

Limitations of the Income Statement

Limitations of using the income statement for decision making include the following:

- The income statement does not always show all items of income and expense. Some of the items are reported on a statement of other comprehensive income and not included in the calculation of net income.
- The financial statements report accrual-basis results for the period. The company may recognize revenue and report net income before any cash was actually received.
- The data from the income statement are not sufficient for assessing liquidity. This statement must be viewed in conjunction with other financial statements, such as the balance sheet and statement of cash flows.
- The preparation of the income statement requires estimates and management judgment.

Copyright © 2026 Gleim Internet, Inc. All rights reserved. Duplication prohibited. Reward for information exposing violators. Contact copyright@gleim.com.