

Study Unit One

Financial Statements

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1.1 Balance Sheet (Statement of Financial Position)

General purpose financial reporting includes the full set of financial statements, the notes to the financial statements, and required supplemental information.

A **full set of financial statements** presents the elements of financial statements and their related recognition and measurement. It reports the following:

- Financial position at the end of the period, including assets, liabilities, and equity
- Comprehensive income, including revenue, expenses, gains, and losses for the period
- Investment by and distributions to owners (changes in owners' equity) during the period
- Cash flows during the period

Notes to the financial statements supplement or further explain information on the face of the financial statements.

- Examples of such information are descriptions of the accounting policies used and other disclosures required by generally accepted accounting principles (GAAP).
- Notes may **not** be used (1) to correct an improper presentation in the statements or (2) as a substitute for recognition in the statements.
- The notes should contain information about
 - Financial statement line items
 - The reporting entity
 - Unrecognized past events and current circumstances that can affect cash flows

Supplemental information, such as management's discussion and analysis (MD&A), provides information in addition to that in the statements and notes.

Basic Accounting Equation

The balance sheet (statement of financial position) reports assets, liabilities, equity, and their relationships at a moment in time. It helps users to assess liquidity, financial flexibility, and risk.

The balance sheet is a detailed presentation of the basic accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

- The left side of this equation depicts the entity's resource structure. The right side depicts the financing structure.

Assets are generally reported in order of liquidity.

- Some variation of the following classifications is used by most entities:

Example 1-1 Comparative Statement of Financial Position

	Current Year End	Prior Year End		Current Year End	Prior Year End
Current Assets:			Current Liabilities:		
Cash and equivalents	\$ 325,000	\$ 275,000	Accounts payable	\$ 200,000	\$ 125,000
Available-for-sale debt securities	165,000	145,000	Accrued interest on note	5,000	5,000
Accounts receivable	120,000	115,000	Current maturities of L.T. debt	100,000	100,000
Notes receivable	55,000	40,000	Accrued salaries and wages	15,000	10,000
Inventories	85,000	55,000	Income taxes payable	70,000	35,000
Prepaid expenses	10,000	5,000			
Total current assets	\$ 760,000	\$ 635,000	Total current liabilities	\$ 390,000	\$ 275,000
Noncurrent Assets:			Noncurrent Liabilities:		
Equity-method investments	\$ 120,000	\$ 115,000	Bonds payable	\$ 500,000	\$ 600,000
Property, plant, and equipment	1,000,000	900,000	Long-term notes payable	90,000	60,000
Minus: Accum. depreciation	(85,000)	(55,000)	Employee-related obligations	15,000	10,000
Goodwill	5,000	5,000	Deferred income taxes	5,000	5,000
Total noncurrent assets	\$1,040,000	\$ 965,000	Total noncurrent liabilities	\$ 610,000	\$ 675,000
			Total liabilities	\$1,000,000	\$ 950,000
			Equity:		
			Common stock \$1 par	\$ 500,000	\$ 500,000
			Additional paid-in capital	200,000	80,000
			Accumulated OCI	30,000	20,000
			Retained earnings	70,000	50,000
			Total equity	\$ 800,000	\$ 650,000
Total assets	\$1,800,000	\$1,600,000	Total liabilities and equity	\$1,800,000	\$1,600,000

Current Assets

Current assets consist of “cash and other assets or resources commonly identified as reasonably expected to be realized in cash or sold or consumed **during the normal operating cycle** of the business.”

The operating cycle is the average time between the acquisition of resources and the final receipt of cash from their sale as the culmination of revenue generating activities. If the cycle is less than a year, **1 year** is the period used for segregating current from noncurrent assets.

- Thus, an asset is classified as current on the statement of financial position if it is expected to be realized within the entity’s **operating cycle or 1 year**, whichever is **longer**.

Current assets include

- Cash and cash equivalents;
- Certain individual investments in trading, available-for-sale, and held-to-maturity debt securities;
- Receivables;
- Inventories;
- Prepaid expenses; and
- Certain individual investments in equity securities.

Noncurrent Assets

Noncurrent assets are those not qualifying as current.

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
- Other noncurrent equity securities
 - Certain individual investments in available-for-sale and held-to-maturity debt securities may be noncurrent.
- Funds restricted as to withdrawal or use for other than current operations, for example, to
 - Retire long-term debt,
 - Satisfy pension obligations, or
 - Pay for the acquisition or construction of noncurrent assets
- Capital assets not used in current operations, such as
 - Idle facilities or
 - Land held for a future plant site

Property, plant, and equipment (PPE) are tangible operating items recorded at cost and reported net of any accumulated depreciation. They include

- Land and natural resources subject to depletion, e.g., oil and gas
- Buildings, equipment, furniture, fixtures, leasehold improvements, land improvements, noncurrent assets under construction, and other depreciable assets

Intangible assets are nonfinancial assets without physical substance. Examples are patents and goodwill.

Other noncurrent assets include noncurrent assets not readily classifiable elsewhere. Examples are deferred tax assets and long-term receivables.

The category **deferred charges** (long-term prepayments) appears on some balance sheets.



Success Tip

The AICPA has previously tested candidates on their knowledge of what the classification of current liabilities entails. Potentially, candidates could see a list of fixed accounts with a question on the amount of current liabilities of the firm.

Current Liabilities

Current liabilities are “obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities.”

- Current liabilities generally are expected to be settled or liquidated in the ordinary course of business during the longer of 1 year or the operating cycle.

Current liabilities include

- **Trade payables** for items entering into the operating cycle, e.g., for materials and supplies used in producing goods or services for sale.
- **Other payables** arising from operations, such as accrued wages, salaries, rentals, royalties, and taxes.
- **Unearned revenues** (contract liabilities) arising from collections in advance of delivering goods or performing services, e.g., ticket sales revenue.

Other current liabilities include

- Short-term notes given to acquire capital assets
- Payments on the current portion of serial bonds or other noncurrent debt

Noncurrent obligations callable by the creditor because of the debtor’s violation of the debt agreement (e.g., covenant violation) at the balance sheet date are classified as current.

Current liabilities **do not include**

- Current obligations if an entity (1) intends to refinance them on a noncurrent basis and (2) demonstrates an ability to do so.
 - The ability to refinance may be demonstrated by
 - ▶ Entering into a financing agreement meeting all conditions before the balance sheet is issued.
 - ▶ Issuing a noncurrent obligation or equity securities after the end of the reporting period but before issuance of the balance sheet.
 - The amount excluded from current liabilities must not exceed the proceeds from the new obligation or equity securities issued.
- Debts to be paid from funds accumulated in noncurrent asset accounts. Thus, a liability for bonds payable in the next period will not be classified as current if payment is to be from a noncurrent fund.

The difference between current assets and current liabilities is working capital.

Noncurrent Liabilities

Noncurrent 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
- Lease liabilities
- Most postretirement benefit obligations
- Obligations under product or service warranty agreements
- Advances for noncurrent commitments to provide goods or services
- Deferred revenue

Deferred tax liabilities arising from interperiod tax allocation are classified as noncurrent.

Equity

Equity is the residual after total liabilities are subtracted from total assets.

- Equity consists of the following:
 - Capital contributed by owners (par value of common and preferred stock issued and additional paid-in capital)
 - Retained earnings (income reinvested)
 - Accumulated other comprehensive income (all comprehensive income items not included in net income)
 - The noncontrolling interest in a consolidated entity
- Treasury stock is the entity's own common stock that it has repurchased. Treasury stock is presented as a reduction of total equity (discussed in Study Unit 12).

1.2 Statement of Income

Background 1-1 Temporary vs. Permanent Accounts

The accounts presented on the balance sheet are real or permanent accounts. They report an entity's resources and financing elements that exist from period to period. The accounts presented on the income statement are nominal or temporary accounts. They are reported for a period of time, closed at the end of the period, and reopened at the beginning of the next period with zero balances.

Nature of the Income Statement

The results of operations are reported in the income statement (statement of earnings) on the **accrual basis** using an approach oriented to historical transactions.

- The traditional income statement reports **revenues** from, and **expenses** of, the entity's major activities and **gains** and **losses** from other activities.
- The sum of these income statement elements is net income (loss) for an interval of time.

$$\text{Revenues} - \text{Expenses} + \text{Gains} - \text{Losses} = \text{Net income or loss}$$

Income statement elements are reported in temporary (**nominal**) accounts that are periodically closed to permanent (**real**) accounts. The accountant need not close each transaction directly to equity.

- Net income or loss for the period is **closed to retained earnings** at the end of the period.

Any recognized amounts not included in continuing operations are reported in a separate section for **discontinued operations**.

- The term "continuing operations" is used only when a discontinued operation is reported.

The **transactions not included** in net income are

- Transactions with owners,
- Error corrections,
- Items reported initially in other comprehensive income,
- Transfers to and from appropriated retained earnings, and
- Effects on prior periods of accounting changes.

Income Statement Format

Three formats are commonly used for presentation of recurring items:

1. The **single-step income statement** provides one grouping for revenues and gains and one for expenses and losses. The single step is the one subtraction necessary to arrive at net income.

Example 1-2 Single-Step Income Statement

Bouffie Company Income Statement For Year Ended December 31, Year 1		
Revenues and gains:		
Net sales	\$1,050,000	
Other revenues	580,000	
Gains	495,000	
Total revenues and gains		\$2,125,000
Expenses and losses:		
Costs of goods sold	\$ 820,000	
Selling expenses	70,000	
General and administrative expenses	78,000	
Interest expense	124,000	
Losses	198,000	
Income tax expense	85,000	
Total expenses and losses		<u>(1,375,000)</u>
Net income		<u>\$ 750,000</u>
Earnings per common share (simple capital structure) -- assuming 20,000 shares issued and outstanding		<u>\$37.50</u>

2. The **multiple-step income statement** reports operating revenues and expenses in a section separate from nonoperating items. It enhances disclosure by presenting subtotals.

Example 1-3 Multiple-Step Income Statement

Bouffie Company Income Statement For Year Ended December 31, Year 1		
Revenues:		
Gross sales		\$1,600,000
Minus: Sales discounts	\$ (350,000)	
Sales returns and allowances	<u>(200,000)</u>	<u>(550,000)</u>
Net sales		<u>\$1,050,000</u>
Cost of goods sold:		
Beginning inventory		\$1,200,000
Purchases	\$ 500,000	
Minus: Purchase returns and discounts	<u>(100,000)</u>	
Net purchases	\$ 400,000	
Transportation-in	<u>50,000</u>	<u>450,000</u>
Goods available for sale		\$1,650,000
Minus: Ending inventory		<u>(830,000)</u>
Cost of goods sold		<u>(820,000)</u>
Gross profit		\$ 230,000
Operating expenses:		
Selling expenses:		
Sales salaries and commissions	\$18,000	
Freight-out	5,000	
Travel	25,000	
Advertising	10,000	
Office supplies	<u>12,000</u>	\$ 70,000
General and administrative expenses:		
Executive salaries	\$40,000	
Professional salaries	7,000	
Wages of office staff	19,000	
Depreciation	7,000	
Office supplies	<u>5,000</u>	<u>78,000</u>
Total operating expenses		<u>(148,000)</u>
Income from operations		\$ 82,000
Other revenues and gains:		
Gain on investments	\$495,000	
Dividend revenue	<u>580,000</u>	1,075,000
Other expenses and losses:		
Interest expense	\$124,000	
Loss on disposal of equipment	<u>198,000</u>	<u>(322,000)</u>
Income before taxes*		\$ 835,000
Income tax expense		<u>(85,000)</u>
Net income*		<u><u>\$ 750,000</u></u>
Earnings per common share (simple capital structure) -- assuming 20,000 shares issued and outstanding		<u><u>\$37.50</u></u>

* If a discontinued operation is reported, these line items are "Income from continuing operations before taxes" and "Income from continuing operations," respectively.

3. The **condensed income statement** is the most common method of presentation. It includes only the section totals of the **multiple-step format**. The enhanced disclosure of each line item is presented in the notes to the financial statements.

Example 1-4 Condensed Income Statement

Bouffie Company Income Statement For Year Ended December 31, Year 1	
Net sales	\$1,050,000
Cost of goods sold	<u>(820,000)</u>
Gross profit	\$ 230,000
Selling expenses	(70,000)
General and administrative expenses	<u>(78,000)</u>
Income from operations	\$ 82,000
Other revenues and gains	1,075,000
Interest expense	(124,000)
Other expenses and losses	<u>(198,000)</u>
Income before taxes*	\$ 835,000
Income tax expense	<u>(85,000)</u>
Net income*	<u>\$ 750,000</u>
Earnings per common share (simple capital structure) -- assuming 20,000 shares issued and outstanding	<u>\$37.50</u>

* If a discontinued operation is reported, these line items are "Income from continuing operations before taxes" and "Income from continuing operations," respectively.

Income Statement Sections



Success Tip

Previous CPA Exams have included questions with cost and inventory information that require candidates to calculate cost of goods sold or cost of goods manufactured.

Cost of goods sold equals purchases for a retailer or cost of goods manufactured (COGM) for a manufacturer, adjusted for the change in finished goods (FG) in inventory.

$$\begin{array}{r}
 \text{Beginning FG inventory} \\
 + \text{ Purchases or COGM} \\
 \hline
 \text{Goods available for sale} \\
 - \text{ Ending FG inventory} \\
 \hline
 \underline{\underline{\text{Cost of goods sold}}}
 \end{array}$$

Cost of goods manufactured equals the period's manufacturing costs adjusted for the change in work-in-process. It also may be stated as cost of goods sold adjusted for the change in finished goods inventory.

Beginning work in process	Ending FG inventory
+ Sum of periodic manufacturing costs	+ Cost of goods sold
– Ending work-in-process	– Beginning FG inventory
<u>Cost of goods manufactured</u>	<u>Cost of goods manufactured</u>

NOTE: Study Unit 6, Subunit 1, contains a more detailed explanation of this topic.

Selling expenses are incurred in selling or marketing.

- Examples include
 - Sales representatives' salaries, commissions, and traveling expenses;
 - Sales department rent, salaries, and depreciation; and
 - Communications (e.g., Internet) costs.
- Shipping costs also may be classified as selling costs.
- Advertising costs should be expensed either as incurred or when advertising first occurs.
 - Sellers may agree to reimburse customers for the customers' advertising costs (cooperative advertising). The revenues related to the transactions that created such obligations generally are recognized before reimbursement. Accordingly, the obligations must be accrued and the advertising costs expensed when the related revenues are recognized.

General and administrative expenses are incurred for the direction of the entity as a whole and are not related entirely 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.

Interest expense is recognized based on the passage of time. In the case of bonds, notes, and finance leases, the effective interest method is used.

Material items that are **unusual in nature, infrequent in occurrence, or both** are reported as a separate component of income from **continuing operations**.

- These items must **not** be reported net of taxes.
- Gains or losses of a similar nature that are not individually material must be aggregated.
- The nature and financial effect of each item is disclosed in the notes to the financial statements or reported in the income statement.
- The effects of such items on earnings per share must **not** be presented on the income statement.

Discontinued Operation

The operating results of a **discontinued operation** are reported **separately net of tax** in the income statement. This section is presented **after the results of continuing operations**.

- If a component of an entity (discontinued operation) is disposed of during the period, any **gain or loss on disposal** must be disclosed on the face of the income statement or in the notes.
- If a component of an entity (discontinued operation) is classified as **held for sale**, it is measured at the **lower** of its **carrying amount** or **fair value minus cost to sell** (discussed in Study Unit 7, Subunit 8).
 - Operating results reported in discontinued operations include any **income** earned or **loss** incurred during the **entire** reporting period (i.e., before and after the component was classified as held for sale).
 - Operating results also include any loss for a write-down to fair value minus cost to sell recognized on the initial classification as held for sale and subsequently.
- **Intraperiod tax allocation** is required. Thus, income tax expense or benefit is allocated to
 - Continuing operations,
 - Discontinued operations,
 - Other comprehensive income, and
 - Items debited or credited directly to other components of equity.
 - ▶ The operating results of a discontinued operation also must be reported in the comparative financial statements.
- The discontinued operations section presents separately the (1) income or loss from operations of the component and (2) income tax expense or benefit.
- If a discontinued operation is reported, basic and diluted earnings per share amounts for the discontinued operation are presented on the face of the income statement or in the notes (discussed in Study Unit 2, Subunit 2).

Example 1-5 Income Statement Presentation of Discontinued Operations

On July 1, Year 1, Emkay Co. approved a plan to dispose of Segment X on October 1, Year 1. As a result, Segment X (a component of the entity) was properly classified as a discontinued operation. It was sold on October 1, Year 1, for \$480,000. Emkay's income tax rate is 40%. The following data pertain to Segment X:

- Operating losses were \$110,000 for the period January 1 to June 30, Year 1.
- Operating losses were \$100,000 for the period July 1 to October 1, Year 1.
- The operating losses presented above do not include a loss on disposal or a write-down to fair value minus cost to sell.
- The carrying amount on July 1, Year 1, was \$600,000.
- Fair value minus cost to sell on July 1, Year 1, was \$450,000.

-- Continued on next page --

Example 1-5 -- Continued

The following are Emkay's Year 1 income statement items excluding Segment X's operating results:

Revenues	\$950,000
Cost of goods sold	380,000
General and administrative expenses	90,000
Interest expense	50,000

Year 1 operating results of Segment X are reported in discontinued operations. The loss from discontinued operations for the year ended December 31, Year 1, includes all of the following:

- Operating losses incurred during the entire reporting period were \$210,000 (\$110,000 + \$100,000).
- The loss on write-down to fair value minus cost to sell on July 1 was \$150,000 (\$600,000 carrying amount – \$450,000 fair value minus cost to sell).
- The gain on disposal of the segment on October 1 was \$30,000 (\$480,000 – \$450,000).

The total Year 1 loss from discontinued operations before tax is \$330,000 (\$210,000 + \$150,000 – \$30,000). The loss on discontinued operations (net of tax) reported in the income statement is \$198,000 [\$330,000 × (1 – 40%)].

The following format may be used by Emkay to present its Year 1 income statement:

Emkay Co.		
Income Statement		
For the Year Ended 12/31/Yr 1		
Revenues		\$950,000
Cost of goods sold		<u>(380,000)</u>
Gross profit		\$570,000
General and administrative expenses	\$ 90,000	
Interest expense	<u>50,000</u>	<u>(140,000)</u>
Income from continuing operations before income taxes		\$430,000
Income tax expense		<u>(172,000)</u>
Income from continuing operations		<u>\$258,000</u>
Discontinued operations		
Loss from operations of component unit – Segment X (including gain on disposal of \$30,000)	\$(330,000)	
Income tax benefit	<u>132,000</u>	
Loss from discontinued operations		<u>(198,000)</u>
Net income		<u>\$ 60,000</u>
Earnings (loss) per common share (simple capital structure):		
Continuing operations		\$ 12.90
Discontinued operations		<u>(9.90)</u>
Net earnings -- assuming 20,000 shares outstanding		<u>\$ 3.00</u>

1.3 Comprehensive Income

Comprehensive income includes all changes in equity of a business during a period except those from investments by and distributions to owners. It includes all components of

- **Net income** and
- **Other comprehensive income (OCI).**

OCI includes all items of comprehensive income not included in net income. Under existing accounting standards, items of OCI include, among others,

- Unrealized holding gains and losses on **available-for-sale debt securities** (Study Unit 4).
- Gains and losses on **derivatives** designated and qualifying as **cash flow hedges**.
- Foreign currency translation adjustments for a foreign operation (translation gains and losses).
- Changes in fair value attributable to instrument-specific credit risk of financial liabilities for which the fair value option is elected (Study Unit 4).

Each component of OCI must be presented **net of tax**, or one amount must be presented for the aggregate tax effect on the total of OCI. In either case, the tax effect on each component must be disclosed.

Reporting

An entity that presents a full set of financial statements but has no items of OCI need not report OCI or comprehensive income. Otherwise, an entity must present all items of comprehensive income recognized for the period either

- In one continuous financial statement or
- In two separate but consecutive statements.

One continuous statement must have two sections: net income and OCI. It must include

- A total of net income with its components,
- A total of OCI with its components, and
- A total of comprehensive income.

Separate but consecutive statements must be presented as follows:

- 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
 - The components of OCI,
 - The total of OCI, and
 - A total of comprehensive income.
- The entity must begin the second statement with net income.

The following is an example of the **single-statement** presentation for reporting comprehensive income:

Example 1-6 Single-Statement Presentation																																									
CI Company Statement of Comprehensive Income (in millions) Year Ended December 31, Year 1																																									
Statement of Income	<table style="width: 100%; border-collapse: collapse;"> <tr> <td colspan="2">Revenues and gains:</td> <td></td> <td></td> </tr> <tr> <td>Net revenues</td> <td style="text-align: right;">\$250</td> <td></td> <td></td> </tr> <tr> <td>Gain on sale of available-for-sale debt securities</td> <td style="text-align: right;">10</td> <td></td> <td></td> </tr> <tr> <td>Gains reclassified from AOCI</td> <td style="text-align: right;">14</td> <td style="border-top: 1px solid black;"></td> <td style="text-align: right;">\$274</td> </tr> <tr> <td colspan="2">Expenses and losses:</td> <td></td> <td></td> </tr> <tr> <td>Expenses</td> <td style="text-align: right;">\$122</td> <td></td> <td></td> </tr> <tr> <td>Losses</td> <td style="text-align: right;">12</td> <td style="border-top: 1px solid black;"></td> <td style="text-align: right;">(134)</td> </tr> <tr> <td>Income from continuing operations</td> <td></td> <td></td> <td style="text-align: right;">\$140</td> </tr> <tr> <td>Income tax expense</td> <td></td> <td></td> <td style="text-align: right;">(30)</td> </tr> <tr> <td></td> <td></td> <td style="border-top: 1px solid black;"></td> <td style="text-align: right;">\$110</td> </tr> </table>	Revenues and gains:				Net revenues	\$250			Gain on sale of available-for-sale debt securities	10			Gains reclassified from AOCI	14		\$274	Expenses and losses:				Expenses	\$122			Losses	12		(134)	Income from continuing operations			\$140	Income tax expense			(30)				\$110
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OCI			\$ 25																																						
Comprehensive income			\$135																																						

A **two-statement** presentation is easily derived from the example above.

- The final component of the **statement of net income** is net income.
- The first component of the **statement of OCI** is net income, and the final component is comprehensive income.

The **components of OCI** are recorded initially in a temporary (nominal) account. At the end of each reporting period, the total OCI for a period is **closed to accumulated OCI**, a permanent account that is reported in the equity section of the balance sheet.

- Other comprehensive income for the period increases accumulated OCI.
- Other comprehensive loss for the period decreases accumulated OCI.

1.4 Statement of Changes in Equity

A statement of changes in equity is presented as part of a full set of financial statements. This statement provides disclosure of changes during the accounting period in the separate equity accounts. These are retained earnings, accumulated OCI, common stock, preferred stock, additional paid-in capital, and noncontrolling interest.

Example 1-7 Statement of Changes in Equity

CI Company						
For the Year Ended December 31, Year 1						
	Total Equity	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Additional Paid-in Capital	Treasury Stock
Beginning balance	\$500	\$350	\$100	\$40	\$ 30	\$(20)
Net income for the period	110	110				
OCI for the period	25		25			
Common stock issued	90			10	80	
Dividends declared	(60)	(60)				
Repurchase of common stock	(15)					(15)
Ending balance	<u>\$650</u>	<u>\$400</u>	<u>\$125</u>	<u>\$50</u>	<u>\$110</u>	<u>\$(35)</u>

Statement of Retained Earnings

A statement of retained earnings reconciles the beginning and ending balances of the account. This statement is not separately reported. Instead, it is reported as part of the statement of changes in equity in a separate column.

The changes in retained earnings can result from the following adjustments:

- Net income (loss) for the period;
- Any prior-period adjustments, net of tax (discussed in Study Unit 3);
- Dividends declared; and
- Certain other rare items, e.g., reissuance of treasury stock under the cost method (discussed in Study Unit 12).

Retained earnings are sometimes appropriated (restricted) to a special account to disclose that earnings retained in the business (not paid out in dividends) are being used for special purposes (discussed in Study Unit 12).

1.5 Special Purpose Frameworks

Other Bases of Accounting

Financial statements may be prepared using a comprehensive basis of accounting that is not in accordance with GAAP.

Common examples are the following:

- The cash basis or modified cash basis
- A basis used for tax purposes
- A basis used to comply with the requirements of a regulator

Statements using a basis other than GAAP should include a summary of significant accounting policies that discusses the basis used and how it differs from GAAP.

Cash Basis

Under the strict cash basis of accounting, revenues and expenses are recognized when cash is received or paid, respectively, regardless of when goods are delivered or received or when services are rendered.

- The cash basis ignores the revenue and expense recognition principles that are fundamental to the accrual basis.
- This method may be appropriate for small businesses operated as sole proprietorships.



Success Tip

The following equations will help you to convert the accrual-basis amounts in the income statement to the cash basis amount and the opposite:

Beginning accounts receivable	\$XXX	Beginning accounts payable	\$XXX
Sales (accrual basis)	XXX	Purchases (accrual basis)	XXX
Ending accounts receivable	(XXX)	Ending accounts payable	(XXX)
Cash collected from customers	<u>XXX</u>	Cash paid to suppliers	<u>XXX</u>
Beginning interest payable	\$XXX	Ending prepaid expenses	\$XXX
Interest expense (accrual basis)	XXX	Current-period expense (accrual basis)	XXX
Ending interest payable	(XXX)	Beginning prepaid expenses	(XXX)
Interest paid during the period	<u>XXX</u>	Expenses paid during the period	<u>XXX</u>

Modified Cash Basis

The modified cash basis uses the cash basis for typical operating activities with modifications to the accrual basis for activities having substantial support, for example, reporting inventory, accruing income taxes, and capitalizing and depreciating fixed assets.

This method often is used by professional services firms, such as physicians, realtors, and architects.

Income Tax Basis

This basis must be applied to calculate income tax liability.

Certain doctrines underlying the federal tax code differ significantly from those in the conceptual framework. For example, the code requires use of the modified accelerated cost recovery system (MACRS), a depreciation method not recognized under GAAP.