**This sample chapter packet includes:**

1. Pre-class material (an advanced reading guide with guided problems)
2. Video notes, which following along with videos found at the following links:
   1. Video 1 of 2 (22 minutes): <https://mediamatrix.tamu.edu/streams/466604/327_Chapter_4_Video_1_of_2>
   2. Video 2 of 2 (23 minutes): <https://mediamatrix.tamu.edu/streams/466610/327_Chapter_4_Video_2_of_2>
3. Video quiz (3 points) – this is meant to be at a lower skill level
4. In class problems
5. Chapter quiz (5 points) – this is meant to be similar to exam level; students receive two attempts

**Chapter 4 – Pre-Class Material**

**Pre-Class Theory:**

1. Look at your company’s financial statements.
   1. List any items you are not familiar with in the financial statements.
   2. Go back online and search through the annual report (use the find function to search) for one of the items you listed. The footnotes to the financial statements should describe the components of the financial statements.
   3. Be prepared to share what you found with the class.
2. **Complete the income statement at Pre-Class Guided Problem 4.1 below before answering this question.** Where are discontinued operations and extraordinary items on the income statement? Do those items come before or after income tax expense?
   1. Note: A tricky thing to remember. Where these items are shown on the income statement DOES NOT impact the amount of taxes the company pays. It is JUST for PRESENTATION purposes.
   2. Discontinued operations and extraordinary items are presented net of tax, they are still taxed like any other gain or loss (a loss results in a tax benefit). Since they are reported after the total income tax line item the tax expense or benefit is netted with the pre-tax gain or loss.
   3. For example, for a company with a tax rate of 30% a pre-tax gain on discontinued operations of $100,000 would be $70,000 after tax. This is because the company will have to pay a tax on the $100,000 of $30,000 (30%\*$100,000). The net of the money from the gain minus the additional tax they have to pay from the gain equals a net gain of $70,000. Similarly, the company’s tax liability is reduced if they incur a loss (making the net of tax loss smaller than the pre-tax loss). We will discuss this in class.
3. Define discontinued operations (page **169-170**).
4. What two things should a company report as part of the discontinued operations section on the income statement (page **170**)?
   1. Explain the two income/loss items referenced above in your own words.
   2. This is not in the reading, but a question for thought. Do you think the company should still report discontinued operations in the current year if they decide to discontinue a component in that year, but will not complete the sale until the next year? If so, how would this change the items they report for discontinue operations (question 3).

Also, not in the reading. Look up the term impairment loss (in your book or online). Define the term. Based on conservatism do you think you can ever book an impairment gain?

1. What are the two criteria in order to record something as an extraordinary item (page **170**)?
2. List 2 items that are NEVER considered extraordinary (page **171**).
3. List the 3 items your book references as examples of extraordinary items that clearly meet the two criteria (in bold, page **171**).

Read the remainder of chapter 4, but do not place much emphasis on page **177** to the middle of page **178**. It is a confusing way of explaining a simple topic.

1. When a company changes from one accounting principle to another which method (new or old) should be reported on the current financial statements (page **174**)?
2. When a company changes from one accounting principle to another the company needs to change prior year net income. What is a name for an adjustment that changes prior years’ statements (page **174**)? Where should a company make the adjustment to prior year net income (page **174**)?
3. How should you fix prior year net income for an error (page **175**)?
4. What are some common estimates a company makes (page **174-175**)? If a company has to change one of these estimates is it treated the same as a correction of error or change in accounting principle (page **174-175**)?
5. What years are impacted (past, current, future) by a change in estimate (page **175**)? Why do you think that is different from change in accounting principle and correction of error?

Important information not clear in your book: Public companies are required to report multiple years of income on the IS (most report 3 years). All years on the income statement can be adjusted on the actual income statement if necessary (change in accounting principle, correction of an error). For example, if 2010, 2009 and 2008 are on the income statement make the correction there. Net income for any years not reported on the IS must be changed through retained earnings. In this example that would be any years prior to 2008.

1. Know earnings per share (EPS), page **178-179**. Know which items on the income statement need EPS numbers. Know the formula to calculate EPS. We will probably not have time to cover this in class (it is much more straight forward than that other material in this chapter), but I will answer any questions if you have them.
2. Review the statement of retained earnings. Be familiar with the items in retained earnings (page **180**).
3. What is other comprehensive income (OCI) – page **181-183**?
4. Is OCI part of net income (page **181-182**)?
5. What are the three ways OCI can be presented (page **182-183**)?

Important items to review that are not in this section of the reading (**see chapter 11**):

1. How do you calculate depreciation using the straight-line and double-declining balance methods?
2. Whenever there is a change to a component of depreciation how does that impact your calculation of depreciation (i.e. what balance do you depreciate, what useful life do you use)?

**Pre-Class Guided Problem 4.1:**

Use the list of line items below to fill in the blanks on the **multi-step** income statement. **Illustration 4-2** (page **166**) and **Illustration 4-17** (page **179** - for discontinued operations and extraordinary items) will help you determine where the income statement items should go. Mark any items that are new to you or that you are unsure about and we will discuss in class.

**Income Statement**

**Accounts**

Net Sales

Less: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

**Gross Margin on Sales**

Less: Operating Expenses

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**Operating Income**

Other Revenues & Gains

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Other Expenses & Losses

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**Income from (continuing) operations before taxes**

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**Income from continuing operations**

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**Income before extraordinary items**

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**Net Income**

**Income Statement Items (use to fill in the blanks above):**

Depreciation expense

Extraordinary items

Interest from savings account

Gain on sale of equipment no longer used

Loss on building destroyed in a hurricane at coastal factory

Transportation out

Income tax expense

Discontinued operations

Dividends received

Rent revenue on a building not used in manufacturing

Salaries

Cost of Goods Sold

**Pre-Class Guided Problem 4.2: For all of the problems below assume the company only provides one year on their financial statements. Assume a 30% tax rate for all problems below.**

1. **Change in accounting principle (page 174):** ABC changed from LIFO to FIFO at the end of 2010. 2010 COGS was originally calculated using LIFO at $1,000, which resulted in 2010 net income of $10,000. 2010 COGS recalculated using FIFO is $1,500.
   1. What is the impact on 2010 net income of changing from LIFO to FIFO? **Reminder:** COGS is a pre-tax item, while net income (NI) is after tax. Additionally, COGS reduces NI, so an increase in COGS will result in lower NI.
      1. Step 1: first determine the difference in COGS using LIFO and FIFO. What is that number?
      2. Step 2: determine the net of tax difference in COGS. What is that number?
      3. Step 3: determine the difference in 2010 net income as a result of changing from LIFO to FIFO.
      4. Why did you have to take the net of tax difference in COGS before determining the impact of the change on NI?
      5. What was the purpose of calculating the impact on NI?
   2. Assume ABC began operations in 2001 using LIFO. The 12/31/2009 ending retained earnings was $100,000. If ABC had used FIFO from 2001-2009 ending retained earnings (RE) would be $121,000. Only one year is presented on the financial statements. Again, assume a tax rate of 30%.
      1. What account caused net income (and therefore RE) to be different under LIFO versus FIFO?
      2. Should you adjust beginning RE in 2010? If so, by how much?
      3. What if instead of giving you the difference in RE, I gave you the difference in COGS. Use the steps above to determine the appropriate adjustment to RE if COGS was $30,000 lower under FIFO than LIFO.
2. **Correction of error (page 175):** Assume revenue was overstated by $10,000 in the current year and $15,000 in the prior year. Again, assume a tax rate of 30%.
   1. How should you adjust net income for the current period?
   2. How should you adjust net income for a prior period (not stated on the income statement)?
   3. Are there any other accounts that need to be adjusted?

**Chapter 4-VIDEO NOTES**

**Video can be accessed at the following link:** <https://mediamatrix.tamu.edu/streams/466604/327_Chapter_4_Video_1_of_2>

**Discontinued Operations**

**Notes:**

**Declared with conditions met & sold in same year:**

Suppose ABC decided on March 30 to dispose of a component. ABC sold the component on November 1 for one million dollars at which time the book value of the component was $800,000. During January 1-November 1, D had a pre-tax loss of $150,000. Assume a tax rate of 40%.

Discontinued operations

Loss from operations of discontinued Component D

(net of $\_\_\_\_\_\_\_\_\_\_\_ tax effect)

Gain from disposal of Component D

(net of $\_\_\_\_\_\_\_\_\_\_\_ tax) \_\_\_\_\_\_\_\_\_\_\_\_

**Declared with conditions met in year 1 & sold year 2:**

Suppose ABC decided in 2012 to dispose of component E. The sale will be completed in 2013. During 2012, E had a pre-tax loss of $40,000. The carrying value of E is $200,000 and the fair value less cost to sell is $130,000. Assume a tax rate of 40%. The discontinued operations would be disclosed as follows for 2012:

Assume during year 2, ABC sold the component for $150,000 and had a pre-tax loss on operations of $50,000. The discontinued operations would be disclosed as follows for year 2.

**Change in Accounting Principle**

**Notes:**

At the beginning of 2013, ABC decided to adopt FIFO inventory method. ABC had been using LIFO since January 1, 2010 when the company was formed.

**Inventory Determined by Cost of Goods Sold Determined by**

**Date LIFO FIFO LIFO FIFO**

12/31/10 9,000 8,500 78,000 79,500

12/31/11 10,000 8,000 80,000 82,000

12/31/12 20,000 24,000 100,000 94,000

12/31/13 32,000 39,000 113,000 110,000

Assume the income tax rate was 40% for all years. Also assume that sales each year were $300,000 and Selling, General and Administrative Expenses each year were $10,000. Suppose that ABC presents two years of financial results. Retained earnings as of 12/31/2011 were $100,000.

**Multi-Step Income Statement**

**2012 Annual Report 2013 Annual Report**

**Comparative Income Statement Comparative Income Statement**

**Original Income Statements Using LIFO Showing retrospective adjustment for 2012**

**2011 2012 2012 (Adj - Note A) 2013**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Sales | 300,000 | 300,000 |  | 300,000 | 300,000 |
| COGS | 80,000 | 100,000 |  |  |  |
| Gross Margin | 220,000 | 200,000 |  |  |  |
| S, G&A Expense | 10,000 | 10,000 |  | 10,000 | 10,000 |
| Income Before Taxes | 210,000 | 190,000 |  |  |  |
| Income Tax Expense | 84,000 | 76,000 |  |  |  |
| Net Income | 126,000 | 114,000 |  |  |  |

**Change in Accounting Principle (Continued)**

**Statement of Retained Earnings for 2010 and 2011**

**Balance in $’s**

Beginning Retained Earnings as of 1/1/2012

Prior Period Adjustment (correction of an error)

Retrospective Adjustment due to cumulative effect of

Change in accounting principle

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Adjusted Balance

Net Income/loss

Dividends Declared

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Ending Retained Earnings as of 12/31/2012

Beginning Retained Earnings as of 1/1/2013

Prior Period Adjustment (correction of an error)

Retrospective Adjustment due to cumulative effect of

Change in accounting principle

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Adjusted Balance

Net Income/loss

Dividends Declared

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Ending Retained Earnings as of 12/31/2013

**Video 2 can be accessed at the following link:** <https://mediamatrix.tamu.edu/streams/466610/327_Chapter_4_Video_2_of_2>

**Correction of an Error**

**Notes:**

Suppose ABC purchased equipment for $10,000 on 1/1/10 debiting equipment expense. The error was discovered in 2013. The equipment should have had $2,000 salvage value, 5 year useful life and been depreciated by the straight-line method. Assume a 40% income tax rate.

**Correcting entry only:**

**Current year depreciation expense:**

**Change in Accounting Estimate (with Depreciation Review)**

**Notes:**

**Double –declining balance depreciation method:**

**Example:**

Suppose ABC purchased equipment on January 1, 2011 for $10,000. It had salvage value of $1,000 and a 5 year useful life. In 2013, ABC decided to change to straight-line.

**Other Comprehensive Income**

**Notes:**

1. Unrealized gain/loss on available-for-sale securities – Chapter 17
2. Unrealized gain/loss on certain hedging transactions – Chapter 1, and ACCT 445 & 651
3. Unrealized gain/loss on foreign currency translations – ACCT 445
4. Unrecognized prior service costs over estimated pension liability – ACCT 328

**OCI/SHE Problem**

Use the following information concerning 2013 transactions to complete the statement of changes in stockholder’s equity below:

* 1. ABC issued 1,000 shares of $10 par value common stock for $15 per share.
  2. ABC had net income of $200,000.
  3. ABC had an unrealized loss on available-for-sale securities (pre-tax) of $5,000.
  4. ABC declared dividends of $100,000 and paid $75,000 of the declared dividends during 2013.
  5. On March 1, 2012, ABC received $24,000 from a tenant for one year’s rent on part of a warehouse ABC owned. ABC credited a nominal account. Late in 2013, ABC realized that no adjusting entry was made for this transaction at the end of 2012.
  6. ABC’s tax rate for all years is 30%.

**Comprehensive Income Statement:**

**Statement of Stockholders’ Equity**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | Total SHE | Retained Earnings | Accumulated OCI | Common Stock | Additional Paid in Capital |
| Beginning Balance | $500,000 | $200,000 | $50,000 | $200,000 | $50,000 |
|  |  |  |  |  |  |

**Chapter 4 Pre-Class Quiz (taken after watching the video and before class)**

1. ABC Company discounted operations in 20Y2. During the year, the company had a pre-tax operating loss of $10,000. They sold the component during 20Y2 for $100,000. The component had a historical cost of $200,000 and accumulated depreciation of $125,000. Determine the total income or loss on discontinued operations for 20Y2. The company’s tax rate is 30%.
   1. $63,000
   2. $15,000
   3. $10,500
   4. $17,500
2. ABC overstated 20Y1 revenue by $10,000. The error also affected 20Y2 by overstating revenue by $5,000. The company discovered the error in 20Y3, which included an overstatement to revenue of $3,000.

The company reports only 20Y3 on the current income statement and has a 30% tax rate. Determine the PPA the company should record to correct the error. () represents a decrease to beginning retained earnings.

* 1. $(7,000)
  2. $(12,600)
  3. $(10,500)
  4. $(15,000)

1. ABC Company started 20Y1 with accumulated OCI of $15,000. The company recorded net income in 20Y1 of $10,000. Additionally, the company had a pre-tax unrealized loss on available-for-sale securities of $6,000 and a pre-tax unrealized gain on trading securities of $3,000. The company uses a 30% tax rate. Determine ending accumulated OCI.
   1. $12,900
   2. $10,800
   3. $22,900
   4. $20,800

**Chapter 4 – In class problem**

ABC’s tax rate is 40%. ABC originally calculated net income from continuing operations of $400,000 for 2013, prior to consideration of the following. ABC reports one year on the face of their financial statements. ABC elects to record OCI on the income statement as well. Beginning retained earnings for 2013 is $500,000.

1. ABC purchased equipment for $80,000 at the beginning of 2010 and depreciated it using the straight-line method. They estimated a salvage value of $10,000 and useful life of 10 years. At the end of 2013, ABC decided to change the depreciation method to double declining balance, but had already calculated income using straight-line.
2. On November 1, 2013, ABC decided to dispose of a component. The sale was not complete at the end of 2013. During 2013, the component generated operating income of $80,000. At December 31, 2013, the fair value of the component was estimated to be $800,000 and the cost to sell was $30,000. The book value of the component was $820,000 on December 31, 2013. ABC included the operating income from the component in the net income from continuing operations of $400,000.
3. At the end of 2013, ABC discovered that they originally debited a nominal account on November 1, 2012 when they paid $120,000 for two years of rent in advance.
4. ABC had an unrealized loss on trading securities of $10,000 (pre-tax). Additionally, ABC had an unrealized loss on available-for-sale securities of $4,000 (pre-tax). Neither item was included in net income from continuing operations.

Prepare a net income statement for 2013 starting with net income from continuing operations.

Prepare a retained earnings statement for 2013.

**Exam review activity**

Assume a tax rate of 30% for all problems.

1. Aggie Inc. purchased equipment for $100,000 at the beginning of 20Y1 and depreciated it using the straight-line method. They estimated a salvage value of $5,000 and useful life of 5 years. At the end of 20Y3, Aggie Inc. decided to change the depreciation method to double declining balance, but had already calculated income using straight-line. How should net income be adjusted?
2. Aggie Inc. calculated $500,000 in net income. Additionally, Aggie Inc. had a $5,000 pre-tax unrealized loss on a foreign building that they are planning to sell in the future, as well as a pre-tax unrealized loss on available-for-sale securities of $3,000. Prepare a combined statement of net income and other comprehensive income.
3. Aggie Inc. was founded in 20Y1. In 20Y1, Aggie Inc. expensed a piece of equipment that was purchased at the beginning of the year for $50,000. The company estimated a salvage value of $2,000 and 10 year useful life. Net income in 20Y1 and 20Y2 was originally $100,000 and $120,000 and no dividends were declared. Aggie Inc. discovered the error at the very end of 20Y3. Prior to discovery of the error, Aggie Inc. had 20Y3 net income of $130,000. In 20Y3, Aggie Inc. reported two years of income on the income statement. Prepare the statement(s) of retained earnings that would appear in the 20Y3 annual report. Additionally, record the journal entry to book the PPA.
4. On March 1, 20Y2, Aggie Inc. sold a component of their business to XYZ Inc. for $775,000. Aggie determined the component would be discontinued in 20Y1 and properly reported the component in the discontinued operations section of the income statement. At 12/31/20Y1, ABC estimated the fair value less cost to sell of the component to be $850,000, while the book value was $800,000. Determine the gain or loss on disposal in 20Y2.

|  |  |
| --- | --- |
| **Chapter 4 – Chapter Quiz (2 attempts)**  **Problem 1:** | |
|  | On March 1, 2010, ABC Inc. sold a component of their business to XYZ Inc. for $700,000. ABC determined the component would be discontinued in 2009 and properly reported the component in the discontinued operations section of the income statement. At 12/31/2009, ABC estimated the fair value less cost to sell of the component to be $725,000, while the book value was $775,000.   During 2010, ABC had a pre-tax operating loss of $60,000 for the component. ABC is subject to a 30% income tax rate. Use () to show a loss.   1) Determine the net income/(loss) on operations from the discontinued component as of December 31, 2010:  $   2) Determine the net gain/loss on disposal from the discontinued component as of December 31, 2010:  $ |

Problem 2

|  |  |
| --- | --- |
|  | ABC Inc. began operations on January 1, 2006.  During its first 3 years of operations, ABC reported net income and declared dividends as follows.                                Net Income              Dividends                  2006      $ 50,000                     $ 0                  2007         75,000                   10,000                  2008       125,000                        0                  2009       150,000                   50,000  The following information relates to 2010.  • Net income was originally calculated as $200,000 and no dividends were declared during the period.  • Assume ABC is charged a tax rate of 30%.  • Additionally, ABC discovered in 2010 that they understated depreciation expense in 2008 by $25,000 and understated 2009 depreciation expense by $20,000.  • At the end of 2010, after the net income above was determined ABC decided to change from FIFO to LIFO.  The following COGS information was determined under each method.  The net income number given above was calculated for 2010 using FIFO.                      FIFO COGS            LIFO COGS             2006     $135,000               $120,000              2007    $115,000               $130,000              2008    $140,000               $110,000              2009    $150,000               $100,000              2010    $145,000               $115,000  ABC reported two years on the face of the income statement during 2010.  Using the information given complete the 2009 and 2010 Statements of Retained Earnings as reported in the 2010 Annual Report.  Use a parenthesis to indicate a negative balance (or subtraction).  2010 Annual Report  Retained Earnings Statements 2009 and 2010  Beginning Retained Earnings, 1/1/2009                             $  Cumulative Effect due to a Change in Accounting Principle $  Prior Period Adjustment                                                    $  2009 Net Income                                                             $  Dividends                                                                         $  Ending Retained Earnings                                                  $  Beginning Retained Earnings, 1/1/2010                               $  Cumulative Effect due to a Change in Accounting Principle $  Prior Period Adjustment                                                     $  2010 Net Income                                                               $  Dividends                                                                          $  Ending Retained Earnings                                                  $ |