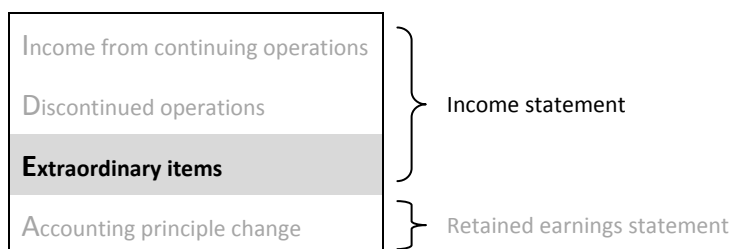


EXTRAORDINARY ITEMS



I. EXTRAORDINARY ITEMS

Extraordinary
Items

A. Defined (*unusual and infrequent*)

Under U.S GAAP, extraordinary items are transactions and other events that are:

1. Material in nature,
2. Of a character significantly different from the typical or customary business activities,
3. Not expected to recur in the foreseeable future, and
4. Not normally considered in evaluating the ordinary operating results of an enterprise.

B. How to Classify

Extraordinary items are usually determined by informed professional judgment, taking into consideration all the facts involved in a particular situation.

C. Separate Disclosure

Extraordinary items must be separately disclosed in the income statement, net of any related tax effects, after discontinued operations.

D. Examples of Extraordinary Items

1. The abandonment of, or damage to, a plant due to an infrequent earthquake or an infrequent flood.
2. An expropriation of a plant by the government.
3. A prohibition of a product line by a newly enacted law or regulation.
4. Certain gains or losses from extinguishment of long-term debt, provided they are not part of the entity's recurring operations and, thus, meet the criteria of unusual and infrequent.

E. Examples of Non-extraordinary Items

The following gains or losses are NOT extraordinary (they are presented as a separate component of "continuing operations"):

1. Gain or loss from sale or abandonment of property, plant, or equipment used in the business.

2. Large write-downs or write-offs of:
 - a. Receivables.
 - b. Inventories.
 - c. Intangibles (including goodwill).
 - d. Long-term securities (permanent decline).
3. Gain or loss from foreign currency transactions or translation, whether from major devaluations or otherwise (provided these occur on a regular basis as part of normal business operations).
4. Losses from major strike by employees.
5. Long-term debt extinguishments that are part of a common management strategy (i.e., **not** unusual and infrequent).

II. MATERIAL UNUSUAL OR INFREQUENT ITEMS

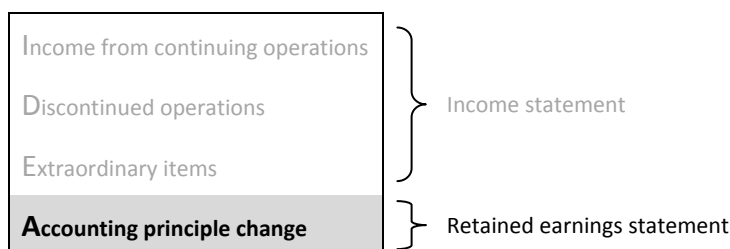
Items of income or loss that are either unusual or infrequent are **not** extraordinary (e.g., gain on the sale of a factory building). If material, these items should be reported as a separate line item as part of income from continuing operations (and not net of tax). The nature of the item and the financial effects should be disclosed on the face of the income statement or in the footnotes.



U.S. GAAP vs. IFRS

IFRS prohibits the reporting of any amount as extraordinary on the income statement or in the notes to the financial statements.

ACCOUNTING CHANGES AND ERROR CORRECTIONS



I. GENERAL

Accounting Changes

Accounting changes are broadly classified as:

- (i) Changes in accounting estimate,
- (ii) Changes in accounting principle, and
- (iii) Changes in accounting entity.

Note that error corrections are not considered accounting changes.

Accounting Estimates

II. CHANGES IN ACCOUNTING ESTIMATE *(prospective)*

A change in accounting estimate occurs when it is determined that the estimate previously used by the company is incorrect.

A. Events Resulting in Estimate Changes

1. Changes in the lives of fixed assets.
2. Adjustments of year-end accrual of officers' salaries and/or bonuses.
3. Write-downs of obsolete inventory.
4. Material non-recurring IRS adjustments.
5. Settlement of litigation.
6. Changes in accounting principle that are inseparable from a change in estimate (e.g., a change from the installment method to immediate recognition method because uncollectible accounts can now be estimated).

EXAMPLE

Carlin Company buys a truck for \$90,000. The truck is expected to last 10 years. During the third year, Carlin Company realizes that the truck is only going to last a total of 5 years. The truck is depreciated on the straight-line basis and has no estimated salvage value.

DEPRECIATION SCHEDULE ILLUSTRATION

<u>Year</u>	<u>Depreciation</u>
1	\$9,000 [\$90,000/10]
2	\$9,000 [\$90,000/10]
3	\$24,000 [\$72,000/3]
4	\$24,000 [\$72,000/3]
5	\$24,000 [\$72,000/3]
	<u>\$90,000</u>

B. Reporting a Change in Estimate**1. Prospectively**

Changes in accounting estimate are accounted for prospectively (i.e., implement in the current period and continue in future periods). They do not affect previous periods (i.e., no effect on previously reported retained earnings).

2. Change in Estimate Affecting Future Periods

If a change in accounting estimate affects several future periods (e.g., a revision of service lives of depreciable assets), the effect on income before extraordinary items, net income, and the related per share information for the current year should be disclosed in the notes to the financial statements.



Note: Changes in ordinary accounting estimates (e.g., uncollectible accounts and inventory adjustments) usually made each period do not have to be disclosed unless they are material.

**Changes in
Accounting Principle****III. CHANGES IN ACCOUNTING PRINCIPLE** (*retrospective application*)

A change in accounting principle is a change in accounting from one accounting principle to another acceptable accounting principle (i.e., GAAP to GAAP or IFRS to IFRS).

A. Rule of Preferability

An accounting principle may be changed only if required by GAAP/IFRS or if the alternative principle is preferable and more fairly presents the information.

B. Nonrecurring Changes

An accounting change should not be made for a transaction or event in the past that has been terminated or is nonrecurring.

C. Effects of a Change**1. Direct Effects**

The direct effects of a change in accounting principle are adjustments that would be necessary to restate the financial statements of prior periods.

2. Indirect Effects

The indirect effects of a change in accounting principle are differences in nondiscretionary items based on earnings (e.g., bonuses) that would have occurred if the new principle had been used in prior periods.

3. Cumulative Effect

If non-comparative financial statements are being presented, then the cumulative effect of a change in accounting principle is equal to the difference between the amount of beginning retained earnings in the period of change and what the retained earnings would have been if the accounting change had been retroactively applied to all prior affected periods. It includes direct effects and only those indirect effects that are entered in the accounting records. If comparative financial statements are being presented, then the cumulative effect is equal to the difference between beginning retained earnings in the first period presented and what retained earnings would have been if the new principle had been applied to all prior periods.

EXAMPLE – CUMULATIVE EFFECT OF A CHANGE IN ACCOUNTING PRINCIPLE

On January 1, 20X5, Harbor Construction Company decided to switch to the percentage-of-completion method in accounting for all of its long-term construction contracts. Prior to 20X5, Harbor used the completed contract method for some of its contracts. Harbor's effective tax rate is 30%. For income tax purposes, Harbor continues to use the completed contract method for all its contracts.

Contract information is as follows:

	<u>Pretax Income from</u>	
	<u>Percentage-of-Completion</u>	<u>Completed Contract</u>
Prior to 20X5	\$800,000	\$600,000
Cumulative effect adjustment as of 1/1/20X5 =	\$200,000	
Less income tax effect @ 30%		<u>(60,000)</u>
Cumulative effect net of income tax		<u>\$140,000</u>

D. Reporting Changes in an Accounting Principle

The general rule is that changes in accounting principle should be recognized by adjusting beginning retained earnings in the earliest period presented for the cumulative effect of the change, and, if prior period financial statements are presented, they should be restated (retrospective application).

U.S. GAAP v.s. IFRS

Under IFRS, when an entity disclosing comparative information applies an accounting principle retroactively or makes a retrospective restatement of items in the financial statements, the entity must (at a minimum) present three balance sheets (end of current period, end of prior period, and beginning of prior period) and two of each other financial statement (current period and prior period). The cumulative effect adjustment would be shown as an adjustment of the beginning retained earnings on the balance sheet for the beginning of the prior period. U.S. GAAP does not have a three balance sheet requirement.

**1. Exceptions to the General Rule****a. Impracticable to Estimate**

To prepare a change in accounting principle handled retrospectively, the amount of the cumulative effect adjustment must be calculated as of the beginning of the first period presented. If it is considered "impractical" to accurately calculate this cumulative effect adjustment, then the change is handled **prospectively** (like a change in estimate). An example of a change handled in this manner is a change in inventory cost flow assumption to **LIFO** (under U.S. GAAP). Since a cumulative effect adjustment to LIFO would require the reestablishment and recalculation of old inventory layers, it is considered impractical to try and rebuild those old cost layers. This change is therefore handled prospectively. The beginning inventory of the year of change is the first LIFO layer. Additional LIFO layers are added on from that point forward.

b. Change in Depreciation Method

A change in the method of depreciation, amortization, or depletion is considered to be both a change in accounting principle and a change in estimate. These changes should be accounted for as changes in estimate and are handled prospectively. The new depreciation method should be used as of the beginning of the year of the change in estimate and should start with the current book value of the underlying asset. No retroactive or retrospective calculations should be made, and no adjustment should be made to retained earnings.

2. Applications of the General Rule

- a. The amount of cumulative effect to be reported on the retained earnings statement is the difference between:
 - (1) Retained earnings at the beginning of the earliest period presented, and
 - (2) Retained earnings that would have been reported at the beginning of the earliest period presented if the new accounting principle had been applied retrospectively for all prior periods, by recognizing only the direct effects and related income tax effect.
- b. The new accounting principle is used for all periods presented (prior periods are restated).
- c. If an accounting change is not considered material in the year of change but is reasonably expected to become material in later periods, it should be fully disclosed in the year of change.

Changes in Accounting Entity

IV. CHANGES IN ACCOUNTING ENTITY (*retrospective application*)

Under U.S. GAAP, a change in accounting entity occurs when the entity being reported on has changed composition. Examples include consolidated or combined financial statements that are presented in place of statements of the individual companies and changes in the companies included in the consolidated or combined financial statements from year to year.

A. Restatement to Reflect Information for the New Entity (*if comparative financial statements are presented*)

If a change in accounting entity occurs in the current year, all previous financial statements that are presented in comparative financial statements along with the current year should be restated to reflect the information for the new reporting entity.

B. Full Disclosure

Full disclosure of the cause and nature of the change should be made, including changes in income before extraordinary items, net income, and retained earnings.



U.S. GAAP vs. IFRS

IFRS does not include the concept of a change in accounting entity.

V. ERROR CORRECTION (*prior period adjustment*)Prior Period
Adjustments

Error corrections include:

- (i) Corrections of errors in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of U.S. GAAP/IFRS, or oversight or misuse of facts that existed at the time the financial statements were prepared.
- (ii) Changes from a non-GAAP/IFRS method of accounting to a GAAP/IFRS method of accounting (e.g., cash basis to accrual basis), which is a specific correction of an error.

A. Accounting**1. Comparative Financial Statements Presented****a. Correct the Information, if the Year is Presented**

If comparative financial statements are presented and financial statements for the year with the error are presented, merely correct the error in those prior financial statements.

b. Adjust Beginning Retained Earnings of the Earliest Year Presented, if the Year is Not Presented

If comparative financial statements are presented and financial statements for the year with the error are not presented (e.g., because it is too far back in years), adjust (net of tax) the opening retained earnings of the earliest year presented.

2. Comparative Financial Statements Not Presented

If comparative financial statements are not presented the error correction should be reported as an adjustment to the opening balance of retained earnings (net of tax).

U. S. GAAP v s. IFRS

Under IFRS, when it is impracticable to determine the cumulative effect of an error the entity is required to restate information prospectively from the earliest date that is practicable. U.S. GAAP does not have an impracticability exemption for error corrections.



B. Example Statement of Retained Earnings *(with restatement effects)*

The purpose of the statement of retained earnings is to reconcile the beginning balance of retained earnings with the ending balance. It is usually presented immediately following the income statement.

EXAMPLE		
Jordan Manufacturing		
Statement of Retained Earnings		
For the Year Ended December 31, Year 1		
Beginning balance (as previously reported)		\$28,000,000
Prior period adjustment (Note 5)	\$(4,500,000)	
Add: Income tax benefit	<u>1,800,000</u>	<u>(2,700,000)</u>
Cumulative effect of accounting change	5,000,000	
Less: Income tax effect	<u>(2,000,000)</u>	<u>3,000,000</u>
Beginning balance (restated)		28,300,000
Add: Net income		<u>1,700,000</u>
		30,000,000
Less: Dividends		
Cash dividend declared on preferred stock	500,000	
Cash dividend declared on common stock	350,000	
Property dividend declared on common stock	100,000	
Stock dividend declared on common stock	<u>50,000</u>	<u>(1,000,000)</u>
Ending balance		<u>\$29,000,000</u>

COMPREHENSIVE INCOME



Pension adjustments
Unrealized gains and losses (available-for-sale securities)
Foreign currency items
Effective portion cash flow hedges
Revaluation surplus (IFRS only)

I. DEFINITIONS

Comprehensive
Income

A. Comprehensive Income

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

Net income
 + Other comprehensive income
 Comprehensive income

B. Net Income

Net income includes the following items:

1. Income from continuing operations
2. Discontinued operations
3. Extraordinary items

C. Other Comprehensive Income

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

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



1. Pension Adjustments

Under U.S. GAAP, changes in the funded status of a pension plan due to gains or losses, prior service costs, and net transition assets or obligations must be recognized in other comprehensive income in the year the changes occur. All gains or losses, prior service costs, and transition assets or obligations are included in other comprehensive income until recognized as a component of net periodic benefit cost. (Pensions are covered in detail in lecture F-6, later in the course.)

Under IFRS, certain actuarial gains and losses may be included in other comprehensive income. These gains and losses are not reclassified to the net income in subsequent periods.





2. Unrealized Gains and Losses (*available for sale securities*)

The following types of unrealized gains and losses on certain investments in debt and equity securities are reported as components of other comprehensive income until the securities are sold. (All are covered in detail in lecture F-3, later in the course.)

- a. Unrealized holding gains and losses on "available-for-sale securities."
- b. Unrealized holding gains and losses that result from a debt security being transferred into the "available-for-sale" category from "held-to-maturity."
- c. Subsequent decreases or increases in the fair value of "available-for-sale" securities previously written down as impaired.



3. Foreign Currency Items

Foreign currency translation adjustments and gains and losses on foreign currency transactions that are designated as (and are effective as) economic hedges of a net investment in a foreign entity (discussed in the F-7 lecture on derivatives and other financial instruments) are reported as a component of other comprehensive income. Foreign currency translation adjustments remain in other comprehensive income until the sale or liquidation of the investment in the foreign entity. (Foreign currency and its related effects are covered in detail in lecture F-2, later in the course.)



4. Effective Portion of Cash Flow Hedges

The effective portion of a cash flow hedge is reported as a component of other comprehensive income until the cash flows associated with the hedged item are realized. (Cash flow hedges are discussed in the F-7 lecture on derivatives and other financial instruments.)



5. Revaluation Surplus (*IFRS only*)

Under IFRS, revaluation surpluses (gains) recognized when intangible assets and fixed assets are revalued, are also included in other comprehensive income. Revaluation surpluses are not reclassified to net income in subsequent periods, but may be transferred directly to retained earnings when the related asset is used or derecognized. (The revaluation of intangible assets is discussed in the F-2 lecture and the revaluation of fixed assets is discussed in the F-4 lecture.)

D. Reclassification Adjustments

Reclassification adjustments move other comprehensive income items from accumulated other comprehensive income to the income statement. These adjustments may be displayed on the face of the financial statement in which comprehensive income is reported or disclosed in the notes to the financial statements.

E. Accumulated Other Comprehensive Income

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

PASS KEY

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

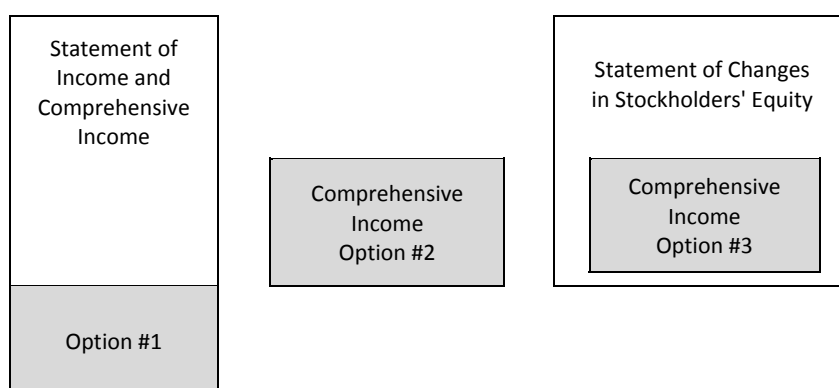


II. FINANCIAL STATEMENT REPORTING

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

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

- (i) A single statement of comprehensive income (single-statement approach);
- (ii) An income statement followed by a separate statement of comprehensive income that begins with net income (two-statement approach); or
- (iii) A statement of changes in equity.



U. S. GAAP vs. IFRS

Under IFRS, comprehensive income may be reported using the single-statement approach or the two-statement approach. IFRS prohibits the presentation of comprehensive income in the statement of changes in equity.



A. Single Statement Approach

The single statement approach displays other comprehensive income below the income statement and totals them for comprehensive income.

EXAMPLE			
Sydney Technologies, Inc.			
Statement of Income and Comprehensive Income			
For the Year Ended December 31, Year 1			
Summarized {	Revenues		\$20,000,000
	Expenses		<u>(\$18,400,000)</u>
	Income before income taxes		1,600,000
	Income tax (25%)		<u>(400,000)</u>
	Net income		1,200,000
Other comprehensive income, net of income tax:			
	Pension net loss	(\$25,000)	
	Unrealized holding gains (available-for-sale securities)	300,000	
	Foreign currency items	<u>(75,000)</u>	<u>200,000</u>
	Comprehensive income		<u>\$ 1,400,000</u>

B. Two-statement Approach

The two-statement approach displays comprehensive income as a separate statement that begins with net income.

EXAMPLE		
Sydney Technologies, Inc.		
Statement of Income and Comprehensive Income		
For the Year Ended December 31, Year 1		
Net income		\$1,200,000
Other comprehensive income, net of income tax		
Pension net loss	(\$25,000)	
Unrealized holding gains (available-for-sale securities)	300,000	
Foreign currency items	<u>(75,000)</u>	<u>200,000</u>
Comprehensive income		<u>\$1,400,000</u>

C. Component within the Statement of Owners' Equity (U.S. GAAP only)

Under U.S. GAAP, comprehensive income may be displayed as a separate column in the statement of owners' equity. This presentation is prohibited under IFRS. Note that the separate presentation of accumulated other comprehensive income is required as part of the statement of owners' equity.

EXAMPLE					
Sydney Technologies, Inc.					
Statement of Changes in Stockholders' Equity					
For the Year Ended December 31, Year 1					
	<u>Total</u>	<u>Comprehensive income</u>	<u>Retained earnings</u>	<u>Accumulated other comp. income</u>	<u>Common stock</u>
Beginning balance	\$30,000,000		\$8,500,000	\$1,500,000	\$20,000,000
Comprehensive income:					
Net income	1,200,000	<u>\$1,200,000</u>	1,200,000		
Pension net loss	(25,000)	(25,000)			
Unrealized holding gains	300,000	300,000			
Foreign currency items	(75,000)	<u>(75,000)</u>			
Other comprehensive income		<u>200,000</u>		200,000	
Comprehensive income		<u>\$1,400,000</u>			
Common stock issued	1,000,000				1,000,000
Dividends declared on common stock	<u>(700,000)</u>		<u>(700,000)</u>		
Ending balance	<u>\$31,700,000</u>		<u>\$9,000,000</u>	<u>\$1,700,000</u>	<u>\$21,000,000</u>
		OPTIONAL FORMAT		REQUIRED FORMAT	
Total = \$31,700,000					