

FINANCIAL 1

Standard Setting, Income Statement, and Reporting Requirements

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NOTES

ACCOUNTING STANDARDS AND CONCEPTUAL FRAMEWORKS



I. STANDARD-SETTING BODIES IN THE UNITED STATES

In the United States, the Securities and Exchange Commission (SEC) has the legal authority to establish U.S. generally accepted accounting principles (GAAP). However, in most instances, the SEC has allowed the accounting profession to establish GAAP and self-regulate. The SEC and three different bodies of the accounting profession have determined GAAP since 1934.

A. Securities and Exchange Commission (SEC)

The SEC was established by the Securities Exchange Act of 1934. All companies that issue securities in the United States are subject to SEC rules and regulations. The SEC has issued public company specific accounting rules and regulations in Regulation S-X, Financial Reporting Releases (FRR), Accounting Series Releases (ASR), Interpretative Releases (IR), Staff Accounting Bulletins (SAB), and EITF Topic D and SEC Observer comments.

B. Committee on Accounting Procedure (CAP)

The Committee on Accounting Procedure (CAP) was a part-time committee of the American Institute of Certified Public Accountants (AICPA) that promulgated Accounting Research Bulletins (ARB), which determined GAAP from 1939 until 1959.

C. Accounting Principles Board (APB)

The Accounting Principles Board (APB) was another part-time committee of the AICPA. It issued Accounting Principles Board Opinions (APBO) and APB Interpretations, which determined GAAP from 1959 until 1973.

D. Financial Accounting Standards Board (FASB)

In 1973, an independent full-time organization called the Financial Accounting Standards Board (FASB) was established, and it has determined GAAP since then. Through 2009, the FASB issued Statements of Financial Accounting Standards (SFAS), FASB Interpretations (FIN), FASB Technical Bulletins (FTB), Emerging Issues Task Force Statements (EITF), FASB Staff Positions, FASB Implementation Guides, and Statements of Financial Accounting Concepts (SFAC).

The FASB has seven full-time members who serve for five-year terms and may be reappointed to one additional five-year term. The Board members must sever connections with firms or institutions before joining the Board.

II. U.S. GAAP—FASB ACCOUNTING STANDARDS CODIFICATION™

The vast number of standards issued by the Committee on Accounting Procedures, the Accounting Principles Board, and the Financial Accounting Standards Board, as well as additional guidance provided by the SEC and the AICPA, made it difficult for users to access the full body of U.S. GAAP. Effective July 1, 2009, the *FASB Accounting Standards Codification*™ became the single source of authoritative nongovernmental U.S. GAAP. Accounting and financial reporting practices not included in the Codification are not GAAP.

A. Authoritative Literature Included in the Codification

The Codification is composed of the following literature that had been issued by various standard setters:

1. Financial Accounting Standards Board (FASB)
 - a. Statements of Financial Accounting Standards
 - b. Interpretations
 - c. Technical Bulletins
 - d. Staff Positions
 - e. Staff Implementation Guides
 - f. Statement No. 138 Examples
2. Emerging Issues Task Force (EITF) Abstracts and Topic D
3. Derivative Implementation Group Issues
4. Accounting Principles Board Opinions
5. Accounting Research Bulletins
6. Accounting Interpretations
7. American Institute of Certified Public Accountants (AICPA)
 - a. Statements of Position
 - b. Auditing and Accounting Guides (incremental accounting guidance only)
 - c. Practice Bulletins
 - d. Technical Inquiry Service (for software revenue recognition)

B. SEC Standards Included in the Codification

To increase the usefulness of the Codification for public companies, relevant portions of the following authoritative pronouncements issued by the SEC were included for reference in the Codification:

1. Regulation S-X
2. Financial Reporting Releases (FRR)
3. Accounting Series Releases (ASR)
4. Interpretative Releases (IR)
5. Staff Accounting Bulletins (SAB)
6. EITF Topic D and SEC Staff Observer Comments



Note: The SEC sections of the Codification do not contain the entire population of SEC rules and regulations.

C. Ongoing Standard-Setting Process

The FASB updates the *Accounting Standards Codification* for new U.S. GAAP issued by the FASB and for amendments to the SEC content with Accounting Standards Updates.

Proposed FASB amendments to the ASC are issued for public comment in the form of Exposure Drafts. A majority vote of the Board members is required to approve an Exposure Draft for issuance. At the end of the Exposure Draft public comment period, the FASB staff analyzes and studies all comment letters and position papers and then the Board redeliberates on the issue. When the Board is satisfied that all reasonable alternatives have been adequately considered, the FASB staff prepares an Accounting Standards Update for Board consideration. A majority vote of the Board members is required to amend the ASC.

Accounting Standards Updates are not authoritative literature, but instead provide background information, update the Codification, and describe the basis for conclusions on changes in the Codification. All new GAAP and SEC amendments are fully integrated into the existing structure of the Codification.

D. Using the Codification

Note: An overview of the structure of the Codification will be provided in a subsequent lecture.



III. INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB)

The International Accounting Standards Board (IASB) was established in 2001 as part of the International Financial Reporting Standards (IFRS) Foundation. The IASB replaced its predecessor, the Board of the International Accounting Standards Committee, which was created in 1973 through an agreement of professional accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States. The purpose of the IASB is to develop a single set of high-quality, global accounting standards.

The IASB has 15 full-time members and two part-time members who are selected to provide a mix of practical experience among auditors, preparers, users, and academics.

In addition to the IASB, the IFRS Foundation sponsors the International Financial Reporting Interpretations Committee (IFRIC).

A. International Financial Reporting Interpretations Committee (IFRIC)

The IFRIC is appointed by the trustees of the IFRS Foundation to assist the IASB in establishing and improving standards of financial accounting and reporting. The IFRIC was established in 2002 and replaced the previous interpretations committee, the Standing Interpretations Committee (SIC). The IFRIC provides guidance on newly identified financial reporting issues not addressed in the IFRSs and assists the IASB in achieving international convergence of accounting standards.

IV. INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

When the IASB was created, it adopted the International Accounting Standards (IAS) that had been issued by the Board of the International Accounting Standards Committee. The IASB issues International Financial Reporting Standards (IFRSs) and related documents, including the *Conceptual Framework for Financial Reporting*, exposure drafts, and other discussion documents. The term International Financial Reporting Standards includes IFRSs, IASs, and Interpretations developed by the IFRIC and the former SIC.

A. Ongoing Standard-Setting Process

The IASB generally publishes a discussion paper as its first publication on a major new topic, although discussion papers are not required. After receiving and reviewing comments on the discussion paper, the IASB staff prepares an Exposure Draft. The publication of an Exposure Draft for public comment is required. At least nine members of the IASB must approve an Exposure Draft for issuance. At the end of the Exposure Draft public comment period, the IASB analyzes and studies all comment letters and position papers and then re-deliberates on the issue. When the IASB is satisfied that all reasonable alternatives have been adequately considered, the IASB staff drafts the IFRS. An IFRS must be approved by at least nine members of the IASB.

B. The Conceptual Framework for Financial Reporting

The IASB is developing the *Conceptual Framework for Financial Reporting (Conceptual Framework)* in a joint project with the FASB. The purpose of the project is to converge and improve the FASB and IASB financial reporting frameworks. As each chapter of the *IASB Conceptual Framework for Financial Reporting* is completed, it will replace the relevant paragraphs in the *Framework for the Preparation and Presentation of Financial Statements*, which was developed by the IASB's predecessor body. The *Conceptual Framework* assists the IASB in developing future IFRSs, evaluating existing IFRSs, and reducing the number of alternative accounting treatments permitted by IFRSs. The *Conceptual Framework* is not an IFRS.

**U.S. GAAP VS. IFRS**

Under IFRS, entities are directed to refer to and consider the applicability of the concepts in the Framework when developing accounting policies in the absence of a standard or interpretation that specifically applies to an item.

Under U.S. GAAP, the Conceptual Framework cannot be applied to specific accounting issues.

V. INTERNATIONAL CONVERGENCE OF ACCOUNTING STANDARDS

The IASB and the FASB have been working together towards the international convergence of accounting standards since 2002. The goal of the convergence project is a single set of high-quality, international accounting standards that companies can use for both domestic and cross-border financial reporting. In order to achieve this goal, the FASB and IASB have cooperated to improve both U.S. GAAP and IFRS and to eliminate the differences between the two sets of standards. The FASB continues to issue U.S. GAAP and the IASB continues to issue IFRS with the expectation that over time the two sets of standards will become increasingly similar, if not the same.

**PASS KEY**

IFRS and U.S. GAAP are the same for the majority of the accounting issues covered on the CPA Exam. Significant differences between IFRS and U.S. GAAP are highlighted throughout the Becker materials. If no difference between IFRS and U.S. GAAP is noted, then the accounting rules are substantially the same.

VI. ADOPTION OF IFRS IN THE UNITED STATES

The SEC has stated that it believes a single set of high-quality globally accounted accounting standards would benefit U.S. investors. The SEC supports the IASB/FASB convergence project and is currently considering the incorporation of IFRS into the U.S. financial reporting system.

VII. CONCEPTUAL FRAMEWORKS UNDERLYING FINANCIAL ACCOUNTING

The FASB has created a conceptual framework (set forth in pronouncements called Statements of Financial Accounting Concepts, or SFAC) that serves as a basis for all FASB pronouncements. The SFAC are not GAAP, but they provide a basis for financial accounting concepts for business and nonbusiness enterprises. The FASB and the IASB have a joint project to improve and converge their financial reporting frameworks. As phases of this project are completed, the FASB will issue each component of the joint conceptual framework as a chapter in Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting*. When the project is completed, the FASB and IASB will share a single *Conceptual Framework for Financial Reporting*.

A. SFAC No. 1, "Objectives of Financial Reporting by Business Enterprises"

This statement was replaced by Chapter 1 of SFAC No. 8.

B. SFAC No. 2, "Qualitative Characteristics of Accounting Information"

This statement was replaced by Chapter 3 of SFAC No. 8.

C. SFAC No. 8, "Conceptual Framework for Financial Reporting—Chapter 1: The Objective of General Purpose Financial Reporting"

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to the primary users of general purpose financial reports in making decisions about providing resources to the reporting entity.

1. Primary Users

The primary users of general purpose financial reports are existing and potential investors, lenders, and other creditors. Other parties, including regulators and members of the public who are not investors, lenders, and other creditors, may also use general purpose financial reports, but are not considered to be primary users.

2. Financial Information Provided in General Purpose Financial Reports

Financial information needed by existing and potential investors, lenders, and other creditors includes information about the resources of the entity, the claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources. Financial information should be presented using the accrual basis of accounting.

Existing and potential investors, lenders, and other creditors use financial information to assess the reporting entity's prospects for future net cash inflows to the entity. Such information may be used to estimate the value of the reporting entity.

D. SFAC No. 8, "Conceptual Framework for Financial Reporting—Chapter 3: Qualitative Characteristics of Useful Financial Information"

The qualitative characteristics of useful financial information are the characteristics that are likely to be most useful to existing and potential investors, lenders, and other creditors in making decisions about the reporting entity based on financial information.

1. Fundamental Qualitative Characteristics

The fundamental qualitative characteristics of useful financial information are relevance and faithful representation. Both characteristics must be present for financial information to be useful.

a. Relevance

Financial information is relevant if it is capable of making a difference in the decisions made by users. To be relevant, financial information must have predictive value and/or confirming value, and must be material.

(1) Predictive Value

Information has predictive value if it can be used by users to predict future outcomes.

(2) Confirming Value

Information has confirming value if it provides feedback about evaluations previously made by users.

(3) Materiality

Information is material if an omission or misstatement of the information could affect the decisions made by users based on financial information. Materiality is an entity-specific aspect of relevance. The FASB/IASB have not specified a uniform quantitative threshold for materiality and have not specified what would be material in specific situations.

b. Faithful Representation

To be useful, financial information must faithfully represent the reported economic phenomena. Faithful representation requires completeness, neutrality, and freedom from error. Although perfect faithful representation is generally not achievable, these characteristics must be maximized.

(1) Completeness

A complete depiction of financial information includes all information necessary for the user to understand the reported economic phenomena, including descriptions and explanations.

(2) Neutrality

A neutral depiction of financial information is free from bias in selection or presentation.

(3) Freedom from Error

Freedom from error means that there are no errors in the selection or application of the process used to produce reported financial information and that there are no errors or omissions in the descriptions of economic phenomena. Freedom from error does not require perfect accuracy because, for example, it is difficult to determine the accuracy of estimates.

c. Steps to Apply the Fundamental Qualitative Characteristics

The most efficient and effective process for applying the fundamental characteristics of useful financial information is:

- (1) Identify the phenomena that has the potential to be useful to the users of a reporting entity's financial information,
- (2) Identify the type of information about the phenomena that would be most relevant,
- (3) Determine whether the information is available and can be faithfully represented.

If the information is available and can be faithfully represented, then the fundamental qualitative characteristics have been satisfied. If not, the process is repeated with the next most relevant type of information.

2. Enhancing Qualitative Characteristics

Comparability, verifiability, timeliness, and understandability enhance the usefulness of information that is relevant and faithfully represented. These characteristics can be used to determine how a phenomena should be depicted if two ways are equally relevant and faithfully represented. The enhancing qualitative characteristics should be maximized.

a. Comparability

Information is more useful if it can be compared with similar information about other entities or from other time periods. Comparability enables users to identify similarities and differences among items. Consistency, which is the use of the same methods for the same items either from period to period or across entities, helps to achieve comparability.

b. Verifiability

Verifiability means that different knowledgeable and independent observers can reach consensus that a particular depiction is faithfully represented. Verifiability does not require complete agreement.

c. Timeliness

Timeliness means that information is available to users in time to be capable of influencing their decisions.

d. Understandability

Information is understandable if it is classified, characterized, and presented clearly and concisely. However, even well-informed and diligent users may need the assistance of advisors to understand complex and difficult phenomena.

3. The Cost Constraint

The cost constraint is a pervasive constraint on the information provided in financial reporting. The benefits of reporting financial information must be greater than the costs of obtaining and presenting the information. The FASB/IASB consider costs and benefits in relation to financial reporting in general and not at the individual reporting entity level.

E. SFAC No. 3, "Elements of Financial Statements of a Business"

This statement was replaced by SFAC No. 6.

F. SFAC No. 4, "Objectives of Financial Reporting by Nonbusiness Organizations"

This statement outlines the characteristics that distinguish nonbusiness organizations from business organizations, describes the users of the financial information provided by nonbusiness organizations, and sets forth the objectives of external financial reporting by nonbusiness organizations.

1. Characteristics of Nonbusiness Organizations

The following characteristics distinguish nonbusiness organizations from business organizations:

- a. A significant portion of their resources come from contributions and grants.
- b. Their operating purposes are other than to provide goods or services for profit.
- c. They lack ownership interests that can be sold, transferred, or redeemed, or that allow a claim on resources upon liquidation.

Nonbusiness organizations include most human service organizations, churches, foundations, and other organizations, such as not-for-profit hospitals and not-for-profit educational institutions that received a significant portion of their resources from contributions and grants.

2. Users of Financial Information of Nonbusiness Organizations

The following groups are interested in the financial information reported by nonbusiness organizations:

- a. Resources providers, including lenders, suppliers, employees, members, contributors, and taxpayers.
- b. Constituents who use and benefit from the services provided by nonbusiness organizations.
- c. Governing and oversight bodies who are responsible for setting policies and for overseeing and evaluating the managers of nonbusiness organizations.
- d. Managers who are responsible for carrying out the policy mandates of the governing bodies and managing the day-to-day operations of the nonbusiness organization.

3. Objectives of Financial Reporting of Nonbusiness Organizations

The objectives of the financial reporting of nonbusiness organizations are to provide:

- a. Information useful in making resource allocation decisions.
- b. Information useful in assessing services and the ability to provide services.
- c. Information useful in assessing management stewardship and performance.
- d. Information about economic resources, obligations, and net resources, organization performance, the nature of and relationship between inflows and outflows, service efforts and accomplishments, and liquidity.

G. SFAC No. 5, "Recognition and Measurement in the Financial Statements"

This statement sets forth the recognition criteria and guidance on what and when information should be incorporated in the financial statements.

1. Full Set of Financial Statements

- a. Statement of financial position (*the balance sheet*)
- b. Statement of earnings (*the income statement*)
- c. Statement of comprehensive Income
- d. Statement of cash flows
- e. Statement of changes in owners' equity

2. Fundamental Recognition Criteria

Recognition is the process of formally recording or incorporating an item in the financial statements of an entity and classifying it as asset, liability, equity, revenue, or expense.

- a. Definitions
- b. Measurability
- c. Relevance
- d. Reliability

3. Measurement Attributes for Assets and Liabilities

- a. Historical cost
- b. Current cost
- c. Net realizable value
- d. Current market value
- e. Present value of future cash flows

4. Fundamental Assumptions**a. Entity Assumption**

Economic activity can be accounted for when considering an identifiable set of activities (e.g., a separate corporation, division, etc.).

b. Going Concern Assumption

For financial accounting, it is presumed (subject to rebuttal by evidence to the contrary) that the entity will continue to operate in the foreseeable future.

c. Monetary Unit Assumption

It is assumed that money is an appropriate basis by which to measure economic activity. The assumption is that the monetary unit does not change over time; thus, the effects of inflation are not reflected in the financial statements.

d. Periodicity Assumption

Economic activity can be divided into meaningful time periods.

e. Historical Cost Principle

As a general rule, financial information is accounted for and based on cost, not current market value.

f. Revenue Recognition Principle

As a general rule, revenue should be recognized when it is earned and when it is realized or realizable.

(1) Earned

Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

(2) Realized or Realizable

Revenues and gains are recognized when products, merchandise, or other assets are exchanged for cash or claims to cash or when related assets received or held are readily convertible to known amounts of cash or claims to cash.

g. Matching Principle

Expenses are necessarily incurred to generate revenue. In accordance with the matching principle, all expenses incurred to generate a specific amount of revenue in a period are **matched** against that revenue. The matching principle does not govern the recognition of losses since they result from unusual events.

h. Accrual Accounting

Revenues are recognized when they are earned and expenses are recognized in the same period as the related revenue (matching or using a systematic and rational allocation or expensing in the period in which they expire), not necessarily in the period in which the cash is received or expended by the company.

i. Full Disclosure Principle

It is important that the user be given information that would make a difference in the decision process but not so much information that the user is impeded in analyzing what is important.

j. Conservatism Principle

If in doubt when selecting from alternative GAAP methods, the method that is least likely to overstate assets (and revenues/gains) and understate liabilities (and expenses/losses) in the current period should be selected.

- (1) Recognize revenues/gains when the earnings process is complete (or virtually completed).
- (2) Recognize expenses/losses immediately.

U.S. GAAP VS. IFRS

The IASB *Framework for the Preparation and Presentation of Financial Statements* outlines only two fundamental assumptions: 1) accrual basis accounting and 2) going concern. This U.S. GAAP vs. IFRS difference will be eliminated when the joint FASB/IASB *Conceptual Framework for Financial Reporting* is completed.

**H. SFAC No. 6, "Elements of Financial Statements"**

Elements are the components of the financial statements. They must be measurable and meet the recognition requirements previously discussed.

1. Comprehensive Income

Comprehensive income includes all differences between beginning equity and ending equity other than transactions with owners (i.e., net income plus other comprehensive income).

2. Revenues

Revenues are inflows, enhancements of assets, or reductions of liabilities from delivering goods or services as a part of normal operations. Recognize revenue at the gross amount (less allowances for returns and discounts given).

3. Expenses

Expenses are outflows, uses of assets, or the incurrence of liabilities from delivering goods or services as part of normal operations.

4. Gains

Gains are increases in equity from peripheral transactions and other events except revenue and investments from owners.

5. Losses

Losses are decreases in equity from peripheral transactions and other events except expenses and distributions to owners.

6. Assets

Assets are probable future economic benefits to be received by the company as a result of past transactions or events. Valuation accounts may be used to show reductions to or increases in an asset that reflect adjustments beyond the historical cost or carrying amount of the asset.

7. Liabilities

Liabilities are probable future sacrifices of economic benefits arising from a present obligation of the company to transfer assets or provide services to other entities in the future as a result of past transactions or events.

8. Equity (of net assets)

Equity is the residual interest in the assets of the company that remains after deducting its liabilities.

9. Investments by Owners

Investments by owners are the increases in assets from transfers of cash, property, or services from owners.

10. Distributions to Owners

Distributions to owners are decreases in assets from transfers of cash, property, or services, or the incurrence of a liability to owners.

U.S. GAAP VS. IFRS

The IASB *Framework for the Preparation and Presentation of Financial Statements* outlines the following elements of financial statements: assets, liabilities, equity, income (including revenue and gains), expenses (including expenses and losses), and capital maintenance adjustments. Capital maintenance adjustments are increases and decreases in equity that arise from the revaluation or restatement of assets and liabilities. This U.S. GAAP vs. IFRS difference will be eliminated when the joint FASB/IASB *Conceptual Framework for Financial Reporting* is completed.



I. SFAC No. 7, "Using Cash Flow Information and Present Value in Accounting Measurements"

SFAC No. 7 provides a framework for accountants to employ when using future cash flows as a measurement basis for assets and liabilities, especially when the factors to consider in the measurement are complex. It also provides a set of principles that govern the use of present value, especially when the timing and/or amount of future cash flows are uncertain.

1. Measurements Based on Future Cash Flows Only

SFAC No. 7 only applies to measurement issues for assets and liabilities that are determined using future cash flows only.

2. Five Elements of Present Value Measurement

The FASB identified five elements of present value (or economic value) measurement that were used as the basis for determining the measurement objective of SFAC No. 7.

- a. Estimate of future cash flow
- b. Expectations about timing variations of future cash flows
- c. Time value of money (the risk-free rate of interest)
- d. The price for bearing uncertainty
- e. Other factors (e.g., liquidity issues and market imperfections)

3. Fair Value Objective

If fair value cannot be determined in the marketplace, the objective must be to obtain an estimate of fair value (i.e., a present value of future cash flows).

4. Present Value Computations

SFAC No. 7 allows the use of two approaches to determine present value (each considering the interest method of allocation), depending on the circumstances.

a. Traditional Approach

The traditional approach (i.e., one discount rate used to take the present value of a future cash flow stream) to present value computations may be used when assets and liabilities have contractual (i.e., fixed) cash flows that are not expected to vary. In this approach, interest rate selection is paramount.

b. Expected Cash Flow Approach

In more complex cases, the expected cash flow approach is to be used. Rather than focusing on the interest rate selection, this approach uses only the risk-free rate of return as the discount rate and then turns its attention to the expected future cash flows, considering uncertainties (e.g., default risk) as adjustments to the future cash flows.

(1) Expected Cash Flow

The expected cash flow approach considers a range of possible cash flows and assigns a (subjective) probability to each cash flow in the range to determine the weighted-average, or "expected," future cash flow.

(2) Risk and Uncertainty Adjustments to Cash Flows

Adjustments to the expected cash flows used in complex present value computations (rather than interest rate adjustments) are required for uncertainties (e.g., default risk).

5. Liability Measurement Considers Additional Factors

The FASB determined that, when using present value, the objective of estimating the fair value of a liability must consider certain other factors, including:

- a. Costs to settle
- b. Credit standing of the company

6. Changes in Estimated Cash Flows Using the Catch-up Approach

To use this approach, simply adjust the carrying amount of the asset or liability to the present value determined using the revised estimates and discount using the original effective interest rate.

INCOME STATEMENT



I. USES AND TERMINOLOGY

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

A. Uses of the Income Statement

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

B. Terminology

1. Cost and Unexpired Costs

a. Cost

Cost is an amount (measured in money) expended for items such as capital assets, services (e.g., payroll), and merchandise received. Cost is the amount actually paid for something.

b. Unexpired Costs

Unexpired costs are costs that will expire in future periods and be charged (allocated in a systematic and rational manner or matched) against revenues from future periods.

c. Examples

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

2. Gross Concept (*revenues and expenses*)

a. Revenues

Revenues are reported at their gross amounts (less allowance for returns and discounts given).

b. Expenses

Expenses (costs that only benefit the current period or the allocation of unexpired costs to the current period for the benefit received) are reported at their gross amounts.

3. Net Concept (*gains and losses*)

a. Gains

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

b. Losses

Losses are reported at their net amounts (i.e., proceeds less net book value). A loss is cost expiration either not in the ordinary course of business (e.g., loss on the sale of investment assets) or without the generation of revenue (e.g., abandonment).

II. PRESENTATION ORDER OF THE MAJOR COMPONENTS OF AN INCOME AND RETAINED EARNINGS STATEMENT

REPORTED ON INCOME STATEMENT



- ☐ A. **Income (or Loss) from Continuing Operations** (*individual line items show "gross of tax", then total reported "net of tax"*)

Income from continuing operations includes operating activities (i.e., revenues, costs of goods sold, selling expenses, and administrative expenses), non-operating activities (e.g., other revenues and gains and other expenses and losses), and income taxes.

- ☐ B. **Income (or Loss) from Discontinued Operations** (*reported "net of tax"*)

Income from discontinued operations is presented net of tax.

- ☐ C. **Extraordinary Items** (*reported "net of tax"*)

Extraordinary items are presented net of tax and include items that are unusual in nature and infrequent in occurrence.

REPORTED ON STATEMENT OF RETAINED EARNINGS

- ☐ D. **Cumulative Effect of Change in Accounting Principle** (*reported "net of tax"*)

The cumulative effect of a change in accounting principle is presented net of tax. It is the cumulative effect (calculated as of the beginning of the earliest period presented in the period of implementation of the new method) of a change from one acceptable method of accounting to another ("GAAP to GAAP") because the new method presents the financial information more fairly than the old method.

INCOME FROM CONTINUING OPERATIONS

Income from continuing operations	
Discontinued operations	} Income statement
Extraordinary items	
Accounting principle change	} Retained earnings statement

Accounting
Changes

I. MULTIPLE STEP INCOME STATEMENT

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

EXAMPLE			
Radon Industries, Inc.			
Income Statement (multiple step)			
for the Year Ended December 31, Year 1 (<i>in thousands</i>)			
Net sales (including goods, services, and rentals)			\$650
Cost of sales (including goods, services, and rentals)		<u>(410)</u>	
Gross margin			\$240
Selling expenses	\$100		
General and administrative expenses	70		
Depreciation expense	<u>80</u>	<u>(250)</u>	
Income (loss) from operations			\$ (10)
Other revenues and gains:			
Interest income	170		
Gain on sale of fixed assets (e.g., equipment)	50		
Other income	<u>130</u>	350	
Other expenses and losses:			
Interest expense	50		
Loss on sale of fixed assets (e.g., equipment)	<u>40</u>	<u>(90)</u>	
Income before unusual items and income tax			\$250
Unusual or infrequent items:			
Loss on sale of available-for-sale securities		<u>(100)</u>	
Income before income tax			150
Provision for income taxes:			
Current	180		
Deferred	<u>(80)</u>	<u>(100)</u>	
Net income (or "income from continuing operations")*			<u>\$ 50</u>
* "Income from continuing operations" would be used if other categories are applicable, such as "discontinued operations," or "extraordinary items."			
1. Inventory Cost Purchase price, freight in 2. Selling Expense Freight out, salaries and commissions, advertising 3. General & Administrative Officer's salaries, accounting and legal, insurance 4. Non-operating Auxiliary activities, interest expense			

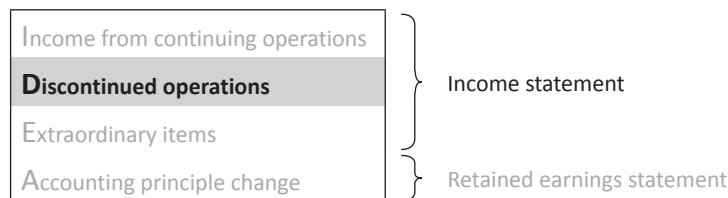
II. SINGLE STEP INCOME STATEMENT

Income Statement

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

EXAMPLE			
Radon Industries, Inc.			
Income Statement (single step)			
for the Year Ended December 31, Year 1 (<i>in thousands</i>)			
Revenues and other items:			
	$\Sigma \textcircled{1} = \650 ←		
Sale of goods	(Refer to multi-step income statement on the prior page)	①	\$ 350
Sale of services		①	200
Interest income			170
Rental income		①	100
Gain on sale of fixed assets (e.g., equipment)			50
Other income			<u>130</u>
Total revenues and other items			\$1,000
Expenses and other items:			
	$\$410$ ←		
Cost of goods sold (including freight in)	(Refer to multi-step income statement on the prior page)		\$ 200
Cost of services sold			150
Cost of rental income			60
Selling expenses (including freight out)			100
General and administrative expenses (including property tax, insurance, officers' salaries, and legal expense)			70
Interest expense			50
Depreciation expense			80
Loss on sale of fixed assets (e.g., equipment)			40
Loss on sale of available-for-sale securities			100
Income tax expense (provision for income tax)			<u>100</u>
Total expenses and other items			\$950
Net income (or income from continuing operations, if necessary)			<u>\$ 50</u>

DISCONTINUED OPERATIONS AND EXIT OR DISPOSAL ACTIVITIES



I. INTRODUCTION TO DISCONTINUED OPERATIONS

Discontinued Operations

Discontinued operations are reported separately from continuing operations in the income statement according to the IDEA mnemonic, net of tax. The (normally) loss from discontinued operations can consist of an impairment loss, a gain/loss from actual operations, and a gain/loss on disposal. All of these amounts are included in discontinued operations in the period in which they occur.

II. DEFINITIONS

A. Component of an Entity

A component of an entity is a part of an entity (the lowest level) for which operations and cash flows can be *clearly distinguished, both operationally and for financial reporting purposes*, from the rest of the entity.

1. U.S. GAAP

Under U.S. GAAP, a component of an entity may be:

- An operating segment,
- A reportable segment (as those terms are defined in segment reporting),
- A reporting unit (as that term is defined in goodwill impairment testing),
- A subsidiary, or
- An asset group (a collection of assets to be disposed of together as a group in a single transaction and the liabilities directly associated with those assets that will be transferred in that same transaction).

2. IFRS

Under IFRS, a component of an entity may be:

- A separate major line of business or geographical area of operations, or
- A subsidiary acquired exclusively with a view to resale.

B. Held for Sale

A component of a business (U.S. GAAP) or a disposal group (IFRS) is classified as "held for sale" in the period in which ALL of the following criteria are met:

- Management commits to a plan to sell the component.
- The component is available for immediate sale in its present condition.

3. An active program to locate a buyer has been initiated.
4. The sale of the component is probable and the sale is expected to be complete within one year.
5. The sale of the component is being actively marketed.
6. Actions required to complete the sale make it unlikely that significant changes to the plan will be made or that the plan will be withdrawn.



U.S. GAAP VS. IFRS

Under IFRS, before a component can be classified as held for sale, the individual assets and liabilities of the component must be measured in accordance with applicable standards and any resulting gains and losses must be recognized. After classification as held for sale, the component is reported at the lower of carrying value and fair value less costs to sell. U.S. GAAP does not require remeasurement of individual assets and liabilities before classification as held for sale, but the classification of a component as held for sale does trigger an impairment analysis of the component.

III. ACCOUNTING RULES

A. Types of Entities to be Considered

The results of operations of a component of an entity will be reported in discontinued operations if either the component:

1. Has been disposed of, or
2. Is classified as held for sale.

B. Conditions that Must be Present

All related costs shall be recognized when the obligations to others exist, not necessarily in the period of commitment to a plan. **Both** of the following conditions must be met in order to report in discontinued operations the results of operations of a component that has been disposed of or is held for sale:

1. Eliminated from Ongoing Operations

The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal.

2. No Significant Continuing Involvement

The entity will not have any significant continuing involvement in the operations of the component after the disposal.

C. Discontinued Operations Calculation

1. Types of Items Included in Results of Discontinued Operations

- a. Results of operations of the component.
- b. Gain or loss on disposal of the component.
- c. Impairment loss (and subsequent increases in fair value) of the component.

(1) Initial and Subsequent Impairment Losses

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

(2) Subsequent Increases in Fair Value

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

2. Report in the Period Disposed of or Held for Sale

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

3. Depreciation and Amortization

Assets within the component are no longer depreciated or amortized.

EXAMPLE

The Golf Division of All Sports Company is losing \$200,000 per month. The Board of Directors decides on April 30, Year 1 to dispose of the Golf Division. The carrying value of the Golf Division on April 30, Year 1 is \$4,000,000, and its fair value less costs to sell is \$2,200,000.

After months of negotiations, the division's net assets are sold on June 30, Year 2 for \$2,000,000. In the meantime, the Golf Division has continued losing \$200,000 per month. All Sports Company's income tax rate is 40%.

How should the disposal of the Golf Division be reported on All Sports Company's Year 1 and Year 2 financial statements?

REPORTING FOR YEAR 1:

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

An impairment loss would be recognized in Year 1 because fair value less costs to sell is lower than carrying value. The continuing loss from the Golf Division would also be included in discontinued operations in Year 1:

$$\text{Impairment loss} = \$2,200,000 - \$4,000,000 = \$1,800,000$$

$$\text{Loss from operations} = \$200,000 \times 12 = \$2,400,000$$

$$\text{Total loss from discontinued operations (after-tax)} = (\$1,800,000 + \$2,400,000) \times (1 - 40\%) = \$2,520,000$$

REPORTING FOR YEAR 2:

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

$$\text{Loss from operations} = \$200,000 \times 6 = \$1,200,000$$

$$\text{Loss on sale} = \$2,000,000 - \$2,200,000 = \$200,000$$

$$\text{Total loss from discontinued operations (after-tax)} = (\$1,200,000 + \$200,000) \times (1 - 40\%) = \$840,000$$

D. Anticipated Future Gains or Losses

A gain or loss not previously recognized that results from the sale of the component is recognized at the date of sale and not before. Gains or losses anticipated to occur in future periods are **not** recognized until they occur.

E. Subsequent Adjustments to Amounts Previously Reported

Adjustments to amounts previously reported in discontinued operations that are *directly related* to the disposal of a component of an entity in a prior period are classified in the current period in discontinued operations.

1. Examples

- a. Resolution of contingencies related to terms of the disposal transaction (e.g., purchase price adjustments and indemnification issues).
- b. Resolution of contingencies directly related to the operations of the component before it was disposed of (e.g., warranty obligations and environmental responsibilities).
- c. Settlement of employee benefit plan obligations.

2. Definition of "Directly Related"

In order for a settlement to be considered directly related to a component of an entity, it must:

- a. Have a demonstrated cause-and-effect relationship, and
- b. Occur no later than one year after the date of the disposal transaction (unless circumstances beyond the control of the entity exist).

F. Measurement and Valuation

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

G. Presentation and Disclosure**1. Present as a Separate Component of Income**

The results of discontinued operations, net of tax, are reported as a separate component of income before extraordinary items.

2. Disclose in Face or in Notes

A gain or loss recognized on the disposal shall be disclosed either on the face of the income statement or in the notes to the financial statements.

IV. EXIT OR DISPOSAL ACTIVITIES

As part of its convergence with IFRS, U.S. GAAP requires the recognition of a liability for the costs associated with an exit or disposal activity.

A. Exit and Disposal Costs

Costs associated with exit and disposal activities include:

1. Involuntary employee termination benefits.
2. Costs to terminate a contract that is not a capital lease.
3. Other costs associated with exit or disposal activities, including costs to consolidate facilities or relocate employees.

B. Criteria for Liability Recognition

An entity's commitment to an exit or disposal plan, by itself, is not enough to result in liability recognition. A liability associated with an exit or disposal activity should be recognized only when all of the following criteria are met:

1. An obligating event has occurred,
2. The event results in a present obligation to transfer assets or to provide services in the future, and
3. The entity has little or no discretion to avoid the future transfer of assets or providing of services.

Future operating losses expected to be incurred as part of an exit or disposal activity are recognized in the period(s) incurred.

C. Liability Measurement

The liability should be measured at fair value. Fair value should be determined using the U.S. GAAP fair value measurement techniques discussed later in this lecture. The liability may be adjusted in future periods as a result of revisions to the timing of or estimated cash flows from the exit or disposal activity. Revisions are accounted for prospectively (change in estimate).

D. Income Statement Presentation

Costs associated with an exit or disposal activity related to a discontinued operation will be reported in discontinued operations. Costs associated with an exit or disposal activity not related to a discontinued operation will be reported in income from continuing operations.

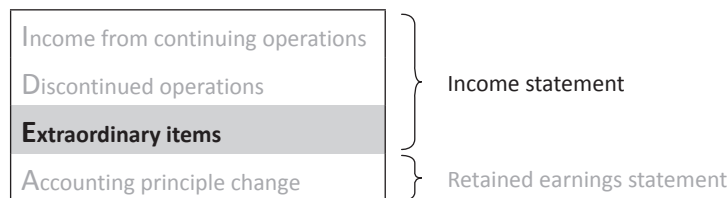
E. Disclosure

All of the following must be disclosed in the notes to the financial statements in the period the exit or disposal activity is initiated and all subsequent periods until the activity is completed:

1. A description of the exit or disposal activity, including the facts and circumstances leading to the expected activity and the expected completion date.
2. For each major cost associated with an activity:
 - a. The total amount expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date.

- b. A reconciliation of the beginning and ending liability balances showing the changes during the period for costs incurred, costs paid or otherwise settled, and any other adjustments with an explanation of the reasons.
- 3. The line item(s) in the income statement in which the costs are aggregated.
- 4. For each reportable segment, the total amount of costs expected to be incurred, the amount incurred in the period and incurred to date, net of any adjustments with an explanation of the reasons.
- 5. If a liability for a cost associated with the activity is not recognized because fair value cannot be reasonably estimated, that fact and the reasons for that should be disclosed.

EXTRAORDINARY ITEMS



Extraordinary
Items

I. 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

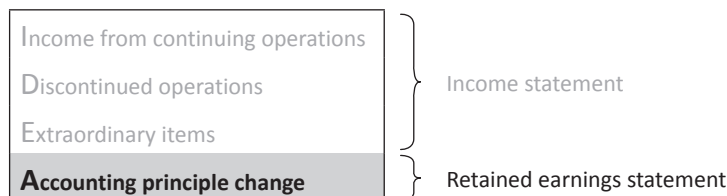
Items of income or loss that are either unusual or infrequent are not extraordinary (e.g., gain on the sale of a factory building). If material, these items should be reported as a separate line item as part of income from continuing operations (and not net of tax). The nature of the item and the financial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



U.S. GAAP VS. IFRS

Under IFRS, an entity cannot present any item of income or expense as extraordinary on the statement of comprehensive income or the separate income statement (if presented), 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.

II. CHANGES IN ACCOUNTING ESTIMATE (*prospective*)

Accounting Estimates

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 nonrecurring 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 VS. 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 VS. IFRS

Under IFRS, when it is impracticable to determine either the period-specific effect or 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.

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

- 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 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.



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.

IFRS



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.

D. Reclassification Adjustments

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

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

U.S. GAAP VS. IFRS

Both U.S. GAAP and IFRS allow the statement of comprehensive income to be presented using the single-statement approach (statement of comprehensive income) or the two-statement approach (statement of income immediately followed by a separate statement of comprehensive income).



A. Single-Statement Approach

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

EXAMPLE

EXAMPLE		
Sydney Technologies, Inc.		
Statement of 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	<u>1,200,000</u>
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>
	Other comprehensive income	<u>200,000</u>
	Comprehensive income	<u><u>\$1,400,000</u></u>

B. Two-Statement Approach

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

EXAMPLE	
Sydney Technologies, Inc. Statement of Comprehensive Income For the Year Ended December 31, Year 1	
Net income	<u>\$1,200,000</u>
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>
Other comprehensive income	<u>200,000</u>
Comprehensive income	<u><u>\$1,400,000</u></u>

III. OTHER REPORTING ISSUES**A. Other Comprehensive Income**

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

B. Income Tax Expense or Benefit

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

C. Interim Period Reporting

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

D. Required Disclosures

All formats must disclose:

1. The tax effects of each component included in (current) other comprehensive income, either as part of the statement presentation or in the notes to the financial statements.
2. The changes in the accumulated balances of each component of other comprehensive income (e.g., pension adjustments, unrealized holding gains/losses on available-for-sale securities, foreign currency items, the effective portion of cash flow hedges, and IFRS revaluation surplus).
 - (a) The changes in the accumulated balances by component may be shown on the face of the financial statements or in the notes to the financial statements.

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

EXAMPLE—CHANGES IN AOCI BY COMPONENT

Brown and Associates Notes to Financial Statements Changes in Accumulated Other Comprehensive Income by Component For the Year Ended December 31, Year 1			
<i>Components</i>	<i>Gains/Losses on Cash Flow Hedges</i>	<i>Foreign Currency Items</i>	<i>Total</i>
Beginning balance	\$2,000	\$4,000	\$6,000
Other comprehensive income before reclassifications	3,000	1,500	4,500
Amounts reclassified from AOCI	<u>(500)</u>	<u>-0-</u>	<u>(500)</u>
Net current-period other comprehensive income	<u>2,500</u>	<u>1,500</u>	<u>4,000</u>
Ending balance	<u>\$4,500</u>	<u>\$5,500</u>	<u>\$10,000</u>

Notes: All amounts are net of tax. Therefore, an additional footnote would disclose the tax effects.
Other columns would be added if Brown had other components of OCI in its financial statements

EXAMPLE—SIGNIFICANT ITEMS RECLASSIFIED OUT OF AOCI

Brown and Associates Notes to Financial Statements Reclassifications out of Accumulated Other Comprehensive Income For the Year Ended December 31, Year 1		
<i>Details About Accumulated Other Comprehensive Income Components</i>	<i>Amount Reclassified From Accumulated Other Comprehensive Income</i>	<i>Affected Line Item in the Statement Where Net Income Is Presented</i>
Gains and losses on cash flow hedges:		
Interest rate contracts	\$3,000	Interest income/(expense)
Commodity contracts	<u>(3,750)</u>	Cost of sales
	(750)	Total before tax
	<u>250</u>	Tax (expense) or benefit
Total reclassifications	<u>\$ (500)</u>	Net of tax

Alternatively, this information could be presented on the income statement. The amounts would be shown parenthetically on each affected line item.

BALANCE SHEET AND DISCLOSURES OVERVIEW



Disclosures

I. BALANCE SHEET OVERVIEW

Under both U.S. GAAP and IFRS, entities may present a classified balance sheet that distinguishes current and noncurrent assets and liabilities. When appropriate, a balance sheet presentation based on liquidity is also permissible. The following is an example of a classified balance sheet.

EXAMPLE	
Company Name BALANCE SHEET As of December 31, Year 1	
<u>Assets</u> <u>Current assets</u> Cash and cash equivalents Trading securities, at fair value Accounts receivable, net of allowance for uncollectible accounts Notes receivable Merchandise inventory, at lower of cost or market Prepaid expenses <u>Investments</u> Available-for-sale securities, at fair value Held to maturity securities Land held for future plant site <u>Property, plant, and equipment</u> Land Building Equipment Less: Accumulated depreciation <u>Intangible assets</u> Goodwill Patents, net of amortization <u>Other assets</u> Bond issue costs Pension and other postretirement benefit assets Total assets	<u>Liabilities and Stockholders' Equity</u> <u>Current liabilities</u> Long-term debt due within one year Accounts payable Notes payable Interest payable Salaries payable Income tax payable Advances from customers (unearned revenue) Unearned rent revenue <u>Long-term liabilities</u> Bonds payable (10%, due December 31, Year 5) Plus: Unamortized premium on bonds or [Less: Unamortized discount on bonds] Deferred income tax liability Pension and other postretirement benefit liabilities Total liabilities <u>Stockholders' equity</u> Capital stock Preferred stock, \$10 par, 8% cumulative and nonparticipating, 10,000 shares authorized, 5,000 shares issued and outstanding Common stock, \$0.01 par, 600,000,000 shares authorized, 57,598,000 shares issued and 57,178,485 shares outstanding Paid-in capital in excess of par Total paid-in capital Retained earnings Accumulated other comprehensive income (Treasury stock at cost) (419,515 shares) Total stockholders' equity Total liabilities and stockholders' equity



II. NOTES TO FINANCIAL STATEMENTS

A. Summary of Significant Accounting Policies

Both U.S. GAAP and IFRS require that a description of all significant policies be included as an integral part of the financial statements. The preferred presentation is to include the "Summary of Significant Accounting Policies" as the first or second note to the financial statements. Policies presented in other notes should not be duplicated.

U.S. GAAP VS. IFRS

IFRS requires an explicit and unreserved statement of compliance with IFRS in the notes to the financial statements. An entity cannot describe financial statements as complying with IFRSs unless they comply with all IFRS requirements.

U.S. GAAP does not have a similar requirement.



1. Identify and describe:
 - a. Measurement bases used in preparing the financial statements
 - b. Accounting principles and methods
 - c. Criteria
 - d. Policies
 - e. Pricing

U.S. GAAP VS. IFRS

IFRS requires disclosure of judgments and estimates that management has made in the process of applying accounting policies and that have a significant effect on the financial statements. Examples of judgments include determining whether financial assets are held-to-maturity securities or determining whether the relationship between an entity and an SPE indicates that the entity controls the SPE. This disclosure is generally made in the "Summary of Significant Accounting Policies."

U.S. GAAP requires disclosure of significant estimates, but does not require the disclosure of judgments made in preparing the financial statements.



2. Accounting policies commonly described in this footnote:
 - a. Basis of consolidation
 - b. Depreciation methods
 - c. Amortization of intangibles
 - d. Inventory pricing
 - e. Accounting for recognition of profit on long-term construction contracts
 - f. Recognition of revenue from franchising or leasing operations
3. Items not included in this footnote:
 - a. Composition of accounts and amounts in dollars of account balances
 - b. Details relating to changes in accounting principles
 - c. Dates of maturity and amounts of long-term debt
 - d. Yearly computation of depreciation, depletion and amortization

B. Remaining Notes to the Financial Statements

The remaining notes contain all other information relevant to decision makers (e.g., investors, creditors, etc.) These notes are used to disclose facts not presented in either the body of the financial statements or in the "Summary of Significant Accounting Policies." Examples of relevant note information include the following:

1. Changes in stockholders' equity including capital stock, paid-in capital, retained earnings, treasury stock, stock dividends and other capital changes;
2. Required marketable securities disclosure including carrying value and gross unrealized gains and losses;
3. Contingency losses;
4. Contractual obligations, including restrictions on specific assets or liabilities;
5. Pension plan description; and
6. Post-balance sheet disclosures of certain events that occurred before the financial statements were issued.

C. Related Party Disclosures

Both U.S. GAAP and IFRS require the disclosure of related party transactions.

1. Related Parties Defined

Related parties include:

- a. Affiliates of an entity.
- b. Entities accounted for using the equity method (investments in affiliates and joint ventures).
- c. Parent or subsidiary entities or subsidiaries of a common parent.
- d. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management.
- e. Management of an entity and their immediate family members.
- f. Owners of more than 10% of the voting interest of an entity (principal owners) and their immediate family members.

**U.S. GAAP VS. IFRS**

Principal owners are not mentioned as related parties in IFRS.

2. Examples of Related Party Transactions

- a. Sales, purchases and transfers of real or personal property.
- b. Services received or furnished, such as accounting, management, engineering, and legal services.
- c. Use of property and equipment by lease or otherwise.

- d. Borrowings, lendings, and guarantees.
- e. Maintenance of compensating bank balances for the benefit of a related party.
- f. Intra-entity billings based on allocations of common costs.
- g. Filings of consolidated tax returns.

3. **Related Party Disclosures** (*U.S. GAAP*)

a. **Material Related Party Transactions**

U.S. GAAP requires the disclosure of material related party transactions, excluding compensation arrangements, expense allowances, and other similar items in the ordinary course of business. The disclosures should include:

- (1) The nature of the relationship.
- (2) A description of the transactions for each period presented.
- (3) The dollar amounts of the transactions for each period presented.
- (4) Amounts due to or from the related parties at each balance sheet date.
- (5) The name of the related party, if necessary to the understanding of the relationship.

Because transactions with related parties cannot be presumed to be arms-length transactions, related party disclosures should not imply that the related party transactions were completed at arm's-length, unless such representations can be substantiated.

b. **Related Party Notes/Accounts Receivable**

Notes or accounts receivable from officers, employees, or affiliated entities must be shown separately from general notes and accounts receivable.

c. **Control Relationships**

Control relationships between the reporting entity and one or more other entities should be disclosed even if there were no transactions between the entities.

4. **Related Party Disclosures** (*IFRS*)

IFRS

a. **Material Related Party Transactions**

IFRS requires the disclosure of material related party transactions, including compensation arrangements, separately for each category of related party (parent, entities with joint control or significant influence over the entity, subsidiaries, associates, joint ventures in which the entity is a venturer, key management personnel of the entity or its parent, and other related parties). The disclosures should include:

- (1) The nature of the relationship.
- (2) A description of the transactions for each period presented.
- (3) The dollar amounts of the transactions for each period presented.
- (4) Amounts due to or from the related parties at each balance sheet date.
- (5) The allowance for bad debts related to amounts due from related parties.
- (6) Bad debt expense and/or write-offs of debts due from related parties.


U.S. GAAP VS. IFRS

U.S. GAAP does not require disclosure of allowance for bad debts, bad debt expense, or write-offs related to amounts due from related parties.

Because transactions with related parties cannot be presumed to be arms-length transactions, related party disclosures should not imply that the related party transactions were completed at arm's-length, unless such representations can be substantiated.

b. Disclosure of Compensation Arrangements

Entities are required to disclose key management personnel compensation in total and for each of the following categories:

- (1) Short-term employee benefits
- (2) Post-employment benefits
- (3) Other long-term benefits
- (4) Termination benefits
- (5) Share-based payments


U.S. GAAP VS. IFRS

U.S. GAAP does not require disclosure of key management compensation arrangements. However, SEC regulations do require disclosure of key management compensation arrangements outside the financial statements.

c. Related Party Notes/Accounts Receivable

Notes or accounts receivable from related parties must be shown separately from general notes and accounts receivable.

d. Control Relationships

Control relationships between the reporting entity and one or more other entities should be disclosed even if there were no transactions between the entities. An entity should disclose the name of its parent and, if different, the ultimate controlling party.

D. Disclosure of Risks and Uncertainties (U.S. GAAP)

U.S. GAAP requires the disclosure of risks and uncertainties existing at the date(s) of the financial statements in the following areas:

1. Nature of Operations

The footnotes should include a description of the entity's major products or services and its principal markets, including the locations of those markets. If the entity operates multiple businesses, the disclosure should describe the relative importance of each business.

2. Use of Estimates in the Preparation of Financial Statements

The footnotes should include the following statement (or a similar statement):

"The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates."

3. Certain Significant Estimates

When it is reasonably possible that an estimate will change in the near term and that the effect of the change will be material, an estimate of the effect of the change should be disclosed.

The following are examples of assets and liabilities and related revenues and expenses, including gain and loss contingencies that may be based on estimates that are particularly sensitive to change:

- a. Inventory or equipment subject to rapid technological obsolescence.
- b. Deferred tax asset valuation allowances.
- c. Capitalized computer software costs.
- d. Loan valuation allowances.
- e. Litigation-related obligations.
- f. Amounts reported for long-term obligations, such as pension and postretirement benefits.
- g. Amounts reported in long-term contracts.

4. Current Vulnerability due to Certain Concentrations

a. Definition

Vulnerability due to concentrations arise when an entity is exposed to risk of loss that could be mitigated through diversification.

b. Examples of Concentrations

The following are common examples of concentrations:

- (1) Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor.
- (2) Concentrations in revenue from particular products, services, or fund-raising events.
- (3) Concentrations in the available supply of resources, such as materials, labor, or services.
- (4) Concentrations in market or geographic area.

c. Disclosure Requirements

Concentrations should be disclosed if all of the following criteria are met:

- (1) The concentration exists at the financial statement date.
- (2) The concentration makes the entity vulnerable to the risk of a near-term severe impact (a significant financially disruptive effect on the normal functioning of an entity).
- (3) It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

U.S. GAAP VS. IFRS

IFRS "risk and uncertainty" disclosure requirements are narrower and focus on sources of estimation uncertainty. IFRS state that an entity should disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amount of assets and liabilities within the next financial year. The notes should include details of the nature and carrying amount at the end of the reporting period of these assets and liabilities.



INTERIM FINANCIAL REPORTING



I. GENERAL

Interim financial reporting is not required under U.S. GAAP or IFRS, however both provide guidance to be used when interim information is presented. In the United States, interim reporting is generally concerned with the quarterly reports that public companies must file with the SEC. Generally accepted accounting principles that were used in the most recent annual report of an enterprise should be applied to interim financial statements of the current year, unless a change in accounting principle is adopted in the current year.



U.S. GAAP VS. IFRS

IFRS requires that interim financial statements be prepared using the same principles and practices used in preparation of the most recent annual financial statements.

U.S. GAAP allows certain principles and practices to be modified when preparing the interim financial statements. For example, under U.S. GAAP certain costs may be allocated to interim periods based on estimates of time expired, benefit received, or other activity associated with the interim period. Under IFRS, the cost would be recognized in the period incurred.



II. MATCHING OF REVENUES AND EXPENSES

The general rule in preparing interim financial statements is that costs and expenses that clearly benefit more than one period should be properly allocated to the periods affected. Revenues should be recognized in the period in which they were earned and realized or realizable. Also, a total for comprehensive income in condensed financial statements of interim periods issued to shareholders shall be reported.

III. TIMELINESS OVER RELIABILITY

For interim reporting only, timeliness is emphasized over reliability.

IV. AN INTEGRAL PART OF ANNUAL FINANCIAL STATEMENTS

Interim financial statements must be viewed as an integral part of the annual financial statements. Because interim financial statements generally are not audited, each statement presented should be marked "unaudited."

U.S. GAAP VS. IFRS

Under IFRS, interim financial statements are required to include, at a minimum:

- 1) Condensed balance sheets (statements of financial position) as of the end of the current interim period and as of the end of the immediately preceding financial year
- 2) Condensed statements of comprehensive income (single-statement or two-statement presentation) for the current interim period and the cumulative year-to-date with comparative statements for the comparable periods (interim and year-to-date) of the immediately preceding financial year
- 3) Condensed statements of changes in equity cumulatively for the current financial year and for the comparable year-to-date period of the immediately preceding financial year
- 4) Condensed statements of cash flows for the current financial year-to-date and the comparable year-to-date period of the immediately preceding financial year

U.S. GAAP does not establish presentation minimums for interim reporting, although guidance is provided by the SEC (as discussed later in this lecture).



V. INCOME TAXES

Income tax expense is estimated each quarter. The general rule is to multiply the year-to-date income by the estimated effective tax rate and subtract the result from the provision included in the previous quarter. The estimate of the effective tax rate expected to be applicable for the full fiscal year should reflect all tax planning alternatives including foreign tax rates, percentage depletion, capital gains rate, and anticipated investment tax credits.



U.S. GAAP VS. IFRS

IFRS allows the effective tax rate to be estimated using enacted or substantially enacted changes in tax rates.

U.S. GAAP allows the use of enacted tax rates only.

VI. INTERIM INVENTORY VALUATION

A. Inventory Estimation Methods

Companies using the gross profit method or a retail inventory method to determine interim inventory valuation, or other methods different from those used for annual inventory valuation, should disclose the method used at the interim date and any material difference when reconciled with the annual physical inventory.

B. Liquidation of a LIFO Base Layer (*U.S. GAAP only*)

A liquidation of a baseperiod LIFO inventory layer at an interim date that apparently will be corrected by the end of the annual period should be valued at the expected cost of replacement. Cost of sales for the interim period should include the expected cost of replacement and not the cost of the baseperiod LIFO inventory.

C. Permanent and Temporary Declines in Market Value

1. Permanent inventory losses from market declines should be reflected in the interim period in which they occur. Market increases in subsequent interim periods should be recognized in the recovery interim period not to exceed the losses included in prior interim periods.
2. Temporary market declines that are expected to reverse before the end of the annual period should not be recognized in interim period statements.

VII. OTHER INTERIM REPORTING ISSUES

A. Seasonal Revenue Variations

Companies that have material seasonal variations in their businesses should ensure that interim period financial statements do not become misleading. Disclosure of material seasonal variations should be made in interim period financial statements. In addition, if large seasonal changes usually occur, it is desirable to disclose results for the full year, which ends at the interim date.

B. Unusual and Infrequent Transactions

Unusual and infrequent transactions that are material and not designated as extraordinary items under U.S. GAAP, such as the effects of a disposal of a segment of business, should be reported separately.

C. Minimum Disclosure Requirements (U.S. GAAP)

U.S. GAAP outlines the following minimum disclosure requirements for interim reporting:

1. Gross sales or revenues, provision for income taxes, extraordinary items, and net income.
2. Basic and diluted earnings per share.
3. Material seasonal variations of revenues, costs, or expenses.
4. Significant changes in estimates or provisions for income taxes.
5. Disposal of a component of a business and extraordinary (U.S. GAAP), unusual, or infrequently occurring items.
6. Contingent items.
7. Changes in accounting principles or estimates.
8. Significant changes in financial position.
9. Reportable operating segment disclosures.
10. Defined benefit pension and postretirement benefit plan disclosures.
11. Fair value measurement disclosures for assets and liabilities, including financial instruments.
12. Derivative disclosures.
13. Disclosures for certain debt and equity securities.
14. Disclosures about other-than-temporary impairments.

D. Minimum Disclosure Requirements (IFRS)

IFRS

IFRS outlines the following minimum disclosure requirements for interim reporting:

1. A statement that the accounting policies and methods of calculation used in the most recent annual financial statements are followed in the interim financial statements, or if those policies and methods have changed, a description of the change.
2. Explanations of seasonal or cyclical interim operations.
3. Nature and amount of unusual items affecting assets, liabilities, equity, net income, or cash flows, including:
 - a. Inventory write-downs and reversals of write-downs.
 - b. Impairment losses and reversals of impairment losses.
 - c. Reversal of any provisions for restructuring costs.
 - d. Acquisitions and disposals of fixed assets.
 - e. Fixed asset purchase commitments.

- f. Litigation settlements.
 - g. Unremedied loan defaults or breaches of loan agreements.
 - h. Related party transactions.
- 4. Changes in accounting estimates and error corrections.
 - 5. Issuances, repurchases and repayments of debt and equity securities.
 - 6. Dividends paid in total or per share.
 - 7. Segment disclosures.
 - 8. Material subsequent events not reflected in the interim financial statements.
 - 9. The effect of changes in the composition of the entity during the interim period.
 - 10. Changes in contingent assets or liabilities.

**U.S. GAAP VS. IFRS**

IFRS requires that the nature and amount of a change in estimate made in the fourth quarter be disclosed in a note to the annual financial statements if a separate financial report is not published for the fourth quarter. U.S. GAAP requires disclosure in a note to the annual financial statements of fourth quarter activity related to changes in accounting principle, discontinued operations, and extraordinary, unusual, or infrequent items if a separate financial report is not published for the fourth quarter.

SEGMENT REPORTING

I. GENERAL

The objective of segment reporting is to provide information on the business activities and the economic environment of a company to help users of the financial statements:

- (i) Better understand the enterprise's performance,
- (ii) Better assess its prospects for future net cash flows, and
- (iii) Make more informed judgments about the enterprise as a whole.

In general, an enterprise is required to disclose segment profit or loss, segment assets, and certain related items, but is not required to report segment cash flow.



Segment
Reporting

U.S. GAAP VS. IFRS

IFRS requires the disclosure of segment liabilities if such a measure is regularly provided to the chief operating decision maker. U.S. GAAP does not require the disclosure of segment liabilities.



A. Required Disclosures for all Public Enterprises

In order to conform with U.S. GAAP and IFRS, financial statements for public business enterprises must report information about a company's:

1. Operating segments (*annual and interim*).
2. Products and services.
3. Geographic areas.
4. Major customers.

B. Use Same Accounting Principles as Main Financial Statements

The required financial statement information is essentially a disaggregation of the entity's regular financial statements. The accounting principles used in preparing the financial statements should be used for the segment information. Segment information presented must be reconciled to the related aggregate amounts in the financial statements.

C. Intercompany Transactions Not Eliminated for Reporting

It is important to remember that transactions between the segments of an enterprise are not eliminated in a consolidation between the parent company and subsidiaries.

D. Scope (*public companies only*)

Segment reporting applies to public companies only. It does not apply to not-for-profit organizations, nonpublic companies, or separate financial statements of members of a consolidated group if both the separate company statements and the consolidated or combined financial statements are included in the same financial report.

II. OPERATING SEGMENTS

A. Definition

An operating segment is a component of an enterprise:

- (i) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise),
- (ii) Whose operating results are regularly reviewed by the enterprise's "Chief Operating Decision Maker" to make decisions about resources to be allocated to the segment and assess its performance, and
- (iii) For which discrete financial information is available.

The definition of a segment depends on how management uses information, which is called the management approach method. For example, management may report results both by product and service lines and by geographical lines.

B. Not Every Enterprise is an Operating Segment

Not every part of an enterprise is necessarily an operating segment or part of an operating segment.

1. Corporate Headquarters Not an Operating Segment

A corporate headquarters or certain functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the enterprise and would, therefore, not be operating segments.

2. Pension Plan Not an Operating Segment

An enterprise's pension and other post-retirement benefit plans are not considered to be operating segments.

C. Reportable Segment

Reportable segments are operating segments of an enterprise that meet the criteria for separate reporting.

Those operating segments that exhibit similar long-term financial performance may be aggregated into a single operating segment if (i) aggregation is consistent with the objective and principles of segment reporting, (ii) the segments have similar economic characteristics, and (iii) the segments are similar in:

- 1. The nature of the products and services,
- 2. The nature of the production processes,
- 3. The type or class of customer for their products and services,
- 4. The methods used to distribute their products or provide their services, and
- 5. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

D. Quantitative Thresholds for Reportable Segments**1. 10% "Size" Test** *(must only meet one)***a. Revenue**

A segment meets the size test if its reported revenue, including both sales to external customers and intersegment sales or transfers (but excluding interest income on advances and loans to other segments), is 10% or more of the combined revenue, internal and external, of all operating segments.

b. Reported Profit or Loss

A segment meets the size test if the absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of

- (1) The combined reported profit of all operating segments that did not report a loss.
- (2) The combined reported loss of all operating segments that did report a loss.

c. Assets

A segment meets the size test if its assets are 10% or more of the combined assets of all operating segments. The assets of a segment are those assets included in the measure of the segment's assets that are reviewed by the chief operating decision maker.

2. 75% "Reporting Sufficiency" Test

If the total of external (consolidated) revenue reported by operating segments constitutes less than 75% of external (consolidated) revenue, additional operating segments need to be identified as reportable segments, even if they do not meet the above three tests, until at least 75% of external (consolidated) revenue is included in reportable segments. The practical limit to the number of segments is 10, which is not a precise limit.

E. "All Other Segments" Category

Information about other business activities and operating segments that are not reportable based on the above criteria should be combined and disclosed in an "all other segments" category.

F. Comparative Reporting

An operating segment that was deemed to be reportable in the immediately preceding period but that does not meet the criteria for reportability in the current period may continue to be reported separately if management judges the segment to have continuing significance.

If an operating segment that was not deemed to be reportable in the prior period meets the criteria for reportability in the current period, segment data for prior periods presented should be restated to reflect the newly reportable segment as a separate segment.

G. Segment Profit (or Loss) Defined**1. Formula**

Revenues
Less: Directly traceable costs
<u>Less: Reasonably allocated costs</u>
<u>Operating Profit (or loss)</u>

2. Items Normally Excluded from Segment Profit (or Loss)

- a. General corporate revenues
- b. General corporate expenses
- c. Interest expense (except for financial institutions)
- d. Income taxes
- e. Equity in earnings and losses of an unconsolidated subsidiary (i.e., under the equity method)
- f. Gains or losses from discontinued operations
- g. Extraordinary items
- h. Minority interest

3. Income and Expense Allocation

Income and expenses are not allocated to a segment unless they are included in the determination of segment profit or loss reported to the "Chief Operating Decision Maker."

III. REPORTABLE SEGMENT DISCLOSURES**A. Identifying Factors**

Factors used to identify the enterprise's reportable segments, including the basis of organization (e.g., products and services, geographic areas, regulatory environments) should be disclosed. Also disclose whether any operation segments have been aggregated.

B. Products and Services

The types of products and services from which the reportable segment derives its revenues must be disclosed.

C. Profit or Loss

The following items must be individually disclosed if the amounts are included in the calculation of segment profit or loss reviewed by the chief operating decision maker:

1. Revenues from external customers.
2. Revenues from transactions with other internal operating segments.

3. Interest revenue.
4. Interest expense.
5. Depreciation, depletion, and amortization.
6. Unusual items, including unusual events and transactions.
7. Equity in net income of investees accounted for by the equity method.
8. Income tax expense or benefit.
9. Extraordinary items (U.S. GAAP only).
10. Significant noncash items other than depreciation, depletion, and amortization expense.

D. Assets

1. The amount of investment in equity method investees.
2. Total expenditures for:
 - a. Additions to long-lived assets other than financial instruments.
 - b. Long-term customer relationships of a financial institution.
 - c. Mortgage and other servicing rights.
 - d. Deferred policy acquisition costs.
 - e. Deferred tax assets.

E. Liabilities (*IFRS only*)

IFRS

Under IFRS, an entity discloses a measure of liabilities for each reportable segment if such an amount is regularly provided to the chief operating decision maker.

F. Measurement Criteria

1. Basis of accounting for any internal transactions.
2. Nature of any differences between measurements of the reportable segments' profits or losses and the enterprise's consolidated income.
3. Nature of any differences between measurements of the reportable segments' assets and the enterprise's consolidated assets, if not apparent from the reconciliation provided.
4. Nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss.
5. The nature and effect of any asymmetrical allocations to segments.

G. Reconciliations

1. The total of the reportable segments' revenues to the enterprise's consolidated revenues.
2. The total of the reportable segments' measures of profit or loss to the enterprise's consolidated income before income taxes, extraordinary items, discontinued operations, and the cumulative effects of changes in accounting principles.
3. The total of the reportable segments' assets to the enterprise's consolidated assets.

4. The total of the reportable segments' liabilities to the enterprise's consolidated liabilities (IFRS only).
5. The total of the reportable segments' amounts for every other significant item of information disclosed to the corresponding consolidated amount.

IV. ENTERPRISE-WIDE DISCLOSURES

The following disclosures apply to enterprises regardless of the number of reportable segments. They are required disclosures for all public enterprises.

A. Products and Services

Revenues from external customers for each product or service or each group of similar products and services must be disclosed unless it is impracticable to do so, and that fact must be disclosed.

B. Geographic Areas

1. Revenues

Disclose the revenues from external customers that are:

- a. Attributable to the enterprise's domicile country.
- b. Attributed to all foreign countries if the amount is material.
- c. Attributed to individual foreign countries if the amount is material.
- d. The basis for attributing revenues from external customers to individual countries.

2. Long-lived Assets

Disclose the long-lived assets that are:

- a. Located in the enterprise's domicile country.
- b. Located in all foreign countries in total in which the enterprise holds assets.
- c. Located in individual foreign countries if the amount is material.

C. Major Customers

An enterprise that generates 10% or more of its revenue from sales to a single customer must disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The identity of the major customer need not be disclosed.

DEVELOPMENT-STAGE ENTERPRISES (U.S. GAAP)**I. OVERVIEW**

Under U.S. GAAP, a development-stage enterprise is one in which either:

- (i) Principal operations have not yet commenced, or
- (ii) Principal operations have generated an insignificant amount of revenue (or a loss).

During the development stage, a company devotes most of its activities and resources toward establishing the business.

Development-Stage
Enterprises

II. DISCLOSURE

A development-stage enterprise must issue the same financial statements as any other enterprise. These statements should be prepared in conformity with U.S. GAAP. The additional required disclosures are as follows:

- A. Identify the financial statements as those of a development stage enterprise.
- B. In the balance sheet, describe cumulative net losses as "deficit accumulated during the development stage."
- C. In the income statement, show revenues and expenses for each period being presented, and present a *cumulative* amount (generally of losses) from the company's inception.
- D. In the statement of cash flows, include:
 - 1. Cumulative amounts of cash inflows and cash outflows from the company's inception, and
 - 2. Current amounts of cash inflows and cash outflows for each period presented.
- E. In the statement of stockholders' equity, include the following:
 - 1. Number of shares of stock (or other securities) issued,
 - 2. Dates of issuance, and
 - 3. Dollar amounts assigned.
 - 4. If noncash consideration is involved in the issuance, then include:
 - a. A description of the nature of the consideration, and
 - b. The basis for its valuation.

FIRST-TIME ADOPTION OF IFRS

I. FIRST-TIME ADOPTION OF IFRS

IFRS

An entity's first IFRS financial statements are the first annual financial statements in which the entity adopts IFRS and makes an explicit and unreserved statement in those financial statements of compliance with IFRS.

Financial statements prepared in accordance with IFRS are an entity's first IFRS financial statements if the entity:

- ✓ Presented its most recent previous financial statements in accordance with national requirements not consistent with IFRS in all material respects, or in conformity with IFRS without an explicit and unreserved statement of compliance with IFRS, or containing an explicit statement of conformity with some (but not all) IFRS.
- ✓ Prepared financial statements in accordance with IFRS for internal use only, without making them available to owners or other external parties.
- ✓ Prepared a reporting package in accordance with IFRS for consolidation purposes without preparing a complete set of financial statements as required by IFRS.
- ✓ Did not present financial statements for a previous period.

A. Opening IFRS Financial Statements

An entity's first IFRS financial statements must include at least three balance sheets (end of current period, end of prior period, and beginning of prior period), two statements of comprehensive income, two income statements (if using the two-statement approach to presenting comprehensive income), two statements of cash flows, two statements of changes in equity, and related notes.



PASS KEY

The date of transition to IFRS is the date of the opening balance sheet. If three balance sheets are presented, this is the date of the beginning of the prior period.

EXAMPLE

The end of an entity's first IFRS reporting period is December 31, Year 2. The date of the transition to IFRS is January 1, Year 1 (or, equivalently, the close of business on December 31, Year 0). IFRS must be applied when preparing and presenting the opening IFRS balance sheet at January 1, Year 1, when preparing and presenting the balance sheets for December 31, Year 1 and December 31, Year 2, and when preparing and presenting the statements of comprehensive income (and income statements), statement of cash flows, statements of changes in equity, and related notes for Year 1 and Year 2.

1. Asset and Liability Recognition

In its opening IFRS balance sheet, an entity should recognize all assets and liabilities required by IFRS and should apply IFRS in measuring and classifying all recognized assets and liabilities. Adjustments needed to restate assets and liabilities in conformity with IFRS should be made directly to retained earnings at the date of transition to IFRS.

a. Financial Assets and Financial Liabilities

On the opening balance sheet date, an entity may designate a previously recognized financial asset or financial liability at fair value through profit or loss.

b. Long-Term Assets

On the opening balance sheet date, an entity may use fair value as the deemed cost of fixed assets, investment property, or intangible assets. If fair value is used as the deemed cost of long-term assets, the entity must disclose:

- (1) The total of those fair values, and
- (2) The total adjustment to the carrying amounts reported under previous GAAP.

c. Investments in Subsidiaries, Joint Ventures, and Associates

On the opening balance sheet date, the entity must disclose the following for investments in subsidiaries, joint ventures, and associates:

- (1) The total of investments for which deemed cost is equal to the carrying amount under previous GAAP,
- (2) The total of investments for which deemed cost is fair value on the opening balance sheet date, and
- (3) The total adjustment to the carrying amounts reported under previous GAAP.

2. Accounting Policies

An entity must use the same accounting policies in its opening IFRS balance sheet and in all periods presented in the first IFRS financial statements. IFRS allows limited exemptions in areas where the cost of the initial application of IFRS accounting policies would be likely to exceed the benefits to financial statement users. IFRS also prohibits the retrospective application of certain IFRS that would require judgments by management about past conditions after the outcome of a particular transaction is already known.

PASS KEY

The following is a list of the mandatory exceptions to the retrospective application of IFRS at the time of the initial adoption of IFRS.

- a) Derecognition of financial assets and financial liabilities
- b) Hedge accounting
- c) Non-controlling interests
- d) Classification and measurement of financial assets
- e) Embedded derivatives



3. Accounting Estimates

The accounting estimates used by an entity on the date of transition to IFRS should be consistent with the estimates for the same date made under the previous GAAP, after adjustment for any differences in accounting policies. New estimates required by IFRS should be prepared in accordance with IFRS on the date of transition.

4. Explanation of Transition to IFRS

An entity should disclose how the transition from previous GAAP to IFRS affected its reported financial position, financial performance, and cash flows. The disclosure should include:

- a. A reconciliation of its equity reported under previous GAAP to its equity under IFRS for:
 - (1) The date of transition to IFRS, and
 - (2) The end of the last period presented in the entity's most recent annual financial statements in accordance with previous GAAP.
- b. A reconciliation of total comprehensive income in accordance with IFRS to total comprehensive income (or total net income if comprehensive income was not reported) in accordance with previous GAAP for the latest period in the entity's most recent financial statements.
- c. Disclosures related to the recognition or reversal of impairment losses, if impairment losses or reversals were recognized for the first time when preparing the opening IFRS balance sheet.

Similar reconciliations are also required for any interim financial report presented for part of a period covered by the first IFRS financial statements.

SEC REPORTING REQUIREMENTS

I. OVERVIEW OF SEC REPORTING REQUIREMENTS

The SEC requires that more than 50 forms be filed to comply with reporting requirements. These forms are filed electronically through the *electronic data gathering, analysis, and retrieval system* (EDGAR) and are available online to the public. The following is a brief overview of several significant forms that must be filed by companies registered with the SEC.

A. Securities Offering Registration Statements

When a company issues new securities, it is required to submit a registration statement to the SEC that includes:

1. Disclosures about the securities being offered for sale.
2. The relationship of the new securities to the company's other securities.
3. Information similar to that filed in the annual filing.
4. Audited financial statements.
5. A description of business risk factors.

B. Form 10-K

Form 10-K must be filed annually by U.S. registered companies (issuers). The filing deadline for Form 10-K is 60 days after the end of the fiscal year for large accelerated filers, 75 days after the end of the fiscal year for accelerated filers, and 90 days after the end of the fiscal year for all other registrants. These forms contain financial disclosures, including a summary of financial data, management's discussion and analysis (MD&A), and audited financial statements prepared using U.S. GAAP.

PASS KEY

A large accelerated filer is defined by the SEC as an issuer with a worldwide market value of outstanding common equity held by non-affiliates of \$700 million or more as of the last business day of the issuers most recently completed second fiscal quarter. An accelerated filer is defined as an issuer with a worldwide market value of outstanding common equity held by non-affiliates of \$75 million or more, but less than \$700 million.



C. Form 10-Q

Form 10-Q must be filed quarterly by U.S. registered companies (issuers). The filing deadline for Form 10-Q is 40 days after the end of the fiscal quarter for large accelerated filers and accelerated filers, and 45 days after the end of the fiscal quarter for all other registrants. This form contains unaudited financial statements prepared using U.S. GAAP, interim period MD&A, and certain disclosures (discussed below).

D. Form 11-K

This is the annual report of a company's employee benefit plan(s).

E. Forms 20-F and 40-F

These forms must be filed annually by foreign private issuers. Form 40-F is filed by specific Canadian companies registered with the SEC and Form 20-F is filed by other non-U.S. registrants. These forms are similar to Form 10-K and contain financial disclosures, including a summary of financial data, management's discussion and analysis (MD&A), and audited financial statements. The financial statements may be prepared using U.S. GAAP, IFRS, or a comprehensive body of accounting principles other than U.S. GAAP or IFRS. If a comprehensive body of accounting principles other than U.S. GAAP or IFRS is used, certain reconciliations to U.S. GAAP must be provided.

F. Form 6-K

This form is filed semi-annually by foreign private issuers. This form is similar to the Form 10-Q and contains unaudited financial statements, interim period MD&A, and certain disclosures.

G. Form 8-K

This form is filed to report major corporate events such as corporate asset acquisitions or disposals, changes in securities and trading markets, changes to accountants or financial statements, and changes in corporate governance or management.

H. Forms 3, 4 and 5

These forms are required to be filed by directors, officers, or beneficial owners of more than 10% of a class of equity securities of a registered company.

II. REGULATION S-X

In Regulation S-X (17 CFR part 210), the SEC sets forth the form and content of and requirements for interim and annual financial statements to be filed with the SEC. The key provisions of Regulation S-X are outlined below.

A. Requirements for Interim Financial Statements**1. Review Requirement**

Interim financial statements filed with the SEC must be reviewed by an independent public accountant and the review report must be filed with the financial statements.

2. Statements and Periods Presented

The interim financial statements should include the following:

- a. *Balance sheets* as of the end of the most recent fiscal quarter and as of the end of the preceding fiscal year. A balance sheet for the corresponding fiscal quarter for the preceding fiscal year is not required unless necessary to understand the impact of seasonal fluctuations.
- b. *Income statements* for the most recent fiscal quarter, for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year. The financial statements may also include income statements for the cumulative 12-month period ended during the most recent fiscal quarter and for the corresponding preceding period.
- c. *Statements of cash flows* for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding period for the preceding fiscal year. The financial statements may also present statements of cash flows for the cumulative 12-month period ended during the most recent fiscal quarter and for the corresponding preceding period.

3. Adjustments for Fair Presentation

Interim financial statements should reflect adjustments necessary to fairly state the results of the interim period and a statement to that effect should be included in the notes to the financial statements. Adjustments include estimated provisions for bonus and profit sharing arrangements that are normally determined or settled at year-end. If all such adjustments are of a normal recurring nature, a statement should be made to that effect. The financial statements should include a detailed description of the nature and amount of adjustments that are not normal recurring adjustments.

4. Condensed Financial Statements

Interim financial statements may be condensed financial statements.

5. Disclosure

Interim financial statement disclosures should be sufficient so that the interim information is not misleading.

a. Omitted Disclosures

Because users have access to the most recent annual financial statements, interim reports may omit the summary of significant accounting policies, the details of accounts that have not changed significantly since the end of the most recent fiscal year, and the detailed annual disclosures described below.

b. Required Disclosures

Disclosures should include:

- (1) Material contingencies.
- (2) Events subsequent to the end of the most recent fiscal year that have a material impact on the entity, including changes in accounting principles and practices (including the date of and reasons for the change), changes in estimates, changes in the status of long-term contracts, significant new borrowings or modifications of financing arrangements, and business combinations or dispositions.

B. Requirements for Annual Financial Statements**1. Audit Requirement**

Annual financial statements filed with the SEC must be audited by an independent public accountant, and the audit report must be filed with the financial statements.

2. Periods Presented

The audited financial statements must include balance sheets for the two most recent fiscal years and statements of income, changes in owners' equity, and cash flows for each of the three fiscal years preceding the date of the most recent audited balance sheet.

U.S. SEC REQUIREMENTS VS. IFRS

IFRS requires, at a minimum, two balance sheets, two statements of comprehensive income (and net income, if using the two-statement approach), two statements of changes in equity, two statements of cash flows and related notes.



3. Disclosure Requirements

The following items must be disclosed in the financial statements or notes:

- a. Dividends per share and in total for each class of shares
- b. Principles of consolidation or combination
- c. Assets subject to lien
- d. Defaults with respect to any issue of securities or credit agreements if the default or breach existed at balance sheet date and has not been subsequently cured
- e. Preferred shares disclosures
- f. Restrictions that limit the payment of dividends
- g. Significant changes in bonds, mortgages, or similar debt
- h. Summarized financial information of subsidiaries not consolidated and 50% or less owned entities
- i. Income tax expense
- j. Warrants or rights outstanding
- k. Related party transactions which affect the financial statements
- l. Repurchase and reverse repurchase agreements
- m. Accounting policies for derivative instruments

III. SEC XBRL REPORTING REQUIREMENTS

A. Definition of XBRL

XBRL (Extensible Business Reporting Language) is a royalty-free, open specification for software that uses XML (Extensible Markup Language) data tags to describe financial information for business and financial reporting. XBRL is a next-generation language after HTML. HTML tells computers how to display text. XML and XBRL tell computers how to interpret the context of the text.

B. Key XBRL Terms

1. Tag

A machine-readable code that gives a standard definition for each line item in an income statement, cash flow statement, balance sheet, or other financial or non-financial data, including data contained in the notes to the financial statements. Tags include descriptive labels, definitions, references to U.S. GAAP, and other elements that provide contextual information that allow data to be recognized and processed by software.

2. Taxonomy

A taxonomy defines the specific tags used for individual items of business and financial data. XBRL taxonomies include:

a. XBRL U.S. GAAP Financial Reporting Taxonomy

The XBRL U.S. GAAP taxonomy is maintained and updated by the FASB and the Financial Accounting Foundation to reflect changes in U.S. GAAP and SEC financial statement disclosure requirements, as well as changes in common reporting practices.

b. XBRL IFRS Taxonomy

The XBRL IFRS taxonomy is maintained by the IFRS Foundation to reflect changes in IFRS disclosure requirements. The development of the IFRS taxonomy is supported by the XBRL Quality Review Team and the XBRL Advisory Council.

c. Global Ledger Taxonomy

A taxonomy independent of other reporting standards or system types that permits flexible, multi-national consolidation.

d. Industry Specific Taxonomies

Taxonomies have been created to accommodate industry specific financial reporting needs. Industry specific taxonomies exist for the commercial and industrial, banking and savings, real estate, insurance, and broker/dealer industries.

e. Company Specific Tags

Companies can create their own tags when needed tags are not included in any existing taxonomy.

3. Instance Document

An instance document is an XBRL formatted document that contains tagged data.

C. SEC Interactive Data Rule

The SEC's Interactive Data Rule requires U.S. public companies and foreign private issuers that use U.S. GAAP, as well as foreign private issuers that use IFRS, to present financial statements and any applicable financial statement schedules in an exhibit prepared using XBRL. This exhibit is required with the filers' SEC registration statements, quarterly and annual reports, and reports 6-K and 8-K containing revised or updated financial statements.

1. Phase-In Periods

The SEC is phasing in the interactive data (XBRL) reporting requirement over three years.

a. Phase-In Year 1

Domestic and foreign large accelerated filers that use U.S. GAAP and have a worldwide public float above \$5 billion were required to begin using interactive data (XBRL) reporting beginning with the first periodic report (Form 10-Q, Form 20-F, or Form 40-F) containing financial statements for a fiscal period ending on or after June 15, 2009.

b. Phase-In Year 2

All other domestic and foreign large accelerated filers that use U.S. GAAP were required to begin using interactive data (XBRL) reporting beginning with the first periodic report (Form 10-Q, Form 20-F, or Form 40-F) containing financial statements for a fiscal period ending on or after June 15, 2010.

c. Phase-In Year 3

All remaining filers using U.S. GAAP, including smaller reporting companies, and all foreign private issuers that prepare their financial statements in accordance with IFRS are required to begin using interactive data (XBRL) reporting beginning with the first periodic report (Form 10-Q, Form 20-F, or Form 40-F) containing financial statements for a fiscal period ending on or after June 15, 2011.

2. Data Tagging Details

Tagged disclosures must include the primary financial statements, notes, and financial statement schedules. A filer's primary financial statements are required to be tagged in detail. Financial statement footnote and financial statement schedule tagging is broken into four different levels. Level 1 tagging is required for a company's first XBRL submission. Level 1 through Level 4 tagging is required starting one year from the filer's initial submission.

a. Level 1

Each complete footnote and schedule is tagged as a single block of text.

b. Level 2

Each significant accounting policy within the significant accounting policies footnote is tagged as a single block of text.

c. Level 3

Each table within each footnote or schedule is tagged as a separate block of text.

d. Level 4

Within each footnote or schedule, each amount (i.e., monetary value, percentage, and number) is required to be separately tagged.

3. Modified Liability

XBRL exhibits submitted to the SEC are subject to modified liability for 24 months from the time the filer first is required to submit interactive data files. The modified liability provision will terminate completely on October 31, 2014. During the modified liability period, the interactive data files will be protected from liability for failure to comply with the tagging requirements if the failure occurred despite the filer's good faith effort and the filer corrected the failure promptly after becoming aware of it.

4. 30-Day Grace Period

Each company's initial interactive data exhibit, regardless of filing type, will be required within 30 days after the earlier of the due date or filing date of the related report or registration statement. Filers will also receive a 30-day grace period for the first filing that is required to have footnotes and schedules tagged using all levels of detail.

5. Posting to Corporate Web Site

Information submitted by a filer to the SEC in interactive data format must also be posted to the filer's corporate Web site no later than the end of the calendar day on which the filer filed or was required to file the related registration statement or report with the SEC, whichever is earlier.

APPENDIX

IFRS vs. U.S. GAAP



Note: Unless specifically noted, IFRS and U.S. GAAP accounting rules are the same. This chart highlights the significant differences between IFRS and U.S. GAAP covered in this lecture.

ISSUE	IFRS	U.S. GAAP
<i>Conceptual Framework</i>	Entities are directed to refer to and consider the applicability of the concepts in the IASB <i>Conceptual Framework</i> when developing accounting policies in the absence of a standard or interpretation that specifically applies to an item.	Entities cannot apply the FASB conceptual framework to specific accounting issues.
<i>Discontinued Operations</i>	Before a component can be classified as held for sale, the individual assets and liabilities of the component must be measured in accordance with applicable standards and any resulting gains and losses must be recognized. After classification as held for sale, the component is reported at the lower of carrying value and fair value less costs to sell.	Assets and liabilities are not required to be remeasured before a component is classified as held for sale, but the classification of a component as held for sale does trigger an impairment analysis of the component.
<i>Extraordinary Items</i>	The reporting of amounts as extraordinary is prohibited.	Gains and losses may be reported as extraordinary if they are unusual in nature, infrequent in occurrence, and material.
<i>Accounting Changes</i>	When an entity applies an accounting change 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. The cumulative effect adjustment is an adjustment to beginning retained earnings at the beginning of the prior period.	Comparative financial statements are not required by U.S. GAAP. Note that the SEC does require comparative annual financial statements for public companies (at a minimum, two balance sheets and three statements of income, changes in owners' equity, and cash flows). Neither GAAP nor the SEC have a three balance sheet requirement when an entity applies an accounting change retroactively. The cumulative effect adjustment is an adjustment to the beginning retained earnings of the earliest period presented.
<i>Change in Accounting Entity</i>	IFRS does not include the concept of a change in accounting entity.	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.

ISSUE	IFRS	U.S. GAAP
<i>Error Correction</i>	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.	There is no impracticability exemption for error corrections.
<i>Comprehensive Income</i>	Other comprehensive income includes revaluation surpluses (gains) recognized when intangible assets and fixed assets are revalued.	Long-term asset revaluation is not permitted under U.S. GAAP. Therefore, revaluation surpluses are not included in other comprehensive income.
<i>Notes to Financial Statements</i>	IFRS requires an explicit and unreserved statement of compliance with IFRS in the notes to the financial statements. An entity cannot describe financial statements as complying with IFRSs unless they comply with all IFRS requirements.	U.S. GAAP does not have a similar requirement.
<i>Notes to Financial Statements</i>	The summary of significant accounting policies includes disclosure of judgments and estimates made in the process of applying accounting policies.	The summary of significant accounting policies includes disclosure of significant estimates, but not of judgments made in preparing the financial statements.
<i>Related Party Disclosures</i>	Disclosure of key management compensation arrangements is required.	No disclosure of key management compensation arrangements under U.S. GAAP. The SEC does require disclosure of key management compensation arrangements outside the financial statements.
<i>Risks and Uncertainties</i>	Required disclosure of assumptions made about the future and other major sources of estimation uncertainty at the end of the reporting period that could result in a material adjustment to the carrying amount of assets and liabilities within the next financial year.	Required disclosure of: 1. Nature of operations 2. Use of estimates in the preparation of financial statements 3. Estimate of the effect of a change in accounting estimate when it is possible that the accounting estimate will change in the near term and that the effect of the change will be material 4. Vulnerability to the risk of a near-term severe impact from a material concentration

ISSUE	IFRS	U.S. GAAP
<i>Interim Financial Reporting</i>	Interim financial statements must be prepared using the same principles and practices used in preparation of the most recent annual financial statements.	Certain principles and practices may be modified when preparing interim financial statements. For example, certain costs may be allocated to interim periods based on estimates of time expired, benefit received, or other activity associated with the interim period.
<i>Interim Financial Reporting</i>	Interim financial statements are required to include, at a minimum: 1. Condensed balance sheets as of the end of the current interim period and as of the end of the immediately preceding financial year. 2. Condensed statements of comprehensive income (single-statement or two-statement presentation) for the current interim period and the cumulative year-to-date with comparative statements for the comparable periods (interim and year-to-date) of the immediately preceding financial year. 3. Condensed statements of changes in equity cumulatively for the current financial year and for the comparable year-to-date period of the immediately preceding financial year. 4. Condensed statements of cash flows for the current financial year-to-date and the comparable year-to-date period of the immediately preceding financial year. 5. Required disclosures	U.S. GAAP does not establish presentation minimums for interim reporting. Under SEC guidelines, the interim financial statements should include the following: 1. Balance sheets as of the end of the most recent fiscal quarter and as of the end of the preceding fiscal year. A balance sheet for the corresponding fiscal quarter for the preceding fiscal year is not required unless it is necessary to understand the impact of seasonal fluctuations. 2. Income statements for the most recent fiscal quarter, for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year. The financial statements may also include income statements for the cumulative 12-month period ended during the most recent fiscal quarter and for the corresponding preceding period. 3. Statements of cash flows for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding period for the preceding fiscal year. The financial statements may also present statements of cash flows for the cumulative 12 month period ended during the most recent fiscal quarter and for the corresponding preceding period.
<i>Interim Financial Reporting</i>	The effective tax rate may be calculated using enacted or substantially enacted changes in tax rates.	The effective tax rate may be calculated using enacted tax rates only.
<i>Segment Reporting</i>	Segment disclosures include segment profit or loss, segment assets and segment liabilities (if a segment liability measure is regularly provided to the chief operating decision maker).	Segment disclosures include segment profit or loss and segment assets. There is no requirement to disclose segment liabilities.

CLASS QUESTIONS

Question Number	First Choice Answer	Correct Answer	
			CLASS QUESTIONS ANSWER WORKSHEET
1.			
2.			
3.			
4.			Task-based simulation
5.			
6.			
7.			
8.			
9.			
10.			
11.			
12.			
GRADE			
Attempt	Multiple-choice Questions		Task-based Simulations
1st	Questions correct _____ ÷ 11 questions = _____ %		Questions correct _____ ÷ 1 question = _____ %
2nd	Questions correct _____ ÷ 11 questions = _____ %		Questions correct _____ ÷ 1 question = _____ %
3rd	Questions correct _____ ÷ 11 questions = _____ %		Questions correct _____ ÷ 1 question = _____ %
Final	Total questions correct _____ ÷ 12 questions = _____ %		

NOTES

1. CPA-00010

According to the FASB and IASB conceptual frameworks, completeness is an ingredient of:

	<u>Relevance</u>	<u>Faithful Representation</u>
a.	Yes	No
b.	No	Yes
c.	Yes	Yes
d.	No	No

2. CPA-00031

Scott Corporation sold a fixed asset used for operations for greater than its carrying amount. Scott should report the transaction in the income statement using the:

- a. Gross concept, showing the proceeds as part of revenues and the carrying amount as part of expenses in the continuing operations section.
- b. Net concept, showing the total amount as an extraordinary item, net of income taxes.
- c. Net concept, showing the total gain as part of discontinued operations, net of income taxes.
- d. Net concept, showing the total gain as part of continuing operations, not net of income taxes.

3. CPA-00052

Which of the following should be included in general and administrative expenses?

	<u>Interest</u>	<u>Advertising</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

4. TBS-00010

The board of directors of Super Conglomerate, Inc. voted to dispose of its Tiny Co. subsidiary on October 31, Year 8. On that date, the net book value of the subsidiary was \$15,000,000, but Super Conglomerate believed that it could sell the subsidiary for no more than \$12,500,000. No buyer had been found as of December 31, Year 8, but the company was committed to the plan to sell and was actively looking for a buyer. On May 1, Year 9, the sale of the subsidiary was completed for \$13,000,000.

The subsidiary's operating results for Year 8 and Year 9 were:

January 1, Year 8 – October 31, Year 8	(\$5,000,000)
November 1, Year 8 – December 31, Year 8	(\$1,500,000)
January 1, Year 9 – April 30, Year 9	(\$2,250,000)

Super Conglomerate's tax rate is 30%. Calculate the amount to be reported on Super Conglomerate's Year 8 financial statements for the disposal of Tiny Co.

<u>Loss from discontinued operations – Year 8:</u>	<u>Answer</u>
Impairment loss	
Operating loss	
Gain/loss on disposal	
Loss from discontinued operations, before tax	
Tax benefit	
Loss from discontinued operations, after tax	

5. CPA-00050

During the current year, both Raim Co. and Cane Co. suffered losses due to the flooding of the Mississippi River. Raim is located two miles from the river and sustains flood losses every two to three years. Cane, which has been located 50 miles from the river for the past 20 years, has never before had flood losses. How should the flood losses be reported in each company's income statement under U.S. GAAP?

<u>Raim</u>	<u>Cane</u>
a. As a component of income from continuing operations	As an extraordinary item
b. As a component of income from continuing operations	As a component of income from continuing operations
c. As an extraordinary item	As a component of income from continuing operations
d. As an extraordinary item	As an extraordinary item

6. CPA-00098

Midway Co. had the following transactions during the current year:

- \$1,200,000 pretax loss on foreign currency exchange due to a major unexpected devaluation by the foreign government.
- \$500,000 pretax loss from discontinued operations of a division.
- \$800,000 pretax loss on equipment damaged by a hurricane. This was the first hurricane ever to strike in Midway's area. Midway also received \$1,000,000 from its insurance company to replace a building, with a carrying value of \$300,000 that had been destroyed by the hurricane.

What amount should Midway report in its year-end income statement as extraordinary loss before income taxes under U.S. GAAP?

- a. \$100,000
- b. \$1,300,000
- c. \$1,800,000
- d. \$2,500,000

7. CPA-00071

Per U.S. GAAP, which of the following statements is correct regarding accounting changes that result in financial statements that are, in effect, the statements of a different reporting entity?

- a. Cumulative-effect adjustments should be reported as separate items on the income statement in the year of change.
- b. No restatements or adjustments are required if the changes involve consolidated methods of accounting for subsidiaries.
- c. No restatements or adjustments are required if the changes involve the cost or equity methods of accounting for investments.
- d. The financial statements of all prior periods presented should be restated.

8. CPA-00081

For Year 1, Pac Co. estimated its two-year equipment warranty costs based on \$100 per unit sold in Year 1. Experience during Year 2 indicated that the estimate should have been based on \$110 per unit. The effect of this \$10 difference from the estimate is reported:

- a. In Year 2 income from continuing operations.
- b. As an accounting change, net of tax, below Year 2 income from continuing operations.
- c. As an accounting change requiring Year 1 financial statements to be restated.
- d. As a correction of an error requiring Year 1 financial statements to be restated.

9. CPA-00102

One of the elements of a financial statement is comprehensive income. Comprehensive income excludes changes in equity resulting from which of the following?

- a. Loss from discontinued operations.
- b. Prior period error correction.
- c. Dividends paid to stockholders.
- d. Unrealized loss on investments in noncurrent marketable equity securities.

10. CPA-00103

Which of the following information should be disclosed in the summary of significant accounting policies?

- Refinancing of debt subsequent to the balance sheet date.
- Guarantees of indebtedness of others.
- Criteria for determining which investments are treated as cash equivalents.
- Adequacy of pension plan assets relative to vested benefits.

11. CPA-00107

For interim financial reporting, a company's income tax provision for the second quarter should be determined using the:

- Effective tax rate expected to be applicable for the full year as estimated at the end of the first quarter.
- Effective tax rate expected to be applicable for the full year as estimated at the end of the second quarter.
- Effective tax rate expected to be applicable for the second quarter.
- Statutory tax rate.

12. CPA-00127

The following information pertains to revenue earned by Timm Co.'s industry segments for the year ended December 31:

<u>Segment</u>	<u>Sales to unaffiliated customers</u>	<u>Intersegment sales</u>	<u>Total revenue</u>
Alo	\$ 5,000	\$3,000	\$ 8,000
Bix	8,000	4,000	12,000
Cee	4,000	-	4,000
Dil	<u>43,000</u>	<u>16,000</u>	<u>59,000</u>
Combined	60,000	23,000	83,000
Elimination	<u>-</u>	<u>(23,000)</u>	<u>(23,000)</u>
Consolidated	<u>\$60,000</u>	<u>-</u>	<u>\$60,000</u>

In conformity with the revenue test, Timm's reportable segments were:

- Only Dil.
- Only Bix and Dil.
- Only Alo, Bix, and Dil.
- Alo, Bix, Cee, and Dil.