CHAPTER

5

The Income Statement and the Statement of Cash Flows

OBJECTIVES

After careful study of this chapter, you will be able to:

1. Understand the concepts of income.
2. Explain the conceptual guidelines for reporting income.
3. Define the elements of an income statement.
4. Describe the major components of an income statement.
5. Compute income from continuing operations.
6. Report results from discontinued operations.
7. Identify extraordinary items.
8. Prepare a statement of retained earnings.
10. Explain the statement of cash flows.
11. Classify cash flows as operating, investing, or financing.
SYNOPSIS

Concepts of Income

1. The income statement summarizes the results of a company's operations for the period.

2. Under the capital maintenance concept, income for a period is the amount that may be paid to stockholders during that period while leaving the company as well off at the end of the period as it was at the beginning.

3. The transactional approach is currently used for income measurement. Under this approach, companies report assets and liabilities at their historical costs and do not record any change in value unless a transaction, event, or circumstance has provided reliable evidence of the change. Using the accrual basis approach, a company records the impact of a change in the period in which the change occurs, rather than the period in which the company pays or receives the related cash. Net income is measured by the equation:

   \[ \text{Net Income} = \text{Revenues} - \text{Expenses} + \text{Gains} - \text{Losses} \]

4. Consistent with the transactional approach, the FASB has defined comprehensive income as the change in equity of a company during a period from transactions, other events, and circumstances relating to nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

Purposes of the Income Statement

5. The purposes of a company's income statement are: (1) to help evaluate management's past performance; (2) to help predict the company's future income and cash flows; (3) to help assess the company's creditworthiness; and (4) to help in comparisons with other companies.

6. According to the FASB, the income statement should provide information on return on investment, risk, financial flexibility, and operating capability. Return on investment measures overall company performance. Risk is the uncertainty or unpredictability of the future results of a company. In general, the greater the risk, the higher the rate of return expected from an investment. Financial flexibility is the ability of a company to adapt to unexpected needs and opportunities. Operating capability refers to a company's ability to maintain a given physical level of operations.

7. Managers should not practice earnings management in reporting income statement information. That is, they should not enter into transactions or choose among generally accepted accounting principles for the purpose of artificially influencing reported net income.

Conceptual Reporting Guidelines

8. The FASB has suggested types of information to be presented on the income statement and has established more specific guidelines on the reporting of such information. According to the FASB, components of net income may be more important than the total amount. Companies should report components separately when they are important for the assessment of future income.

9. The AICPA Special Committee on Financial Reporting issued guidelines for the reporting of income. The committee recommended that an income statement present two categories of earnings: core earnings and noncore earnings.
Elements of the Income Statement

10. **Revenues** are inflows of (or increases in) assets of a company or settlement of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that are the company's ongoing major or central operations. Revenues are a measurement of a company's accomplishments in operating activities and are a component of equity.

11. Most revenues result gradually from a company's earning process. The earning process includes purchasing, producing, selling, delivering, administering, and collecting and paying cash. Revenues are usually not recognized (formally recorded and reported in a company's financial statements) until (a) realization has taken place, and (b) the revenues have been earned; that is, when the earning process is complete or essentially complete. Realization means the process of converting noncash resources into cash or rights to cash, and encompasses two terms: Realized refers to the actual exchange of noncash resources into cash or near cash. Realizable describes noncash resources that are readily convertible into known amounts of cash or claims to cash. A company usually recognizes revenue under the accrual method at the time goods are sold or services are rendered.

12. **Expenses** are outflows of (or decreases in) assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that are the company's ongoing major or central operations. Expenses are a measurement of a company's efforts or sacrifices during operating activities, and are components of (decreases in) equity.

13. For income determination, companies recognize and match expenses against revenues using three principles: (a) association of cause and effect (for example, costs of products sold, delivery costs, and sales commissions), (b) systematic and rational allocation (for example, depreciation, amortization, and allocated prepaid costs), and (c) immediate recognition (for example, management salaries and most selling and administrative costs).

14. **Gains** are increases in a company's equity (net assets) from peripheral or incidental transactions of the company.

15. **Losses** are decreases in a company's equity (net assets) from peripheral or incidental transactions of the company.

16. Revenues and expenses differ from gains and losses in several ways: (a) Revenues and expenses are associated with a company's major operating activities, while gains and losses are identified with peripheral or incidental activities or events and circumstances, many beyond the control of the company. (b) Revenues and expenses are reported at "gross" amounts, while gains and losses are reported "net." (c) Revenues are generally recognized when realized. In contrast, some gains are recognized when realizable; that is, when recorded assets are readily convertible into known amounts of cash based on interchangeable units and quoted prices available in an active market.

Income Statement Content

17. The major components of a company's income statement are: (a) income from continuing operations; (b) results from discontinued operations; (c) extraordinary items; (d) net income; and (e) earnings per share.

19. Some accountants and external users have advocated the current operating performance concept, under which only normal, ordinary, recurring results of current operations are included in net income. Unusual and nonrecurring items are reported in the retained earnings statement under this concept.
20. Under the all-inclusive concept, all items increasing or decreasing stockholders' equity during the period (except dividends and capital transactions) are included in net income. The FASB generally supports the all-inclusive concept of net income and suggested that a company's financial statements should present both net income and comprehensive income for the period.

Income Statement: Income from Continuing Operations

21. Income from continuing operations summarizes a company's income from usual and recurring operating activities. It includes sales revenues (net of returns, allowances, and discounts), cost of goods sold, operating expenses, other items, and income tax expense related to continuing operations. Operating expenses are usually classified according to functional categories, such as selling expenses, and general and administrative expenses. Other items include recurring revenues and expenses not directly related to the company's primary operations (for example, dividend revenue and interest revenue and expense), material gains and losses from sales of assets that are not classified as results of discontinued operations, and material gains and losses that are not classified as extraordinary.

22. Tax regulations frequently differ from accounting principles. Consequently taxable income often is not the same as the pretax financial income reported on a corporation's income statement, and income tax expense (based on pretax financial income) may be more or less than the actual tax liability (based on taxable income).

23. Two basic formats—single-step and multiple-step—are used in the income statement to report income from continuing operations. Under the pure single-step format, a company classifies its items as either revenues or expenses. Total expenses are then deducted from total revenues in a single computation to determine income from continuing operations. In the multiple-step format, several subtotals are presented. For example, cost of goods sold is typically deducted from net sales to compute the gross profit or gross margin on sales, from which operating expenses are deducted to determine operating income. The net total of other items is then added or deducted, resulting in pretax income from continuing operations. Related income tax expense is subtracted to determine income from continuing operations.

Income Statement: Results from Discontinued Operations

24. FASB Statement No. 144 addresses the reporting by a company of the sale of a component of its operations. A component of a company involves operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the company.

25. The results of discontinued operations section, included on the company's income statement directly after its income from continuing operations, reports: (1) the operating income (loss) of the discontinued component for the period, and (2) the gain (loss) from its sale. The income (or loss) is reported after the consideration of taxes (net of tax).

26. A company may take some time to plan and complete the sale of a component of its operations. The company classifies this component as held for sale when all of six specified criteria are met. A company classifying a component as held for sale records and reports the component at the lower of (1) book value (book value of assets minus book value of liabilities) or (2) fair value less any costs to sell. The company reports the loss (after taxes) in the results of discontinued operations section of its income statement.
Income Statement: Extraordinary Items

27. An event or transaction is defined as extraordinary if it is both unusual in nature and infrequent in occurrence. The environment in which a company operates is a primary consideration in using judgment to determine whether an item is extraordinary. Material gains and losses from extraordinary items are reported, net of taxes, in a separate section of a company's income statement after results of discontinued operations (if any).

28. An event or transaction is "unusual" if it is highly abnormal and unrelated to, or only incidentally related to, the company's ordinary activities. An event or transaction is "infrequent" if it would not reasonably be expected to recur in the foreseeable future.

29. Material gains and losses from events or transactions that are either unusual in nature or infrequent in occurrence but not both are reported as a separate component of income from continuing operations. Such items are not shown net of income taxes.

Income Statement: Earnings Per Share

30. Earnings per share (EPS) are often used to predict future earnings and dividends. A recommended method for displaying EPS is to show each component of EPS net of tax. The number of common shares used in the calculations should also be disclosed. (EPS is discussed later in the text.)

Income Statement: Related Issues

31. Estimates are used throughout accounting because the future results of an action are many times not known by the end of an accounting period. As with most estimates, revisions will be necessary as additional facts become known or the passage of time occurs. When a company changes an accounting estimate, it accounts for the change in the current and future periods. It does not go back and change prior-period financial statements.

International Income Statement

32. Example 5-6 in the text shows comparative income statements for an international company. These income statements were prepared using IFRS.

Statement of Retained Earnings

33. The statement of retained earnings is a schedule that links a company's balance sheet and its income statement. Retained earnings, a major component of stockholders’ equity, are the total amount of company earnings that have not been paid out as dividends. In the schedule, net income is added to, and dividends are deducted from, the beginning retained earnings balance to arrive at ending retained earnings.

34. A change in accounting principle occurs when a company adopts a generally accepted accounting principle that is different from the one it has been using. In most cases, a change in accounting principle is accounted for by retrospective adjustment and reports the cumulative effect on prior years’ earnings as an adjustment of the beginning retained earnings balance for the earliest year presented.
35. If a company makes a material error in previous financial statements, it is required to address this through a **prior period adjustment**. These adjustments are reported as adjustments to beginning retained earnings.

36. The statement of retained earnings may be presented as a separate schedule or included in a statement of changes in stockholders' equity.

**Comprehensive Income**

37. A company's **comprehensive income** consists of net income and **other comprehensive income**. Other comprehensive income includes items related to: (a) investments in available-for-sale securities; (b) pension liabilities; (c) "derivative" financial instruments; and (d) any translation adjustment from converting the financial statements of foreign operations into U.S. dollars.

38. A company may report comprehensive income: (a) on the face of its income statement, (b) in a separate statement of comprehensive income, or (c) in its statement of changes in stockholders' equity. If a company chooses (c), the statement must be included as a **major** financial statement in the annual report. Disclosure of earnings per share on the company's comprehensive income is not required.

**Statement of Cash Flows**

39. **FASB Statement No. 95** requires that a company present a statement of cash flows for the accounting period, with its income statement and balance sheet. The statement of cash flows reports on the company's cash inflows and cash outflows, and reconciles the beginning and ending cash balances. It includes three major sections, showing the net change in cash from **operating**, **investing**, and **financing** activities.

40. External users need information to assess a company's liquidity, financial flexibility, and operating capability. The statement of cash flows, used with the other financial statements, aids external users in assessing a company's (a) ability to generate positive future cash flows, (b) ability to meet its obligations and pay dividends, (c) need for external funding, (d) net income in relation to its associated cash receipts and payments, and (e) cash and noncash investing and financing transactions for the period.

41. Operating activities include the transactions and events related to the earning process. The most common operating cash inflows are collections from customers and interest and dividends received. The most common operating cash outflows are payments to suppliers and employees, and payments of interest and taxes. The section showing **Net Cash Flow From Operating Activities** is most often prepared by the **indirect method**. Using this method, net income is listed first. Then adjustments are made to convert net income to net cash provided by (or used in) operations. The FASB encourages the use of the **direct method**, in which operating cash outflows are deducted from operating cash inflows to determine the net cash provided by (or used in) operating activities.

42. The **Cash Flows From Investing Activities** section includes all cash inflows and outflows from the company's investment transactions. The most common cash inflows from investing activities are receipts from sales of investments in stocks and bonds, and receipts from sales of property, plant, and equipment. The most common outflows from investing activities are payments for investments in stocks and bonds, and payments for investments in property, plant, and equipment.
The Cash Flows From Financing Activities section includes all cash inflows and outflows from the company's financing transactions. The most common cash inflows from financing activities are receipts from the issuance of stocks and debt securities. The most common cash outflows from financing activities are payments of dividends, and payments to reacquire stock and to retire debt securities.

SELF-EVALUATION EXERCISES

True-False Questions

Determine whether each of the following statements is true or false.

1. Under the capital maintenance concept, income for a period is the amount that stockholders may be paid while leaving the company as well off at the end of the period as it was at the beginning.

   Answer: True

   Under the capital maintenance concept, a corporation's income for a period of time is the amount that it may pay to stockholders during that period and still be as well off at the end of the period as it was at the beginning. In other words, capital must be maintained before a corporation earns income on that capital.

2. Using the multiple-step format, cost of goods sold is typically deducted from net sales to arrive at net income.

   Answer: False

   In the multiple-step format, cost of goods sold is deducted from net sales to arrive at gross profit. Then operating expenses are deducted to determine operating income.

3. The results from discontinued operations section of a company's income statement include the operating income or loss of a discontinued component, and the loss or gain from the component's sale.

   Answer: True

   The results of discontinued operations section are included on the company's income statement directly after its income from continuing operations. The results from discontinued operations section include: (1) the operating income (loss) of the discontinued component, and (2) the gain (loss) from its sale.

4. The income or loss from discontinued operations and the gain or loss on the sale of a component is reported without regard to income taxes.

   Answer: False

   The income (loss) from discontinued operations and the gain (loss) from the sale of the component are reported net of income tax. That is, the related income taxes are deducted directly from each item, and only the after-tax amount is included in the computation of net income.
5. When all six specified criteria are met during the process of selling a component, the company classifies the component as held for sale.

\textbf{Answer: True}

Because it may take some time for a company to plan and make a sale of a component of its operations, FASB Statement No. 144 identifies six criteria that must be met for a component to be considered as held for sale. A company classifies a component as held for sale at the end of the current accounting period when all six of the criteria are met.

6. An event or transaction is infrequent if it is highly abnormal and unrelated to, or only incidentally related to, the entity's ordinary activities.

\textbf{Answer: False}

An event or transaction that is highly abnormal and unrelated to an entity's ordinary activities is considered unusual, not infrequent.

7. An event or transaction is infrequent if it would not reasonably be expected to recur in the foreseeable future.

\textbf{Answer: True}

If an event or transaction is of a type that is not reasonably expected to recur in the foreseeable future, taking into account the environment in which the company operates, it is considered infrequent.

8. Whether an event or transaction is extraordinary is determined solely by determining if the event is infrequent and unusual only.

\textbf{Answer: False}

While an event must be both unusual and infrequent before it can be considered extraordinary, the environment in which the company operates must also be considered. An event may be unusual in nature for one company but not for another because of differences in their respective environments. Similarly, the determination of whether an event is infrequent in occurrence should consider the operating environment of the company. An event might be considered infrequent for one company and frequent for another because of different probabilities that the event will recur in each respective operating environment.

9. A material change in accounting principle is in most instances reported by the cumulative effect of the change (net of tax) on prior periods' earnings as a component of net income in the period of the change.

\textbf{Answer: False}

A change in accounting principles is not reported on the income statement. Instead, a company reports the cumulative effect on prior years' earnings as an adjustment of its beginning retained earnings balance for the year in which it makes the change. The amount of the cumulative effect of the change in accounting principle is reported (net of taxes) directly after the beginning retained earnings amount on the company's retained earnings statement.
10. Other comprehensive income includes, among other things, any unrealized gain or loss in the market value of a company’s investments in available-for-sale securities, gains or losses related to derivative financial instruments and gains or losses on extraordinary items.

**Answer: False**
Extraordinary items are not considered part of other comprehensive income. However, any unrealized gain or loss in the market value of a company’s investments in available-for-sale securities, gains or losses related to derivative financial instruments, along with items related to pension liability and foreign currency translations, are considered other comprehensive income.

11. Expenses include decreases in net assets from peripheral or incidental transactions of a company.

**Answer: False**
This question used the definition of losses, not expenses. Losses are decreases in the equity (net assets) of a company from peripheral or incidental transactions. Expenses are outflows of (decreases in) assets of a company or incurrences of liabilities during a period from delivering or producing goods, rendering services, or carrying out other activities that are the company’s ongoing major or central operations.

12. Material gains and losses from transactions or events that are either unusual in nature or infrequent in occurrence, but not both, are reported as a part of income from continuing operations.

**Answer: True**
Generally accepted accounting principles require that a company report material unusual or infrequent gains or losses as a separate component of income from continuing operations. These items are usually included in the Other Items section. Because these items are a separate component of income from continuing operations, for which a related income tax expense is computed, unusual or infrequent gains or losses are not shown net of income taxes.

13. A company’s comprehensive income consists of net income and other comprehensive income.

**Answer: True**
A company’s comprehensive income consists of two parts: net income and other comprehensive income.

14. A major unforeseen strike is an example of an extraordinary item.

**Answer: False**
Some events and transactions are considered to be either unusual in nature or may recur because of continuing economic or political activities. These are not extraordinary items and include the effects of a strike.
15. Under the transactional approach, assets and liabilities are carried at historical cost unless a transaction, event, or circumstance provides reliable evidence of a change in value.  

**Answer: True**

Generally, in the transactional approach, a company records its net assets at their historical cost, and it does not record changes in the assets and liabilities unless a transaction, event, or circumstance has occurred that provides reliable evidence of a change in value.

16. As required by FASB Statement No. 144, the sale of a component of a company is reported as an extraordinary item.

**Answer: False**

The sale of a component of a company is reported in its own section, discontinued operations, below income from continuing operations and not as an extraordinary item.

17. Revenues are usually recognized when realization has taken place and the revenues have been earned.

**Answer: True**

Revenues generally are recognized when two criteria are met: (1) realization has taken place, and (2) they have been earned.

18. A company’s operating capability is its ability to adapt to unexpected needs and opportunities.

**Answer: False**

Operating capability refers to a company’s ability to maintain a given physical level of operations, while financial flexibility is the ability of a company to adapt to unexpected needs and opportunities.

19. The three major sections of the statement of cash flows report the net change in cash from operating, investing, and financing activities.

**Answer: True**

The statement of cash flows reports on a company’s cash inflows, cash outflows, and net change in cash from its operating, investing, and financing activities.

20. The FASB encourages the use of the indirect method to report net cash flows from operations on the statement of cash flows.

**Answer: False**

The FASB encourages use of the direct method. Despite this, the vast majority of companies use the indirect method of reporting cash flows from operating activities.
Multiple Choice Questions

Select the one best answer for each of the following questions

1. Which of the following is not a pervasive principle for matching expenses against revenues?
   (a) association of cause and effect
   (b) systematic and rational allocation
   (c) immediate recognition
   (d) arbitrary assignment

Answer: (d) arbitrary assignment

Arbitrary assignment is not one of the three recognition principles that have been identified by the FASB.

Answers (a), (b), and (c) have been identified by the FASB to properly match expenses against revenues.

2. A material change in accounting principle is in most instances reported:
   (a) as a prior period adjustment on the face of the income statement.
   (b) by adjusting the beginning retained earnings balance for the year in which the change is made.
   (c) by including the cumulative effect of the change on prior periods’ earnings in current income from continuing operations.
   (d) as an extraordinary item.

Answer: (b) by adjusting the beginning retained earnings balance for the year in which the change is made.

In most cases, a change in accounting principle is accounted for by retrospective adjustment. That means that a company reports the cumulative effect on prior years’ earnings as an adjustment of its beginning retained earnings balance for the year in which it makes the change.

Answer (a) is incorrect because there is no requirement to report the effect of the changes in the income statement. Answer (c) is incorrect for the same reason as answer (a), and if it were included in the income statement as a part of continuing operations, it would distort the income from continuing operations and make it harder for users of the statement to determine the true income from continuing operations. Answer (d) is incorrect because a change in accounting principles does not meet the definition of an extraordinary item.

3. The major components of the income statement do not include:
   (a) cumulative effects of changes in accounting principles.
   (b) extraordinary items.
   (c) net income.
   (d) All of the above items are major components of the income statement.

Answer: (a) cumulative effects of changes in accounting principles.

Cumulative effects of changes in accounting principles are included in the statement of retained earnings, not on the income statement and therefore are not a major component of the income statement.

Answers (b) and (c) are incorrect because they are major components of the income statement. Answer (d) is incorrect because not all of the items are major components of the income statement.
4. Income from continuing operations does not include:
   (a) net sales revenues.
   (b) cost of goods sold.
   (c) operating expenses.
   (d) current results of discontinued operations.

   **Answer:** (d) current results of discontinued operations.

   Current results of discontinued operations are not included with income from continuing operations. They are not included because to include them would make it difficult for external users of the income statement to determine what income is coming from operations that will still be part of the company in the future.

   Answers (a), (b), and (c) are all included in income from continuing operations.

5. The operating income or loss for the period of a discontinued component is reported on the income statement:
   (a) as an item of income from continuing operations.
   (b) as an extraordinary item.
   (c) net of tax, in a separate section.
   (d) as a prior period adjustment to retained earnings.

   **Answer:** (c) net of tax, in a separate section.

   Operating income or loss for the period of a discontinued component is reported net of tax, in a separate section of the income statement.

   Answer (a) is incorrect because to do so would distort the results from operations that the company will report from the operations that it plans to keep as a part of the company. Answer (b) is incorrect because it does not meet the definition of an extraordinary item. Answer (c) is incorrect because FASB dictates that the operating income or loss for the period of a discontinued component must be reported on the income statement, not the statement of retained earnings.

6. Which of the following statements regarding comprehensive income is incorrect?
   (a) A company must report comprehensive income on the income statement preceding net income.
   (b) The FASB does not require disclosure of a company's earnings per share on comprehensive income.
   (c) A company may report comprehensive income in its statement of changes in stockholders' equity.
   (d) Comprehensive income includes all changes in the equity of a company, except those resulting from investments by owners and distributions to owners.

   **Answer:** (a) A company must report comprehensive income either the income statement preceding net income.

   Note that this question is asking which of the statements is incorrect. Therefore, the best answer to this question is the one that identifies the statement that is not correct. Answer (a) is incorrect and therefore the best answer for this question because the FASB does not require a specific location for the reporting of comprehensive income. While reporting on the face of the income statement is an option allowed by the FASB, so is reporting in a note to the financial statements, or reporting comprehensive income as a part of the changes in stockholders' equity section.

   Answer (b) is an incorrect choice because this statement is true. FASB does not require comprehensive income to be reported as a per share number. Answer (c) is also an incorrect choice because this statement is also true as discussed above. Answer (d) is incorrect because it is a true statement.
7. The three major sections of the statement of cash flows are cash flows from:
   (a) operating activities, selling activities, and investing activities.
   (b) continuing activities, financing activities, and investing activities.
   (c) operating activities, financing activities, and investing activities.
   (d) operating activities, discontinued activities, and extraordinary activities.

   **Answer: (c) operating activities, financing activities, and investing activities.**

   The three major sections of the statement of cash flows are cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities.

   Answer (a) is incorrect there is not a section on the statement of cash flows for cash flows from selling activities. These cash flows would be included in the operating activities section.

   Answer (b) is incorrect because the statement of cash flows does not contain a section for cash flows from continuing activities. Answer (d) is incorrect because the statement of cash flows does not contain sections for cash flows from discontinued or extraordinary activities.

8. The FASB encourages the use of which method to prepare the cash flows from operating activities section of the statement of cash flows?
   (a) Indirect method
   (b) Direct method
   (c) Recognition method
   (d) Matching method

   **Answer: (b) Direct method**

   While either the indirect method or the direct method is acceptable to prepare the operating section of the statement of cash flows, the FASB encourages the use of the direct method.

   Answer (a) is incorrect because the FASB encourages the use of the direct method. Despite this preference, the FASB allows the use of either the indirect or the direct method and the vast majority of companies use the indirect method. Answers (c) and (d) are incorrect because there are no methods for preparing the cash flows from operating activities called the recognition or matching method.

9. The correction of a previous material error is reported on which statement?
   (a) Statement of cash flows
   (b) Income statement
   (c) Statement of retained earnings
   (d) Balance sheet

   **Answer: (c) Statement of retained earnings**

   The correction of a material error is accounted for as a prior period adjustment to the beginning retained earnings balance in the period that the accounts are corrected on the statement of retained earnings.

   Answers (a), (b), and (c) are incorrect. All of these statements deal with transactions and events that occur in the current period, not previous periods.
10. Material results of events or transactions that are either unusual in nature or infrequent in occurrence, but not both, are shown:
(a) net of tax in the continuing operations section of the income statement.
(b) net of tax in the extraordinary items section of the income statement.
(c) without consideration of tax as a separate component of income from continuing operations.
(d) net of tax as a separate component of income from continuing operations.

**Answer:** (c) without consideration of tax as a separate component of income from continuing operations.

A company reports material unusual or infrequent (not both) gains or losses as a separate component of income from continuing operations. Because these items are a component of income from continuing operations, for which a related income tax expense is computed, unusual or infrequent gains or losses are not shown net of income taxes.

Answer (a) is incorrect because these items are not reported net of tax. Answer (b) is incorrect because these items do not meet the definition of extraordinary, which requires that the items be both unusual and infrequent. Answer (d) is incorrect because these items are not listed net of tax, although they are listed as a separate component of income from continuing operations.

11. In a multiple-step income statement, the amount left after subtracting operating expenses from gross profit but before other losses and gains that do not relate to the primary activities of the company is called:
(a) net income.
(b) earnings per share.
(c) operating income.
(d) income from continuing operations.

**Answer:** (c) operating income.

Cost of goods sold is subtracted from net sales to determine the gross profit. The operating expenses are then deducted from gross profit to show operating income.

Answer (a) is incorrect because net income takes into account all income and gains or losses, regardless of whether they are from the primary activities of the company. Answer (b) is incorrect because earnings per share are calculated using net income, which we have already shown to be incorrect. Answer (d) is incorrect because the important, nonoperating revenues, expenses, gains, and losses that do not relate to the primary activities of the company are then summarized and then added to (or deducted from) operating income to determine pretax income from continuing operations. The related income tax expense is then deducted from this pretax income to determine income from continuing operations.
12. To be extraordinary, a material event or transaction must be:

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**Answer:** (b) Unusual - Yes; Infrequent - Yes

To be considered extraordinary, an event or transaction must be both unusual and infrequent.

Answers (a) and (d) are incorrect because these items do not meet both criteria for consideration as an extraordinary item. These items would not be listed with extraordinary items but instead would be listed separate from other transactions in the continuing operations section of the income statement. Answer (c) is incorrect because these transactions would be considered ordinary and reported in the continuing operations section of the income statement.

13. A company had the following infrequent events occur during the current year:

I. Inventory originally purchased for $75,000 was written down to $0 due to obsolescence.
II. A strike by workers cost the company $65,000 in expenses.
III. A tornado destroyed $35,000 worth of equipment. Tornadoes in this area are very rare.
IV. The company purchased a smaller company paying less than the fair value of the smaller company’s net assets.

Which of the item(s) would be considered extraordinary?

(a) III only  
(b) III and IV  
(c) II, III, and IV  
(d) I, II, III, and IV

**Answer:** (b) III and IV

An extraordinary item is an event or a transaction that is unusual in nature and infrequent in occurrence. There are some items that are always included as extraordinary and some items that are never included as extraordinary. Although quite rare, when a company purchases another company and pays less than the fair value of the net assets of the other company, it reports the difference (sometimes class "negative goodwill") as an extraordinary gain therefore IV should be recorded as extraordinary. In addition, the tornado would be considered extraordinary because they are infrequent and unusual in the area.

Answer (a) is incorrect because it does not reflect the purchase of the company for less than the fair value of that company’s net assets. Answer (c) is incorrect because in addition to the correct items (III and IV), it includes the costs associated with the strike. Costs associated with a strike, despite the fact that strikes may be unusual or infrequent, are always defined as not being extraordinary. Answer (d) is incorrect because the write down of inventory is never considered to be an extraordinary item.

See Chapter 12, page 565. You should first reduce noncurrent assets, with some exceptions, to zero. Only if some excess remains at this point is it negative goodwill/badwill and recorded as an extraordinary item.
14. Using the information in the table below, calculate the proper amount of cost of goods sold for the period.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases</td>
<td>$275,000</td>
</tr>
<tr>
<td>Purchase returns</td>
<td>12,500</td>
</tr>
<tr>
<td>Freight-in</td>
<td>45,000</td>
</tr>
<tr>
<td>Freight-out</td>
<td>15,000</td>
</tr>
<tr>
<td>Beginning inventory</td>
<td>95,000</td>
</tr>
<tr>
<td>Ending inventory</td>
<td>67,000</td>
</tr>
</tbody>
</table>

(a) $290,500  
(b) $303,500  
(c) $320,500  
(d) $335,500  

Answer: (d) $335,500  

To determine the cost of goods sold we must add net purchases (purchases - purchase returns and purchase discounts) to the beginning inventory. We must also add freight-in because this is a cost required to get the products ready for sale. This gives us the cost of goods available for sale. From this we subtract the ending inventory to arrive at the cost of goods actually sold as shown below:

\[
\begin{align*}
\text{Purchases} & \quad \$275,000 \\
- \text{Purchase returns} & \quad 12,500 \\
- \text{Purchase discounts} & \quad 0 \\
+ \text{Beginning Inventory} & \quad 95,000 \\
+ \text{Freight-in} & \quad 45,000 \\
\text{Cost of goods available for sale} & \quad 402,500 \\
- \text{Ending inventory} & \quad 67,000 \\
\text{Cost of goods sold} & \quad \$335,500
\end{align*}
\]

Answer (a) is incorrect because it does not take into consideration the freight-in as a part of the cost of goods available for sale. Answer (b) is incorrect because it does not reflect the purchase returns. Answer (c) is incorrect because it includes the cost of the freight-out in the cost of goods available for sale. This is a common mistake to make; however, it should be noted that the cost of providing transportation for the goods after they have been sold is a selling expense.

15. The correction for a material mistake in the financial statements of a previous year will be reported:

<table>
<thead>
<tr>
<th>Net of tax</th>
<th>In the Income Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Yes</td>
<td>No</td>
</tr>
<tr>
<td>(b) Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>(c) No</td>
<td>No</td>
</tr>
<tr>
<td>(d) No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Answer: (a) Net of tax - Yes; In the Income Statement - No  

The correction of a material error is accounted for as a prior period adjustment. The company describes and reports the prior period adjustment (net of income taxes) as an increase or a decrease in the beginning retained earnings on its statement of retained earnings. As a result, the adjusted beginning retained earnings balance is the amount that retained earnings would have been if the error had not been made.

Answer (b) and (d) are incorrect because a correction is not listed in the income statement because it does not pertain to transactions or events that occurred during the current year. The income statement deals with events and transactions for the current year. Answer (c) is incorrect because a correction of the error is reported net of tax to arrive at the final correction total.
Matching

1. The list below includes components of the income statement, the statement of retained earnings, and statement of comprehensive income.

   a. Income from continuing operations
   b. Results from discontinued operations
   c. Extraordinary items
   d. Other comprehensive income
   e. Earnings per share
   f. Statement of retained earnings

Show where each of the following items would be most appropriately reported by placing one letter in the space provided.

   ___  1. crop loss of farming corporation due to flooding of Missouri River bottomland
   ___  2. effect on prior periods' earnings of changing from straight-line to sum-of-the-years' digits method of depreciation
   ___  3. service revenues of computer equipment company
   ___  4. dividends declared during the current period
   ___  5. current operating income of a subsidiary that was sold at end of current period
   ___  6. cost of goods manufactured
   ___  7. correction of a material computational error in prior year's financial statements
   ___  8. beginning retained earnings balance
   ___  9. item presented on the face of the income statement, usually directly below net income
   ___ 10. gain from the sale of the net assets of an operating segment
   ___ 11. cost of goods sold
   ___ 12. income tax related to continuing operations
   ___ 13. net income
   ___ 14. recording of bad debts expense
   ___ 15. financial effects of a natural disaster
   ___ 16. unrealized decrease in value of available-for-sale securities
   ___ 17. sudden expropriation of assets by a foreign country

Chapter 5  The Income Statement and the Statement of Cash Flows  5-17
**Problem-Solving Strategies**

**Capital Maintenance Approach**

FASB uses a financial capital maintenance concept with regard to income measurement. To use this concept, the beginning and ending capital (that is, the net assets) must be compared after adjusting for any additional investments or disinvestments during the period. The resulting difference is the corporation's income.

Using the following information, determine the company's net income for the period.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in assets</td>
<td>$175,000</td>
</tr>
<tr>
<td>Change in liabilities</td>
<td>15,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>$125,000</td>
</tr>
</tbody>
</table>

At the basic level is to determine how these changes affect the basic accounting equation:

\[ \text{Assets (A)} = \text{Liabilities (L)} + \text{Stockholders' Equity (SE)} \]

To maintain the accounting equation in balance, changes in each section must in the end be equal. In other words:

\[ \Delta A = \Delta L + \Delta SE \]

Applying the information provided above, we can then determine how much retained earnings changed during the period.

1. A change in assets of $175,000 by a debit equals an increase of $175,000 in assets.
2. A change in liabilities of $15,000 by a debit equals a decrease of $15,000 in liabilities.
3. The $125,000 credit to common stock is an increase in common stock, which represents further investment by the stockholders.

Substituting these values into the accounting equation would yield the following:

\[ +$175,000 = -$15,000 + $125,000 \]
\[ +$175,000 = +$110,000 \]

This shows that assets went up by $175,000 when the change in liabilities and stockholders’ equity only changed by $110,000. In order for the equation to stay balanced there has to be a further increase of $65,000 ($175,000 – $110,000). For this to happen, retained earnings would have had to increase by the $65,000. Retained earnings are increased by net income and decreased by a net loss and dividends declared.

Retained earnings increased; therefore we know that we had net income and not a net loss. Because there was no mention of dividends, we can assume that the increase in retained earnings was due to net income for the period; therefore, the net income for the period is the amount that stockholders’ equity must increase to keep the accounting equation in balance; $65,000.

The net income ($65,000) along with the additional stockholders’ contributions ($125,000) was used for two things in this example: (1) to purchase more assets ($175,000); and (2) to pay more liabilities ($15,000).
Income Statement Preparation

There are two ways to present an income statement: (1) the single-step income statement presentation; and (2) the multiple-step income statement presentation.

In a single-step income statement, transactions are separated into two categories: expenses and revenues. The expenses are then subtracted from the revenues in a "single step" to arrive at net income. A multiple-step income statement is more complex and separates and classifies expenses based on where they are expended (primary operations of the company vs. other company activities) and what function they serve (selling, administration, manufacturing, etc.).

We will prepare an income statement for 2011 using the single-step and multiple-step format for Nealy Corporation. Nealy is a retailer and resells goods that they purchase from wholesale companies. The following information is what we will use in our examples:

1. Advertising expense $ 55,000
2. Depreciation expense 24,500
3. Nonsales salaries 155,000
4. Freight-in 15,000
5. Freight-out 17,650
6. Insurance expense 50,000
7. Interest revenue 7,500
8. Interest expense on notes payable 8,500
9. Inventory 1/1/2011 85,000
10. Inventory 12/31/2011 91,250
11. Miscellaneous expenses 16,750
12. Purchase discounts 22,500
13. Purchases 275,000
14. Rent revenue (this is not revenue from our main retail business) 15,500
15. Sales 1,025,000
16. Sales salaries 275,000
17. Sales returns 17,350
18. Utilities expense 22,450

In addition to the above information, we need the tax rate in order to calculate taxes (assume tax rate = 30%), and how many shares of common stock are outstanding to determine earnings per share (assume 50,000 shares of common stock outstanding).

Single-Step Income Statement Preparation

The first step to prepare the single-step income statement is to group expenses and revenues together.

Strategy: In grouping items together, you need to be sure and include related items. For example, in addition to sales revenue you need to include sales returns so that you can arrive at a "net" revenue figure.

Based on the numbers in the table, items 7 (interest revenue), 14 (rent revenue), 15 (sales), and 17 (sales returns) would be included as a part of revenue. The rest would be part of expenses, or used to determine expenses.
Strategy: Information such as inventory levels will not appear on the income statement, however, it is necessary to determine what the cost of goods sold was for the period.

The first item in the single-step income statement is revenue. Item totals are used, as opposed to detailed information so net sales will be listed. Net sales consist of sales less sales returns and allowances and sales discounts. In this example we just have sales returns so net sales equals sales less sales returns. ($1,025,000 – $17,350 = $1,007,650.) This is added to the remaining revenues to get total revenue:

```
<table>
<thead>
<tr>
<th>Revenue</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1,007,650</td>
</tr>
<tr>
<td>Interest revenue</td>
<td>7,500</td>
</tr>
<tr>
<td>Rent revenue</td>
<td>15,500</td>
</tr>
<tr>
<td>Total revenue</td>
<td>$1,030,650</td>
</tr>
</tbody>
</table>
```

Once the revenue section is completed we need to work on the expense section. While the single-step income statement does not show much detail, it does require that several calculations be completed to arrive at the numbers that are reported.

The first of these calculations is the determination of the cost of goods sold, which is usually the largest expense of a nonservice-oriented business. To determine cost of goods sold, we must add all the costs required to get our inventory ready to sell and then subtract the costs of the inventory that we did not sell. To do this we begin with our inventory at the beginning of the period ($85,000). To this amount we add our net purchases. Similar to net sales, net purchases is equal to purchases less purchase discounts and purchase returns and allowances. Because we do not have any purchase returns and allowances in our example, net purchases will be equal to purchases less purchase discounts ($275,000 – $22,500 = $252,500). In addition to determining net purchases we must also include in the cost of goods sold the cost of shipping (usually called freight-in) the inventory to us. Note that only the cost of shipping the goods to us (not from us) is included in cost of goods sold. The cost of shipping goods to our customers is a selling cost to us, not an inventory cost. Therefore the cost of goods sold is calculated as follows:

```
<table>
<thead>
<tr>
<th>Inventory 1/1/11</th>
<th>$ 85,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases</td>
<td>$275,000</td>
</tr>
<tr>
<td>Less: purchase discounts</td>
<td>22,500</td>
</tr>
<tr>
<td>Net Purchases</td>
<td>252,500</td>
</tr>
<tr>
<td>Freight-in</td>
<td>15,000</td>
</tr>
<tr>
<td>Goods available for sale</td>
<td>352,500</td>
</tr>
<tr>
<td>Less: Inventory 12/31/11</td>
<td>91,250</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$261,250</td>
</tr>
</tbody>
</table>
```

After cost of goods sold is calculated, the next step is to group the remaining expenses into categories. The two major categories are selling expenses and general (sometimes called administrative) expenses. Selling expenses are those expenses required for a company to make sales. General expenses are those expenses that support the company but are not directly related to sales.

Selling expenses would be:

```
<table>
<thead>
<tr>
<th>Selling Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising expense</td>
<td>$ 55,000</td>
</tr>
<tr>
<td>Freight-out</td>
<td>17,650</td>
</tr>
<tr>
<td>Sales salaries</td>
<td>275,000</td>
</tr>
<tr>
<td>Total selling expenses</td>
<td>$347,650</td>
</tr>
</tbody>
</table>
```
General expenses would be:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expense</td>
<td>$24,500</td>
</tr>
<tr>
<td>Nonsales salaries</td>
<td>$155,000</td>
</tr>
<tr>
<td>Insurance expense</td>
<td>$50,000</td>
</tr>
<tr>
<td>Miscellaneous expense</td>
<td>$16,750</td>
</tr>
<tr>
<td>Utilities expense</td>
<td>$22,450</td>
</tr>
<tr>
<td><strong>Total General expenses</strong></td>
<td><strong>$268,700</strong></td>
</tr>
</tbody>
</table>

There are now only two expenses that are left from our example: (1) interest expense and (2) income tax expense. Interest expense is given ($8,500). Income tax expense, however, will need to be calculated. To do this we must determine the net income before income tax and then apply the given income tax rate (30%) to determine the income tax expense. The calculation of the income tax expense is:

\[
\text{Revenue} = 1,030,650 \\
\text{Less: Cost of goods sold} = 261,250 \\
\text{Selling expense} = 347,650 \\
\text{General expense} = 268,700 \\
\text{Interest expense} = 8,500 \\
\text{Income before taxes} = 144,550 \\
\text{Income tax expense (30%)} = 43,365
\]

This means that net income for the period will be the income before taxes less income tax expense ($144,550 − 43,365 = $101,185). Because it is given that there are 50,000 shares of common stock outstanding, the earnings per share are $2.02 ($101,185 ÷ 50,000).

**Strategy:** Note that Earnings Per Share are always reported to the penny (two decimal places). In the calculation above ($101,185 ÷ 50,000) the result is 2.0237. However, because the smallest amount of currency is two decimal places, we round the result to $2.02.

We are now ready to put together the single-step income statement. Remember that financial statements require a proper heading that includes the name of the entity, title of the statement, and the date or period covered.
Nealy Corporation
Income Statement
For the period ended December 31, 2011

**Revenues**
- Net sales $1,007,650
- Interest revenue 7,500
- Rent revenue 15,500
- Total revenue $1,030,650

**Expenses**
- Cost of goods sold $261,250
- Selling expenses 347,650
- General expenses 268,700
- Interest expenses 8,500
- Income tax expense 43,365
- Total expenses $929,465

**Net income**
- $101,185

**Earnings per share**
- $2.02

**Multiple-Step Income Statement Preparation**

In essence, the multiple-step income statement preparation is no different from the preparation of the single-step income statement. Where the two really differ is in the presentation. The multiple-step income statement presents much of the information that we had to calculate in the single-step income statement.

In order to prepare the multiple-step income statement we start with the sales revenue, this time presenting all the components of sales revenue used to arrive at net sales:

**Sales Revenue**
- Sales $1,025,000
- Less: Sales returns 17,350
- Total revenue $1,007,650

To this we add the calculations for the cost of goods sold section:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory 1/1/11</td>
<td>$85,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>$275,000</td>
</tr>
<tr>
<td>Less: purchase discounts</td>
<td>22,500</td>
</tr>
<tr>
<td>Net Purchases</td>
<td>252,500</td>
</tr>
<tr>
<td>Freight-in</td>
<td>15,000</td>
</tr>
<tr>
<td>Goods available for sale</td>
<td>267,500</td>
</tr>
<tr>
<td>Less: Inventory 12/31/11</td>
<td>352,500</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>363,750</td>
</tr>
</tbody>
</table>
At this point we calculate an intermediate amount called gross profit (or gross margin). This is the amount that revenue exceeds cost of goods sold.

- **Sales revenues**: $1,007,650
- **Less: cost of goods sold**: 261,250
- **Gross profit**: $746,400

The next step is to put together the detailed operating expenses, which consist of the selling expenses and general expenses:

### Selling Expenses
- **Advertising expense**: $55,000
- **Freight-out**: 17,650
- **Sales salaries**: 275,000
- **Total selling expenses**: $347,650

### General Expenses
- **Depreciation expense**: $24,500
- **Nonsales salaries**: 155,000
- **Insurance expense**: 50,000
- **Miscellaneous expense**: 16,750
- **Utilities expense**: 22,450
- **Total General expenses**: 268,700

At this point we again calculate an intermediate income figure. We call this figure income from operations. (If the company has discontinued operations, which we will discuss later, this figure would be called “Income from continuing operations.”) To calculate income from operations, we take our two operating expenses (selling expenses and general expenses) and subtract them from gross profit.

After this we list other revenues and gains and other expenses and losses. These items are important and provide information that must be reported and used when calculating net income; however, they are listed separately to show that they do not represent the principal operations and activities of the company.

In our example we have a few of these types of items. The first is interest revenue of $7,500. This is listed separately because it is revenue on investments that we have made and not revenue from the selling of our products. In addition to this item we also separately report the rental revenue ($15,500) that we received during the period for the same reason; it is not related to our main business. In addition we report the interest expense on our notes payable ($8,500) in this section as well.
It is now time to put all of this information together in a multi-step income statement:

Nealy Corporation  
Income Statement  
For the period ended December 31, 2011

<table>
<thead>
<tr>
<th>Sales Revenue</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,025,000</td>
</tr>
<tr>
<td>Less: Sales returns</td>
<td>17,350</td>
</tr>
<tr>
<td><strong>Total revenue</strong></td>
<td><strong>$1,007,650</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cost of Goods Sold</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inventory 1/1/11</strong></td>
<td>85,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>$275,000</td>
</tr>
<tr>
<td>Less: Purchase discounts</td>
<td>22,500</td>
</tr>
<tr>
<td><strong>Net Purchases</strong></td>
<td><strong>252,500</strong></td>
</tr>
<tr>
<td>Freight-in</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>Goods available for sale</strong></td>
<td><strong>352,500</strong></td>
</tr>
<tr>
<td>Less: <strong>Inventory 12/31/11</strong></td>
<td><strong>91,250</strong></td>
</tr>
<tr>
<td><strong>Cost of goods sold</strong></td>
<td><strong>261,250</strong></td>
</tr>
</tbody>
</table>

| Gross Profit | 746,400 |

<table>
<thead>
<tr>
<th>Operating Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Selling Expenses</strong></td>
<td></td>
</tr>
<tr>
<td>Advertising expenses</td>
<td>$55,000</td>
</tr>
<tr>
<td>Freight-out</td>
<td>17,650</td>
</tr>
<tr>
<td>Sales salaries</td>
<td>275,000</td>
</tr>
<tr>
<td><strong>Total selling expense</strong></td>
<td><strong>347,650</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>General Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expense</td>
<td>$24,500</td>
</tr>
<tr>
<td>Nonsales salaries</td>
<td>155,000</td>
</tr>
<tr>
<td>Insurance expense</td>
<td>50,000</td>
</tr>
<tr>
<td>Miscellaneous expense</td>
<td>16,750</td>
</tr>
<tr>
<td>Utilities expense</td>
<td>22,450</td>
</tr>
<tr>
<td><strong>Total general expenses</strong></td>
<td><strong>268,700</strong></td>
</tr>
</tbody>
</table>

| Total Operating Expenses | 616,350 |

| Income from operations | 130,050 |

<table>
<thead>
<tr>
<th>Other revenues and gains</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest revenue</td>
<td>7,500</td>
</tr>
<tr>
<td>Rental revenue</td>
<td>15,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>23,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other expenses and losses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>8,500</td>
</tr>
</tbody>
</table>

| Income before taxes | 144,550 |
| Income taxes | 43,365 |
| **Net Income** | **$101,185** |

| Earnings per share | $2.02 |
The $101,185 in the previous example was appropriately called net income. However, if the company had discontinued operations or extraordinary items, the $101,185 figure that we calculated would have been called income from continuing operations. Any gains or losses from the discontinued operations and the extraordinary items would have been placed below this item. These two items (discontinued operations and extraordinary items) are listed after the effects of tax have been taken into consideration (net of tax).

**Statement of Cash Flows Preparation**

The statement of cash flows is divided into three main sections: (1) net cash flow from operating activities; (2) cash flows from investing activities; and (3) cash flows from investing activities. In order to prepare the statement of cash flows we first decide into which category each cash transaction falls.

Operating activities include the transactions that involve providing a service or producing and delivering merchandise to customers. These are the normal activities of a business in pursuing income. Any activity that cannot be defined as a financing or investing activity is included in the operating section.

**Strategy:** It is sometimes helpful to think of operating activities as the components that are used to calculate net income. This becomes readily apparent if the company uses the indirect method to determine cash flows from operations.

**Strategy:** The collection of interest and dividends from investments in other companies is considered an operating activity, even though the original purchase and sale of these investments is an investing activity. Similarly, the payment of interest on debt issued by our company is also an operating activity even though the original issuance and payment of principal is a financing activity. An easy way to remember this is that all interest payments are operating activities. Dividends received are operating activities while dividends that we pay are financing activities.

Examples of cash flows from operating activities would include:

**Inflows:**
- Selling inventory
- Collecting accounts receivable
- Interest and dividends received on investments in other companies

**Outflows:**
- Paying accounts payable
- Paying employees
- Paying interest on loans
- Paying taxes

Investing activities include transactions that involve buying, building, or selling assets that are used in the business. These assets are normally classified as property, plant, and equipment and do not include assets that are sold during the normal course of business. In addition to these items, any transactions related to acquiring investments (equity and debt) in other companies as well as making and collecting loans to other companies are included in the investing section.

**Strategy:** Investing in stocks and bonds is usually apparent to most students as an investing activity. The purchase and sale of assets used in business is not as apparent an investing activity. If you will think of these items (buying or building assets to be used in the business) as “investing” in the business by the stockholders, it will be clearer.
Examples of cash flows from investing activities would include:

**Inflows:**
- Selling a piece of equipment used in the business
- Collecting the principal of a loan made to another company
- Selling the stock of another company

**Outflows:**
- Buying assets that will be used in the business
- Making loans to other companies
- Buying debt and equity investments in other companies

Financing activities include cash transactions between the business and its stockholders such as the issuance of stock or the payment of dividends. The borrowing and repayment of debt (either through bonds or loans) is also included in this section.

**Strategy:** Debt and equity transactions (buying or selling stocks and bonds) in “other” companies are investing activities. A debt and equity transaction in the company that is preparing the statement of cash flows is a financing activity.

Examples of cash flows from financing activities would include:

**Inflows:**
- Selling stock in our company
- Issuing notes payable and bonds in our company

**Outflows:**
- Buying our stock back from stockholders
- Paying dividends to our stockholders
- Paying back our debt

There are two ways to prepare the Net Cash Flow from Operating Activities section of the Statement of Cash Flows: (1) direct method and (2) indirect method. While the FASB encourages firms to use the direct method, the vast majority of firms use the indirect method.

In the indirect method, net income is listed first and then additions or subtractions are made to net income. These additions and subtractions are to remove noncash transactions that affected net income, such as depreciation expense and gains or losses on the sale of assets. In addition to removal of the noncash transactions from net income, the indirect method also adjusts net income for changes in the balances of current assets (other than cash) and current liability accounts.

The direct method, on the other hand, uses the actual operational cash inflows and outflows as opposed to adjusting net income. While both arrive at the same value, the direct method is usually considered to be more useful in estimating future cash flows. The most common cash inflows and outflows for operating activities are:

**Operating Cash Inflows**
1. Collections from customers
2. Interest and dividend payments collected

**Operation Cash Outflows**
1. Payments made to suppliers and employees
2. Payments of interest
3. Payments of income taxes

5-26 Chapter 5 The Income Statement and the Statement of Cash Flows
ANSWERS TO MATCHING

1. 1. a  6. a  12. a
2. f  7. f  13. f
3. a  8. f  14. a
4. f  9. e  15. c
5. b  10. b  16. d
11. a  17. c

TEST YOUR KNOWLEDGE

5-1. Below are selected pretax account balances of the Port Company on December 31, 2011. Prepare a multiple-step income statement for the year. Include a separate schedule for cost of goods sold.

Purchases (net) $25,000
Merchandise inventory, 1/1/11 4,000
Extraordinary gain 13,000
Income from operations of discontinued component 2,000
Loss on disposal of discontinued component 5,000
Sales (net) 60,000
Other items (revenues) 6,000
Operating expenses 7,000

Merchandise inventory at 12/31/11 is $4,000. Five thousand shares of stock have been outstanding for the entire year. The income tax rate is 30%. Round all calculations to the nearest dollar.
5-2. Below is information about the Sierra Company for 2011:

Cash balance, January 1, 2011 $ 4,100
Payment for purchase of land 45,000
Proceeds from issuance of bonds 50,000
Payments to suppliers and employees 30,000
Increase in accounts receivable (net) 1,000
Collections from customers 72,000
Increase in deferred income taxes 300
Bond discount amortization 500
Payments of income taxes 7,000
Depreciation expense 15,000
Proceeds from sale of building 30,000
Interest and dividends collected 1,000
Decrease in advances from customers 1,200
Increase in accounts payable 1,500
Decrease in salaries payable 600
Payments of interest 4,000
Increase in inventories 2,500
Payment of dividends 2,000
Net income 20,000

Required:  (a) Prepare a 2011 statement of cash flows for the Sierra Company, using the indirect method to report the net cash flow from operating activities.
Prepare the operating cash flows section of the statement, using the direct method.
Answers to Test Your Knowledge

5-1.

PORT COMPANY
Income Statement
For Year Ended December 31, 2011

Sales (net) $ 60,000
Cost of goods sold (Schedule 1) (25,000)
Gross profit $ 35,000
Operating expenses (7,000)
Operating income $ 28,000
Other items 6,000
Pretax income from continuing operations $ 34,000
Income tax expense (10,200)
Income from continuing operations $ 23,800
Results from discontinued operations
   Income from operations of discontinued component (net of $600 income taxes) $ 1,400
   Loss on disposal of discontinued component (net of $1,500 income tax credit) (3,500) (2,100)
Income before extraordinary items $ 21,700
Extraordinary gain (net of $3,900 income taxes) 9,100
Net income $ 30,800

Components of Income

<table>
<thead>
<tr>
<th>Components of Income</th>
<th>(5,000 shares)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations</td>
<td>$4.76</td>
</tr>
<tr>
<td>Results from discontinued operations</td>
<td>(0.42)</td>
</tr>
<tr>
<td>Extraordinary gain</td>
<td>1.82</td>
</tr>
<tr>
<td>Net income</td>
<td>$6.16</td>
</tr>
</tbody>
</table>

Schedule 1: Cost of Goods Sold
For Year Ended December 31, 2011

| Inventory, 1/1/11                                 | $ 4,000        |
| Purchases (net)                                   | 25,000         |
| Cost of goods available for sale                  | $ 29,000       |
| Less: Inventory, 12/31/11                          | (4,000)        |
| Cost of goods sold                                | $ 25,000       |
5-2. (a)

SIERRA COMPANY
Statement of Cash Flows
For Year Ended December 31, 2011

Net Cash Flow From Operating Activities

Net income $ 20,000

Adjustments for differences between income flows and cash flows from operating activities:
Add: Depreciation expense  15,000
Bond discount amortization  500
Increase in accounts payable  1,500
Increase in deferred income taxes  300

Less: Increase in accounts receivable (net)  (1,000)
Increase in inventories  (2,500)
Decrease in salaries payable  (600)
Decrease in advances from customers  (1,200)

Net cash provided by operating activities $ 32,000

Cash Flows From Investing Activities
Payment for purchase of land $ (45,000)
Proceeds from sale of building  30,000

Net cash used for investing activities (15,000)

Cash Flows From Financing Activities
Payment of dividends $ (2,000)
Proceeds from issuance of bonds  50,000

Net cash provided by financing activities  48,000

Net Increase in Cash $ 65,000
Cash, January 1, 2011  4,100
Cash, December 31, 2011 $ 69,100

(b)

SIERRA COMPANY
Partial Statement of Cash Flows
Operating Activities
For Year Ended December 31, 2011

Cash Flows From Operating Activities

Cash Inflows:
Collections from customers $ 72,000
Interest and dividends collected  1,000
Cash inflows from operating activities $ 73,000

Cash Outflows:
Payments to suppliers and employees $ 30,000
Payments of interest  4,000
Payments of income taxes  7,000
Cash outflows for operating activities (41,000)

Net cash provided by operating activities $ 32,000