Income Statement: Accounting and Reporting

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Course Description

This course addresses income statement accounting and reporting. It discusses a variety of accounting issues surrounding income statement items and related information; the format of the income statement, major income statement categories, extraordinary and nonrecurring items, discontinued operations, research and development costs, deferred compensation arrangements, share-based payment, compensation expense arising under a stock option plan, insurance costs, and earnings per share (EPS) calculation.

Field of Study	Accounting
Level of Knowledge	Basic to Intermediate
Prerequisite	Basic Accounting
Advanced Preparation	None

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The Income Statement:

Accounting and Reporting

Learning Objectives:

After completing this section, you should be able to:

1. Identify the differences between a single-step income statement and a multiple-step income statement.
2. Recognize key items of the income statements and how they should be reported.
3. Determine the requirements for extraordinary gains and losses.
4. Understand requirements when reporting discontinued operations
5. Recognize how stock option compensation plans affect the income statement.
6. Compute earnings per share in a simple and complex capital structures.
7. Recognize the ASC 220 requirements for comprehensive income.

This course discusses the format of the income statement, major income statement categories, extraordinary and nonrecurring items, discontinued operations, research and development costs, deferred compensation arrangements, compensation expense arising under a stock option plan, insurance costs, and earnings per share calculation.

Revenue, Expenses, Gains, and Losses

The four major components of an income statement, according to Statement of Financial Accounting Concepts (SFAC) No. 6, *Elements of Financial Statements*, are revenues, expenses, gains, and losses:

1. *Revenues* Actual or expected inflows of cash or other assets or reductions in liabilities resulting from producing, delivering, or providing goods or services constituting an entity's major or central operations.

2. *Expenses* Actual or expected outflows of cash or other assets or incurrences of liabilities resulting from producing, delivering, or providing goods or services constituting an entity's major or central operations.

3. *Gains* Increases in equity or net assets from peripheral or incidental activities of an entity and from all other transactions except those resulting from revenues or investments by shareholders or owners.

4. *Losses* Decreases in equity or net assets from peripheral or incidental activities of an entity and from all other transactions except those resulting from expenses or distributions to shareholders or owners.

Revenues

Revenue is recognized when:

- It is *realized* or *realizable* (goods or services are converted or convertible to cash or claims to cash or receivables), *and*

- It is earned (the earning process is complete or virtually complete when the entity has substantially completed what it must do to receive the benefits represented by the revenues).

Revenue from selling products is usually recognized on the date of delivery of goods to customers. Revenue from services performed is usually recognized when the services have been rendered and are billable. Revenue is usually recognized at point of delivery.

Sales with Buyback Agreements

No sale is recognized when a company sells a product in one accounting period and agrees to buy it back in the next accounting period at a set price that includes not only the cost of inventory but also related holding costs. Although the legal title may transfer in such a transaction, the economic substance of the transaction is to leave the risk with the seller, and hence no sale is recognized.

Sales When Right of Return Exists

When a company experiences a high rate of return, it may be necessary to delay reporting sales until the right of return has substantially expired. The right of return may be specified in a contract or it may be a customary business practice involving "guaranteed sales" or consignments. Three methods are generally used to record sales when the right of return exists. First, the company may decide not to record any sale until the right of return has substantially expired. Second, the company may record the sale and estimated future returns. Finally, the company may record the sale and accounting for returns as they occur. According to FASB Accounting Standards Codification™ (ASC) 605-15-25-1, *Revenue Recognition: Products*, the company may recognize revenue at the time of sale only if *all* of the following six conditions are satisfied:

1. The price is fixed or determinable at the date of sale.
2. The obligation of the buyer to pay the seller is not contingent on resale of the product, or the buyer has paid the seller.
3. Theft or other damage to the product would not affect the buyer's obligation to the seller.
4. The product being acquired by the buyer for resale has economic substance apart from that provided by the seller.
5. Seller does not have significant future obligations to assist directly in the resale of the product by the buyer.
6. Future returns can be reasonably estimated.

Whereas revenue is generally recognized at the delivery date, under certain circumstances revenue may be recognized before the completion and delivery, such as in long-term construction contracts. Two methods have been used for recognizing revenues from long-term contracts. Under the *percentage-of-completion method*, revenues are recognized based on the progress of construction. The *completed contract method* recognizes revenue only when the contract is complete.

Expenses

Expenses are generally recognized when incurred. Expenses are "matched" against revenues and should be recorded in the same accounting period. Expenses that benefit several periods, such as depreciation, should be allocated systematically over relevant periods.

Gains and Losses

Gains and losses do not involve an earnings process and are typically recognized at the time of sale of assets, at disposition of liabilities, or when the price of certain assets changes. Gains or losses may also result from environmental factors, such as damage by fire, flood, or earthquake.

Income Statement Formats

There are two generally accepted formats for preparing the income statement: the single-step format and the multistep format. The single-step format contains just two sections: Revenues minus Expenses Equals Net Income. The revenue section includes sales revenue, interest income, gains, and all other types of revenues. The expense section includes cost of goods sold, selling and administrative expenses, interest expense, losses, and taxes. The single-step format does not emphasize any one type of revenue or expense. Potential problems with classifying revenues and expenses are thus eliminated.

An example of a single-step income statement is shown in Exhibit 1. Entities that choose the single-step format for income statement presentation break out income tax expense separately at the bottom of the statement placing it directly after the caption “income before taxes.” Although this is not strictly in accordance with the single-step concept, which requires income tax expense to be included in the expenses category it is done to enhance the comparability of the entity's income statement to other entities.

Exhibit 1: Example of Single-Step Income Statement

XYZ Company
Income Statement
For the Year Ended December 31, 2X13

REVENUES		
Net sales	$3,000,000	
Interest income	120,000	
Dividend income	45,000	
Rental income	36,000	
Gain on sale	150,500	
Total revenues	$3,351,500	
EXPENSES		
Cost of goods sold	$2,000,000	
Selling expenses	700,000	
Administrative expenses	250,000	
Interest expense	65,000	
Loss on disposal	55,000	
Income tax expense	110,500	
Total expenses		3,180,500
NET INCOME		$ 171,000
Less: Net income attributable to the noncontrolling interest		(10,000)
Net income attributable to XYZ Company		161,000
EARNINGS PER SHARE (500,000 shares)		$ .34

A multistep income statement is used to emphasize certain sections and relationships. It contains separate sections for operating and nonoperating activities. Expenses are also classified by functions, such as merchandising or manufacturing (cost of goods sold), selling, and administration.

It is acceptable to combine the statement of income with the statement of retained earnings to produce a combined Statement of Income and Retained Earnings. The first part of the statement may be prepared using either the single-step or the multistep approach to derive net income. The beginning balance of retained earnings is added to net income. Dividends declared are deducted to arrive at ending retained earnings. An example of a combined Statement of Income and Retained Earnings using a multistep approach is shown in Exhibit 2.

Exhibit 2: Combined Statement of Income and Retained Earnings Using the Multistep Approach

XYZ Company
Combined Statement of Income and Retained Earnings
For the Year Ended December 31, 2X13

REVENUES		
Sales		$5,000,000
Less: Sales returns and allowances	$ 670,000	
Sales discounts	95,000	765,000
Net sales		4,235,000
COST OF GOODS SOLD		
Beginning inventory	$ 620,000	
Plus: Net purchases	1,300,000	
Merchandise available for sale	$1,920,000	
Less: Ending inventory	435,000	
Cost of goods sold		1,485,000
Gross profit		$2,750,000
OPERATING EXPENSES		
Selling expenses		
Advertising	$ 35,000	
Rent	150,000	
Travel	87,000	
Sales salaries	320,000	
Depreciation	120,000	
Utilities	77,000	
Commissions	150,000	
Total selling expenses		939,000
ADMINISTRATIVE EXPENSES		
Legal expenses	$ 215,000	
Professional expenses	125,000	
Insurance	83,000	
Supplies	62,000	
Officers' salaries	250,000	
Miscellaneous office expenses	35,000	
Total administrative expenses		770,000
INCOME FROM OPERATIONS		$1,041,000
OTHER REVENUES AND GAINS		
Interest income	$ 370,000	
Dividend income	425,000	
Rental income	325,000	

Gain on sale	175,000	
Total		1,295,000
		$2,336,000
OTHER EXPENSES AND LOSSES		
Interest expense	$ 400,000	
Loss on disposal	395,000	
Total		$ 795,000
INCOME BEFORE TAXES		$1,541,000
Income tax expense (30%)		462,300
NET INCOME		$1,078,700
Less: Net income attributable to the noncontrolling interest		(25,000)
Net income attributable to XYZ Company		$1,053,700
Beginning Retained Earnings		800,000
		$1,878,700
Less: Cash dividends declared and paid		(650,000)
Ending Retained Earnings		$1,228,700
EARNINGS PER SHARE (500,000 shares)		$ 2.16

Nonrecurring Gains or Losses

Nonrecurring gains or losses are items that are either unusual or infrequent. They are not considered extraordinary and are presented separately before tax prior to income from continuing operations. Examples are a loss on the sale of property, plant, and equipment as well as the cost of closing a warehouse as part of a business line. Disclosure should be made of the nature and effect of nonrecurring items.

Exhibit 3 provides a brief summary of nonrecurring items in the income statement.

Although simplified, the chart provides a useful framework for determining the treatment of special items in the income statement.

Exhibit 3: Summary of Nonrecurring Items in the Income Statement

Type of Situation*	Criteria	Examples	Placement on Income Statement
Extraordinary items	Material, and both unusual and infrequent (nonrecurring).	Gains or losses resulting from casualties, an expropriation, or a prohibition under a new law	Show in separate section entitled "Extraordinary items." (Shown net of tax.)
Unusual gains or losses, **not** considered extraordinary	Material; character typical of the customary business activities; unusual or infrequent but not both.	Write-downs of receivables, inventories; adjustments of accrued contract prices; gains or losses from fluctuations of foreign exchange; gains or losses from sales of assets used in business.	Show in separate section above income before extraordinary items. Often reported in "Other revenues and gains" or "Other expenses and losses" section. (**Not** shown net of tax.)
Discontinued operations	Disposal of a component of a business for which the company can clearly distinguish operations and cash flows from the rest of the company's operations.	Sale by diversified company of major division that represents only activities in electronics industry. Food distributor that sells wholesale to supermarket chains and through fast-food restaurants decides to discontinue the division that sells to one of two classes of customers.	Show in separate section after continuing operations but before extraordinary items. (Shown net of tax.)

*'This summary provides only the general rules to be followed in accounting for the various situations described above. Exceptions do exist in some of these situations.

Because of the restrictive criteria for extraordinary items, financial statement users must carefully examine the financial statements for items that are unusual or infrequent but not both. Recall that companies cannot consider items such as write-downs of inventories and transaction gains and losses from fluctuation of foreign exchange as extraordinary items. Thus, companies sometimes show these items with their normal recurring revenues and expenses. If not material in amount, companies combine these with other items in the income statement. If material, companies must disclose them separately, and report them above "Income (loss) before extraordinary items." For example, PepsiCo, Inc. presented an unusual charge in its income statement, as Exhibit 4 shows.

Exhibit 4: Income Statement Presentation of Unusual Charges

PepsiCo, Inc.

(in millions)

Net sales	$20,917
Costs and expenses, net	
Cost of sales	8,525
Selling, general, and administrative expenses	9,241
Amortization of intangible assets	199
Unusual items (Note 2)	290
Operating income	$ 2,662

Note 2 (Restructuring Charge)

Dispose and write down assets	$183
Improve productivity	94
Strengthen the international bottler	13
Net loss	$290

The net charge to strengthen the international bottler structure includes proceeds of $87 million associated with a settlement related to a previous Venezuelan bottler agreement, which were partially offset by related costs.

IFRS CONNECTION

No items are classified as extraordinary, either on the income statement or in the notes.

Research and Development Costs

Research is defined as testing to search for a new product, service, technique, or process. Research may also be undertaken to improve already existing products or services. Development is defined as translating the research into a design for a new product or process. Development may also encompass improvements made to existing products or processes.

ASC 730-10-05-1, *Research and Development: Overall*, requires the expensing of internally generated research and development costs as incurred. R&D costs are presented separately within income from continuing operations.

When research is performed under contract for a fee from a third party, a receivable is charged.

Equipment, facilities, materials, and intangibles (e.g., patents) bought that have alternative future benefit in R&D activities are capitalized. Any resulting depreciation or amortization expense on such assets (e.g., the depreciation on an R&D building) is presented as an R&D expense. When there is no future alternative use, the costs must be immediately expensed.

R&D costs include employee salaries directly tied to R&D efforts, and directly allocable indirect costs for R&D efforts.

If a group of assets is bought, proper allocation should be made to those applicable to R&D activities.

Accounting Standards Update (ASU) 2009-03 (August 2009) (ASC 730, *Research and Development*), *SEC Update—Amendment to Various Topics Containing SEC Staff Accounting Bulletins*, states that a significant related-party relationship to an R&D arrangement exists when 10 percent or more of the entity providing the funds is owned by related parties (ASC 730-20-S99-1) (SAB Topic 5.B).

Research and Development Costs Acquired as Part of a Business Combination

ASC 730-10-14-4f, amends ASC 730-10-25-1 as it relates to research and development costs.

ASC 730-10-14-4f requires that all research and development assets acquired in a business combination be initially recognized and measured at fair value, even if those assets do not have alternative future use.

If payments are made to others to undertake R&D efforts on the company's behalf, R&D expense is charged.

Exception: ASC 730-10-15-4, *Research and Development: Overall*, is not applicable to the extractive (e.g., mining) or regulated industries.

Examples of R&D activities are:

- Testing the feasibility of products.
- Engineering functions so the new product may satisfy manufacturing requirements.
- Developing models and prototypes before manufacturing.
- Formulating and designing product alternatives.
- Laboratory research conducted to uncover new knowledge.
- Pilot programs before operations commence.

The following are **not** R&D activities:

- Marketing research.
- Legal fees to secure a patent.
- Quality control during commercial production.
- Rearrangement and startup activities.
- Design changes due to changes in the season (e.g., winter to spring).
- Identifying and solving manufacturing problems during commercial production.
- Construction engineering.
- Routine or periodic alterations to existing products, operations, or production processes.
- Commercial applications of the product.

ASC 985-20-25, *Software: Costs of Software to Be Sold, Leased, or Marketed*, provides special treatment for R&D costs incurred for computer software, whether leased, sold, or otherwise marketed. R&D costs for software development are expensed up until there is a working (program) model (technological feasibility). Technological feasibility is established when the enterprise has completed all planning, designing, coding, and testing activities necessary to establish that the product can be produced to meet its design specifications, features, functions, and technical performance requirements. Technological feasibility also involves ensuring that all risks have been identified. After a working model has been completed, the R&D production software costs are deferred to an asset and reflected at the lower of unamortized cost or net realizable value. If unamortized cost exceeds net realizable value, the write-down is charged against earnings. The write-down is not reversed for any subsequent recovery in value. Examples of these R&D production software costs incurred after the working model are refining subroutines, debugging, and alternative adaptations. After the software is available to the public (marketable), the R&D asset is amortized. The amortization expense is based on the greater of:

- Straight-line method amount.
- Percent of current-year revenue to total expected revenue from the product.

Note: The purchase price of software bought from others that has future benefit should be deferred and amortized over the period benefited.

Once the product is ready to be sold or otherwise marketed, the costs incurred for duplicating the computer software, documentation, and training materials from the product masters and for physically packing the product for distribution shall be capitalized as inventory. Cost of sales is charged when the related revenue from the sales of those units occurs.

Any costs incurred to maintain or provide customer support for the software once sold to the public are expensed to match against the associated revenue generated. Examples of such costs are costs to correct errors, make updates, and perform routine changes.

ASC 730-10-15-4 does not cover software costs associated with that developed by the company for others or created to use internally within the company. Further, the costs to develop a computer system that enhances the company's administrative or selling activities is not classified as an R&D cost.

According to ASC 730-20-25, *Research and Development: Research and Development Arrangements*, if a company contracts with others to fund R&D efforts, a determination must be made of the nature of the obligation. If the company is obligated to repay the funds regardless of R&D success, the company must first debit cash and credit liabilities at the time of borrowing and then debit R&D expense and credit cash at the time of R&D incurrence.

However, a liability does not exist if the transfer of financial risk to the party is substantive and real. If the financial risk related to the R&D is transferred because repayment depends only on the R&D having future economic benefit, the company treats its obligation as a contract to engage in R&D for others. In this instance, R&D costs are capitalized and revenue is recognized as earned and becomes billable under the agreement. Footnote disclosure should be made of the terms of the R&D agreement, amount of earned compensation, and costs incurred under the agreement.

In the event that loans or advances to the entity depend only on R&D results, such amounts are considered R&D costs to be charged to expense.

Stock issued for R&D should be recorded at the fair value of the stock issued or fair value of the R&D acquired, whichever is more clearly evident. If warrants, options, or other financial instruments are issued in connection with an R&D contract, R&D expense is charged. In addition, the company records part of the proceeds to be provided by the other party as paid-in-capital based on their fair market value on the arrangement date.

According to ASC 730-20-25-13, *Research and Development: Research and Development Arrangements*, nonrefundable advance payments for goods or services that will be used for future research and development activities should be deferred and capitalized. Such amounts should be recognized as an expense as the related goods are delivered or the associated services are performed. If an entity does not anticipate the goods to be delivered or services to be rendered, the capitalized advance payment should be charged to expense.

Footnote disclosures with regard to research and development follow:

- Terms of R&D arrangements, such as options to buy, licensing, royalty basis, and funding commitments.
- Valuation basis.
- Fees earned from R&D contracts.
- Amortization method and time period.

Share-Based Payment

FASB Statement No. 123 (FAS-123), *Accounting for Stock-Based Compensation*, established fair value accounting as the preferential methodology of accounting for share-based compensation to employees. However, it also allowed companies to continue accounting for share-based compensation using the intrinsic method described in APB Opinion No. 25 (APB-25), *Accounting for Stock Issued to Employees*. Under the intrinsic method, many companies recorded no compensation at all for the share options that were issued to employees and exercised by them. In addition, pro forma disclosures of the entity's net income and earnings per share as if the fair-value method was used were also required. For many years, most entities continued to use the intrinsic method of accounting for stock-based compensation to employees. However, beginning in early 2001, serious financial company failures began to surface in several large companies, leading many to surmise that the failure to recognize compensation for employee stock option plans was clouding the communication of a company's performance and preventing users of financial statements from obtaining a faithful representation of the entity's financial health.

ASC 718-10-05, *Compensation—Stock Compensation: Overall*, eradicates this problem by **eliminating the intrinsic value method**. Some of the salient improvements of ASC 718-10-05 relating to employee share-based compensation are:

- The use of the intrinsic method described in APB-25 as an alternative to the fair value method in computing and recognizing share-based compensation cost is no longer acceptable.
- Share-based compensation must now be recorded for most entities in accounting for share options given to employees. Recognition of zero compensation cost in this situation is no longer possible.

- Generally accepted accounting principles (GAAP) are simplified in that there is only one way of accounting for compensatory share options and therefore comparability among financial statements will now be improved.

- Users of financial statements will be able to better understand the economic transactions affecting an entity and will be able to make better decisions as a result of having more accurate and precise information about the entity.

In general, ASC 718-10-55-4 requires that the total compensation cost that should be recognized be equal to **the grant-date fair value of all share options** that actually vest with employees. This amount is then allocated over the service period based on the amount of service performance that has been, or will be, rendered by employees. At grant date, the fair value of the share options “locks” and becomes impervious to subsequent changes in stock prices. In addition, the service period is generally the vesting period; that is, the period that extends from the date of grant to the date of vesting. ASC 718-10-35-3 and 30-16 also require that an entity estimate the number of share options that will be given to employees based on the services performed. This differs from FAS-123 in that the latter allowed entities to account for forfeitures as they occurred. In this updated version, compensation cost should be recognized only if performance by the employee is likely to occur. If it is unlikely that the employee performance will occur (such an expectation may occur, for example, because of expected resignations or other causes of turnover), compensation cost should not be accrued. ASC 718-10-35-3 requires that appropriate estimates of this expectation should be made. If at a subsequent time, for example, it is determined that the original estimates of the number of share options that are likely to be earned by employees were incorrect, a revision should be made. ASC 718-10-35-3 requires that the cumulative effect on current and prior periods of a change in the estimated number of share options for which service is expected to be, or has been, rendered should be recognized as compensation in the period of the change.

A nonpublic entity may be unable to estimate the fair value of it share options simply because it is not able to measure the expected volatility of its future share price. In this case, ASC 718-10-30-20 requires that the fair value calculation should be based on a value calculated using the historical volatility of an appropriate industry sector index instead of the entity's own share price volatility. If an entity issues an equity instrument with terms whose fair value (at the date of grant) cannot be reasonably estimated, it should be accounted for using the intrinsic method with remeasurement taking place at each reporting date through the date of settlement (i.e., exercise). In other words, recorded compensation expense must be adjusted based on the change in the intrinsic value of the equity instrument each reporting period. (Notwithstanding the aforementioned, the emphasis of this section is on public entities. For the remaining discussions on share-based payments, the guidance provided relates to public entities unless otherwise specified.)

Models Used to Value Employee Share Options

The models used to measure the fair value of share options do so at a single point in time, generally the date of grant. The assumptions underlying the fair value measurement are a function of information that is available at the time that the measurement is made. The following is a discussion of the models used to value share options.

The Black-Scholes Option-Pricing Model

The Black-Scholes Option-Pricing Model (OPM) was developed in 1973 by Fischer Black and Myron Scholes. The model provides the relationship between call option value and the five factors that determine the premium of an option's market value over its expiration value:

1. *Time to maturity* The longer the option period, the greater the value of the option.
2. *Stock price volatility* The greater the volatility of the underlying stock's price, the greater its value.
3. *Exercise price* The lower the exercise price, the greater the value.
4. *Stock price* The higher the price of the underlying stock, the greater the value.
5. *Risk-free rate* The higher the risk-free rate, the higher the value.

The formula is:

$$V = P[N(d_1)] - PV(E)\,[N(d_2)]$$

where:

V = current value of a call option

P = current stock price

PV(E) = present value of exercise or strike price of the option, $E = E/e^{rt}$

r = risk-free rate of return, continuously compounded for t time periods

e = 2.71828

t = number of time periods until the expiration date (e.g., 30 days means t = 30/365 = 0.0822)

N(d) = probability that the normally distributed random variable Z is less than or equal to d

$d1 = \ln[P/PV(E)] / \sigma\sqrt{t} + \sigma\sqrt{t/2}$ ln() = natural logarithm of the argument

σ = standard deviation per period of (continuously compounded) rate of return on the stock

$d2 = d1 - \sigma\sqrt{t}$

The formula requires readily available input data, with the exception of σ^2, or volatility. P, X, r, and t are easily obtained. The implications of the option model are as follows:

1. The value of the option increases with the level of stock price relative to the exercise price [P/PV(E)], the time to expiration, and the time to expiration times the stock's variability ($\sigma\sqrt{t}$).
2. Other properties:
   a. The option price is always less than the stock price.
   b. The option price never falls below the payoff to immediate exercise (P - E or zero, whichever is larger).
   c. If the stock is worthless, the option is worthless.
   d. As the stock price becomes very large, the option price approaches the stock price less the present value of the exercise price.

EXAMPLE

The current price of Sigma Corporation's common stock is $59.375 per share. A call option on this stock has a $55 exercise price. It expires in 30 days. If the standard deviation of continuously compounded rate of return on the stock is 0.2968 and the risk-free rate is 5% per year, the value of this call option is determined as follows:

1. Calculate the time until the option expires in years:

   t in years = 30 days/365 days = 0.0822

2. Calculate the values of the other variables:

   $PV(E) = E/e^{rt} = \$55/e^{0.05 \times 0.0822} = \$54.774$

$$d1 = \ln[P/PV(E)] / \sigma\sqrt{t} + \sigma\sqrt{t/2} = \ln[\$59.375/\$54.774]/(0.2968 \times \sqrt{0.0822}) + (0.2968 \times \sqrt{0.0822})/2 = 0.9904$$

$$d2 = d1 - \sigma\sqrt{t} = 0.9904 - 0.2968 \times \sqrt{0.0822} = 0.9053$$

3. Use a table for the standard normal distribution (to determine N(d1) and N(d2)):

$N(d_1) = N(0.9904) = 0.8389$

$N(d_2) = N(0.9053) = 0.8173$

4. Use those values to find the option's value:

$V = P[N(d_1)] - PV(E)\,[N(d_2)]$

$= \$59.375[0.8389] - \$54.774[0.8173]$

$= \$5.05$

This call option is worth \$5.05, a little more than its value if it is exercised immediately, \$4.375 (\$59.375 - \$55), as one should expect.

EXAMPLE

Another option on the same stock has an exercise price of \$50 and expires in 45 days. The value of the call option is determined as follows:

1. Calculate the time until the option expires in years:

t in years = 45 days/365 days = 0.1233

2. Calculate the values of the other variables:

$PV(E) = E/e^{rt} = \$55/e^{0.05 \times 0.1233} = \$49.6927$

$$d_1 = \ln[P/PV(E)]/\sigma\sqrt{t} + \sigma\sqrt{t/2} = \ln[\$59.375/\ \$49.6927]/ (0.2968 \times \sqrt{0.1233}) + (0.2968 \times \sqrt{0.1233})/2 = 1.7602$$

$$d_2 = d_1 - \sigma\sqrt{t} = 1.7602 - 0.2968 \times \sqrt{0.1233} = 1.6560$$

3. Use a table for the standard normal distribution (to determine N(d1) and N(d2)):

$N(d_1) = N(1.7603) = 0.9608$

$N(d_2) = N(1.6561) = 0.9511$

4. Use those values to find the option's value:

$V = P[N(d_1)] - PV(E)\,[N(d_2)]$

$= \$59.375[0.9608] - \$49.6927[0.9511]$

= \$9.78

The call option is worth more than the other option (\$9.78 versus \$5.05) because it has a lower exercise price and a longer time until expiration.

Lattice-Based Models

The major problem with option pricing using the Black-Sholes option pricing model in determining the value is that the true value of the worth of the option is only known when they are cashed in (expensed). Corporations cannot predict what will happen to share prices, which will leave the company before their options are vested, and which options will expire with no value.

The Black-Scholes Model is viewed by some as overstating the value of employee stock options, because the model does not take into account the essential differences between traditional exchange-traded stock options and those granted to employees. Unlike conventional options, employee options are subject to vesting schedules and forfeiture conditions and cannot be transferred. As a result, they are invariably exercised before their usual 10-year term expires. These characteristics reduce the value of an option.

Although ASC 718-10 does not specify a preference for a particular valuation technique or model in estimating the fair values of employee share options, it recognizes that a lattice-based method can take into account assumptions that reflect the conditions under which employee options are typically granted. The binomial model is the most commonly used lattice-based method, but other methods may be better suited to compensation programs that link vesting to specific performance objectives. Each of these models is outlined below:

- *Binomial* Unlike Black-Scholes, the binomial method divides the time from the option's grant date to the expiration date into small increments. Because the share price may increase or decrease during any interval, the binomial model takes into account how changes in price over the term of the option would affect the employee's exercise practice during each interval. The binomial model can also consider an option grant's lack of transferability, its forfeiture restrictions, and its vesting restrictions—even for options with more-complicated terms, such as indexed and performance-based vesting restrictions.

- *Trinomial* The trinomial model goes a step further by allowing for the underlying stock price either to remain unchanged or to move up or down. This is useful for valuing performance-based options that vest only if the stock price exceeds a certain level over time.

- *Multinomial* This model can take many more factors into account than either the binomial or trinomial framework. Such additional flexibility may be required to value options that cannot be exercised unless the underlying stock price exceeds the performance of one or more indices. But when there are more than two such sources of uncertainty, a Monte Carlo simulation may be preferable, as it is easier to apply than lattice models.

Note: The new models are far less familiar to users than Black-Scholes, so individuals must spend considerable time figuring out how to use it. Black-Scholes is so widely used that there are lots of software packages, for laptops and handheld computers, to run the model.

The binomial model. Lattice-based option-pricing models, such as the binomial mode, can explicitly capture assumptions about employee exercise behavior over the life of each option grant, expected changes in dividends, and stock volatility over the expected life of the options, in contrast to the Black-Scholes model, which uses weighted average assumptions about option characteristics.

Exhibit 4 illustrates a simple two-year lattice model that portrays the expected price changes of the security, along with their chance of occurrence. Each node of the lattice reflects an expected share price at year-end. These expectations are developed through analysis of the security's historical volatility and its expected future volatility. Volatility, measured by the expected standard deviation of the returns of a security, then determines expected share price fluctuations over time. In turn, these potential share price fluctuations are a major factor in estimating option value.

Exhibit 4: Two-Year Binomial Lattice

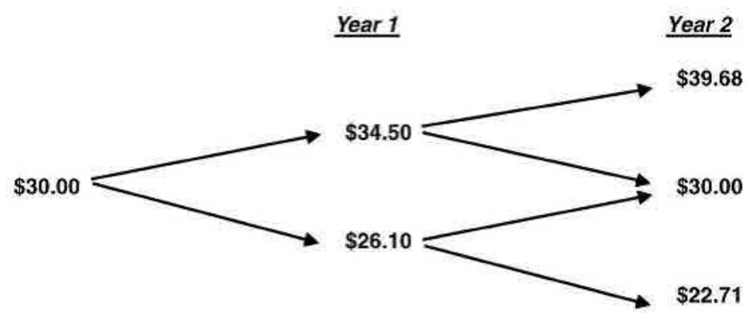
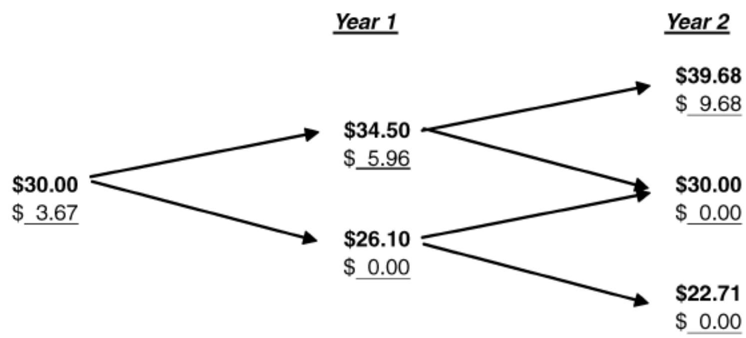


Exhibit 4 presents an example with a 64% probability that the price of the security will increase 15% (from $30.00 to $34.50) and a 36% chance that the price will decline by 13% (from $30.00 to $26.10). Assuming that the probabilities and percentage price increases are the same for each of the two years, if the price does go up to $34.50 in year 1, there is a 64% chance that it will go up again in year 2 (to $39.68) and a 36% chance that it will decline in year 2 (back to $30.00).

Exhibit 5 shows how option values are determined. Assuming that fully vested stock options have been granted with an exercise price of $30.00 and a term of two years, the holder of the option can buy shares of stock for $30.00 until the option expires in two years. If the share price increases in both years 1 and 2, the option holder will net $9.68 ($39.68 - $30.00) upon exercise of the option. If the share price stays at $30.00 a share or falls to $22.71 at the end of year 2, the option holder will not exercise, as the share price does not exceed the exercise price. If the share price has a value of $30.00 or less at the end of the two-year period, there is neither gain nor loss for the holder. The option simply expires unexercised. At the time of the option grant, the option clearly has value. It is more likely that the stock will have a value greater than $30.00 at the end of two years, and the holder will not suffer any loss if it does not.

Exhibit 5: Two-Year Binomial Lattice with Option Values



The mechanics of calculating the option value at the time of grant begin by determining the option value at the expiration period and working backward to the date of the grant. At the end of year 1, the share price will have either increased to $34.50 or fallen to $26.10. If the share price is $34.50 at the end of year 1, the option holder has an asset that will either rise to $9.68 (share price of $39.68) or fall to $0 (share price of $30.00). The respective probability of these outcomes is 64% and 36%. Using a 4% risk-free rate as a time value of money discount rate, the value of the option in year 1 will be $5.96:

$$[(64\% \times \$9.68) \div 1.04] + [(36\% \times \$0) \div 1.04] = \$5.96$$

Continuing to work backward in time, the value of the option at the grant date is based on the option values at the end of year 1. The calculation is the same as in the previous example, and yields an option value of $3.67, the present value of $5.96 and $0 weighted by the probabilities of each outcome occurring:

$$[(64\% \times \$5.96) \div 1.04] + [(36\% \times \$0) \div 1.04] = \$3.67$$

Thus, the option value is based on the expected share price at each node on the lattice. If the historical volatility is higher, and the future volatility is projected to be higher, other things being equal, the option will have more value; the higher the probability of an increase in stock price, the higher the value of the option. There is no real risk of loss to the option holder, who will simply not exercise the option if the stock price declines. Therefore, as long as there is a positive probability that the price will rise above the exercise price, the option has value.

The analysis above illustrates the value of transferable options at the grant date. Employee stock options, however, are not transferable, and this affects their value.

Nontransferability and early exercise If the share price in the preceding example rises to $34.50, the option is then worth $5.96, factoring in the possibility of a rising price in year 2. If, however, the option cannot be sold, the option holder must choose between exercising the option at the end of year 1 and holding it until the end of year 2. If the holder opts to exercise the option at the end of year 1, the proceeds would be only $4.50.

Because they cannot sell the option in the open market, many employees will exercise their options early to realize a gain rather than take the chance that the share price will fall. In other words, the option is worth only $5.96 at the end of year 1 if it can be sold. There is a positive probability that the stock will rise in year 2 and be worth $9.68, but it also might decline and become worthless. Employees may prefer to take a profit of $4.50 rather than risk losing all the potential value. The result of the potential early exercise is that the grant date value of the option falls from $3.67 to $2.77:

$$[(64\% \times \$4.50) \div 1.04] + [(36\% \times \$0) \div 1.04] = \$2.77$$

The reduced option value is due to the increased likelihood of early exercise that nontransferability represents.

Other important share-based payment considerations ASC 718-20-55-24 modifies FAS-95, *Statement of Cash Flows*, to require that excess tax benefits derived from the excess of tax deductible amounts over the compensation cost recognized in the accounting records be classified in the statement of cash flows as a financing cash inflow and as a cash outflow from operating activities. This would be true whether or not the entity's statement of cash flows is presented under the direct or indirect method. In the predecessor statement, the excess tax benefits were viewed as a reduction of taxes paid.

As previously noted, ASC 718-10-55-17 does not suggest a preference for the model that should be used in establishing the value of the employee share options granted. However, in valuing the share options award, it does require that an entity must establish defensible and reasonable estimates for each of the variables used in the model. As an example, the employee share option expected term, the contractual term of the instrument, the effects of employees' expected exercise, and postvesting termination behavior must all be estimated.

If the share options are not fully exercised (or not exercised at all), the amount that is deductible on the entity's tax return may be less than the compensation cost that was recognized in the accounting records. The deferred tax asset related to this situation must be resolved. ASC 718-740-35-5 requires that the deferred tax asset related to this deficiency (net of any related valuation allowance) should be offset against any remaining additional paid-in-capital from previous share option program awards. If any balance in the deferred tax asset account remains, it should be written off and charged to income tax expense.

EXAMPLE

FAIR VALUE METHOD

The stockholders of X Company approve a share option plan that grants share options to employees on January 1, 2X11, to purchase 100,000 shares of $.25 par value common stock. The exercise price of the stock is $18 per share and its current market price (on the date of grant) is $18. Assume that the lattice valuation share option-pricing model determines that the fair value of each share option is $8.50. It is also assumed that the expected forfeitures per year based on the entity's historical turnover rate is 2%. However, at the end of 2X13, it is believed that (based on actual experience and future expectations) the estimated forfeiture rate will improve (decrease) from 2% to 1% per year. Management, therefore, changes the estimated forfeiture rate for the entire award to 1% per year. The share options granted vest at the end of four years (explicit and requisite service period) and the options may be expected to be exercised at any time after this period. At the end of 2X14, it is determined that actual forfeitures averaged 1% per year, therefore no further adjustments are necessary. The total contractual term of the options is 10 years and the tax rate is 40%. All the share options are exercised the first day of the last year of the contract. The share price at the date of exercise is $36. The share options are considered nonqualified stock options for tax purposes. The journal entries to recognize compensation cost and all related transactions follow:

1. Estimate the number of share options that are expected to vest at the end of the four years on the date of grant (January 1, 2X11) based on the 2% annual forfeiture rate: 100,000 share options × .98 (assuming a 2% expected forfeiture in 2X11) × .98 (2X12) × .98 (2X13) × .98 (2X14) = 92,237 share options

2. Compute the required compensation cost based on the data in this problem, assuming there is no revision in estimated forfeitures. The calculation for years 2X11-2X14 is shown below:

Year	*Total Compensation Cost*	*Compensation Cost for the Year (Pre-Tax)*	*Cumulative Compensation Cost*
2X11	$784,015 (92,237 × $8.50)	196,004	196,004
2X12	$784,015	196,004	392,008
2X13	$784,015	196,004	588,012
2X14	$784,015	196,003 (rounded)	784,015

The entries that are required to be made to recognize the required compensation cost and associated deferred tax benefit for 2X11-A4 follow, assuming that the company determines that it will have sufficient taxable income in the future to realize the tax benefit.

2X11-2X14	Compensation cost Paid-in-capital share options	196,004	196,004
	Deferred tax asset	78,402	
	Deferred tax benefit		78,402

Recognition of the deferred tax asset for the temporary difference related to compensation cost ($196,004 × .4).

The net-of-tax effect on income from recognizing compensation cost for 2X11-2X13 is $117,602 ($196,004-78,402) each year.

3. Now, assume instead, that at the end of 2X13, the estimated forfeiture rate used by management improves from 2% to 1%. The new estimated number of share options that are expected to vest at the end of the four years (on the date of grant) must be recalculated, based on the revised forfeiture rate of 1%:

100,000 share options × .99 (assuming an expected 1% forfeiture rate in 2X11) × .99 (2X12) × .99 (2X13) × .99 (2X14) = 96,060 share options

If the entity's estimate of forfeiture rate changes, FAS-123(R) requires that the change be accounted for as a change in estimate and its cumulative retrospective effect should be recognized in the period of the change. The year of the change in this situation is 2X13.

The calculation of compensation cost based on the revised forfeiture rate of X Company in year 2X13 is shown below. The revised forfeiture rate, as previously noted, should be accounted for as a change in estimate with cumulative retrospective effect taking place in year 2X13. For purposes of continuity, the data for years 2X11 and 2X12 are replicated as well. The final year of the service period, year 2X14, is also included.

Year	*Total Compensation Cost*	*Compensation Cost for the Year (Pre-Tax)*	*Cumulative Compensation Cost*
2X11	$784,015(92,237 × $8.50)	196,004 ($784,015/4)	196,004
2X12	$784,015	196,004	392,008
2X13	$816,510(96,060 × $8.50)	$ 220,375*	612,383
2X14	816,510	$204,127**	816,510

* ($816,510 × 3/4) - $392,008.

** $816,510/4 = $204,127.5 rounded down to $204,127 so that the cumulative compensation cost equals $816,510.

The computation to adjust for the new 1% forfeiture at December 31, 2X13 is shown below:

Adjusted total compensation cost as of 12/31/2X13	$816,510	(96,060 × $8.50)
Adjusted cumulative cost that should exist as of 12/31/2X13 based on the revised forfeiture rate	$612,383	($816,510 × 3/4)
Share costs cumulatively recognized for 2X11-2X13	588,012	($196,004 × 3)
Additional amount needed to cumulatively adjust accounts as of 12/31/2X13	$ 24,371	

The following are the entries required to adjust for the new 1% forfeiture rate. The entry for 2X14 is also included.

12/31/2X13	Compensation cost	24,371	
	Paid-in-capital share options		24,371
	Recognition of the adjustment needed to revise the previously recorded compensation cost to the lower forfeiture of 1%.		
	Deferred tax asset	9,748	
	Deferred tax benefit		9,748
	Recognition of the deferred tax asset for the temporary difference related to compensation cost (24,371 × .4).		
2X14	Compensation cost	204,128	
	Paid-in-capital share options		204,128
	Recognition of compensation cost for 2X14.		
	Deferred tax asset	81,651	
	Paid-in-capital share options		81,651
	Recognition of the deferred tax asset for the temporary difference related to compensation cost ($204,128 × .4).		

After the end of the service period, actual forfeitures that took

place should be determined to adjust the cumulative compensation cost for the number of shares that were vested. It is assumed in this illustrative example, that at the end of 2X14, when the award became vested, actual forfeitures actually averaged 1% per year. Therefore, no further adjustments are necessary. If the result is different, then a change to the cumulative compensation cost should be made.

Exercise of the Share Options

4. Assume that all the share options are exercised the first day of the last year (2X10) of the contractual term of the share options program. The share price at the date of exercise is $35. At the date of exercise, employees pay in the exercise price of $18 per share option and those proceeds, as well as the previously credited paid-in-capital share option amounts, are now debited. The total is then credited to common stock and paid-in-capital in excess of par. The following entry illustrates this:

Cash	(96,060 × $18)	1,729,080	
Paid-in-capital share options		816,510	
Common stock	(96,060 × $.25)		24,015
Paid-in-capital in excess of par			2,521,575

Income Tax Considerations

5. Assume for purposes of this problem that X Company has already recognized its income tax expense for the period without considering the effects of the exercise of the employee share options that was described in the initial data. Also, assume that the company is able to deduct the difference between the market price per share and the exercise price on the date of exercise on its tax return. It may be recalled that this employee share option program is classified as a nonqualified plan. ASC 718-740-45-2 requires that realized benefits of income tax deductions in excess of the compensation cost that has already been recognized in the accounting records should be accounted for as a credit to additional paid-in-capital. X Company has sufficient taxable income to fully realize this tax deduction benefit. The amount of the tax deduction is computed based on the difference between the market price per share and the exercise per share on the date of exercise:

96,060 shares × ($36 - $18) = $1,729,080

The tax benefit realized from this deduction is .4 ($1,729,080 × .4) = $691,632. The entries for the income tax effects related to the share option problem, made at the date of exercise, follow:

Deferred tax expense ($816,510 × .4)	326,604	
Deferred tax asset		326,604

Because all the share options were exercised, the benefit of the deferred tax asset related to the deductible share options can be realized at the date of exercise.

Current taxes payable	691,632	
Current tax expense		326,604
Additional paid-in-capital [($1,729,080 - $816,510) × .4] =		365,028

The credit made to additional paid-in-capital in this last entry represents the excess tax benefit due to the amount the entity may deduct on its tax return over the recognized compensation cost in the accounting records. Current tax expense and current taxes payable are also adjusted to recognize the tax benefit from the exercise of the share options.

It is important to note that if the share options were not exercised and expired, the recorded compensation cost would not have been reversed. According to ASC 718-740-35-5, resolving the deferred asset recorded on the accounting records requires that it first be written off against any additional paid-in-capital from excess tax benefits that remained on the accounting records from previously existing share option programs and with any remaining balance then accounted for as income tax expense on the income statement. (Additional information related to the tax aspects arising from share-based payments awards may be found under the heading “Tax Aspects” several sections after this.)

Cash Flow Considerations

6. Consider the implications of this problem on the statement of cash flows. ASC 718-20-55-24 (FAS-123(R)) amended FAS-95 to require that the tax benefits that have been realized as a result of excess deductible amounts on the entity's tax return over the cumulative recorded amounts in the accounting records must be shown as inflow of cash from financing activities and outflow of cash from operating activities. This is done regardless of the cash flow reporting format chosen by the entity—whether the direct or indirect method. The required disclosures relating to the problem are shown below on the Statement of Cash Flows in the last year of the contractual period (12/31/2X10)

Cash outflows from operating activities	
Excess tax benefits from employee share based option plan	($365,028)
Cash inflows from financing activities	
Excess tax benefits from employee share-based option plan	$365,028

Nonvested and Restricted Stock

Nonvested stock is stock that cannot be sold currently because the employee who was granted the shares has not yet met the vesting requirements needed to earn the right to the shares. Vesting of these shares is predicated on some sort of agreed upon consideration such as employee services. The fair value of a share of nonvested stock awarded to an employee is measured at the market price per share as if it was vested and issued on the grant date. If a restriction will be imposed after the employee has a vested right to awarded stock, the resulting shares are entitled "restricted." ASC 718-10-30-19 notes that these shares also should be measured at their fair value, which is the same amount for similarly restricted shares issued to third parties.

Employee Stock Purchase Plans

An employee stock purchase plan permits employees to buy stock at a discount. It is noncompensatory if the discount is minor (5% or less), most fulltime employees may participate, and the plan has no option features.

ASC 480-10-S99-4, *Distinguishing Liabilities from Equity: Overall*, covers the sponsor's balance sheet classification of capital stock with a put option held by any employee stock ownership plan.

ASC 718-40-15-1, 3, and 6 covers the employer's accounting for employee stock ownership plans.

Cash-Settled Share-Based Liability Awards

Some share-based compensation awards called Stock Appreciation Rights (SARs) require that an employer entity pay its recipient employee a cash amount based on only the increase in the market price of one share of the entity's stock over some previously established price. The total cash to be received by the employee is the product of the number of SARs earned times the increase. This type of arrangement is classified as a liability award. ASC 718-30-55-1 requires that the compensation cost of such a share-based payment agreement be based on the change in the award's fair value remeasured at each reporting date until the date of settlement. Depending on the amount of service that has been performed at the given reporting date, the compensation cost may be based on only a portion of the change.

According to **Accounting Standards Update (ASU)** No. 2010-05 (January 2010) (ASC 718, *Compensation—Stock Compensation*), *Escrowed Share Arrangements and the Presumption of Compensation*, in the case of a contract for escrowed stock that is forfeited if employees no longer work is deemed compensation. Escrowed shares may be given back to stockholders when certain conditions as to performance are satisfied. In some cases, major stockholders may be involved in escrow stock contracts (ASC 718-10-S99-2).

In **Accounting Standards Update (ASU)** No. 2010-13 (April 2010) (ASC 718, *Compensation—Stock Compensation*), *Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades*, liability classification is mandated in the case of a share-based payment award when the condition does not apply to service or performance. A worker share-based award having an exercise price in a currency where a significant amount of the company's stock trades is not deemed a service or performance condition. Hence, liability presentation is not appropriate for the award when equity classification is required. Footnote disclosure should be made of the particulars of the award (ASC 718-10-25-14A).

Share-Based Compensation Plan Disclosures

The following disclosure parameters are adapted from ASC 718-10-50-1. They represent the salient disclosure requirements in connection with share-based compensation plans:

1. A general description of the share-based payment arrangement or arrangements, such as the terms of the award. This includes, for example, the:

   a. Service period or periods.

   b. Term of the share options.

   c. Number of authorized shares for awards.

   d. Method of measuring compensation expense from the share-based programs with employees.

2. For the current year for which an income statement is provided, the number and weighted-average exercise prices for the following categories of share options:

   a. Outstanding at the beginning and end of the year.

b. Exercisable at the end of the year.

c. Granted, exercised, forfeited, and expired during the year.

3. For each year for which an income statement is provided, the:

    a. Weighted-average grant-date fair value of equity options granted during the year.

    b. Total intrinsic value of options exercised.

    c. Total fair value of shares vested during the year.

4. For fully vested share options and share options expected to vest at the date of the latest balance sheet date, the:

    a. Number.

    b. Weighted-average exercise price.

    c. Aggregate intrinsic value.

    d. Weighted-average remaining contractual term of options (or shares) outstanding and currently exercisable options (or shares).

5. For each year for which an income statement is presented:

    a. A description of the method used during the year to estimate the fair value of the share-based program.

    b. A description of the significant assumptions used during the year to estimate the fair value of share-based compensation awards, including:

        (1) Expected term of share options. This should include a discussion of the method used to incorporate the contractual term of the instruments and employees' expected exercise and postvesting employment termination behavior into the fair value.

        (2) Expected volatility of the entity's shares and the method used to estimate it. If an entity uses a method that employs different volatilities during the contractual term, it must disclose the range of expected volatilities used and the weighted-average expected volatility.

        (3) Expected dividend rates. An entity that uses a method that employs different expected dividend rates during the contractual term shall disclose the range of expected dividends used and the weighted-average expected dividends.

        (4) Risk-free rates. An entity that uses a method that employs different risk-free rates shall disclose the range of risk-free rates used.

(5) Discount for postvesting restrictions and the method for estimating it.

6. For each year for which an income statement is presented the:

   a. Total compensation cost for the share-based payment arrangement:

      (1) Recognized in income as well as its related total recognized tax benefit and

      (2) The total compensation cost capitalized as part of the cost of an asset, if applicable.

   b. A description of significant modifications, including the:

      (1) Terms of the modifications.

      (2) Number of employees affected.

      (3) Total incremental compensation resulting from the modifications.

7. As of the latest balance-sheet date presented, the total compensation cost related to nonvested awards not yet recognized and the weighted-average period over which they are expected to be recognized.

8. If not separately disclosed elsewhere, the amount of cash received from exercise of share options and similar instruments granted under share-based payment arrangements and the tax benefit realized from stock options exercised during the annual period.

9. A description of the entity's policy, if any, for issuing shares upon share option exercise including the source of those shares (that is, new shares or treasury shares). If, as a result of its policy, an entity expects to repurchase shares in the following annual period, the entity shall disclose an estimate of the amount (or a range, if more appropriate) of shares to be repurchased during that period.

Exhibit 6 presents such a disclosure for Hormel Foods.

Exhibit 6: Hormel Foods 2010 Annual Report

Note K. Stock-Based Compensation

The Company issues stock options and nonvested shares as part of its stock incentive plans for employees and non-employee directors. The Company's policy is to grant options with the exercise price equal to the market price of the common stock on the date of grant. Ordinary options vest over periods ranging from six months to four years and expire ten years after the date of the grant. The Company recognizes stock-based compensation expense ratably over the shorter of the requisite service period or vesting period. The fair value of stock-based compensation granted to retirement-eligible individuals is expensed at the time of grant.

A reconciliation of the number of options outstanding and exercisable (in thousands) as of October 31, 2010, and changes during the fiscal year then ended, is as follows:

	Shares	*Weighted-Average Exercise Price*	*Weighted-Average Remaining Contractual Term*	*Aggregate Intrinsic Value*
Outstanding at October 25, 2009	11,604	$ 30.86		
Granted	1,328	38.51		
Exercised	(1,808)	23.41		
Forfeited	(100)	37.20		
Outstanding at October 31, 2010	**11,024**	**$ 32.94**	**5.7 yrs**	**$ 62,959**
Exercisable at October 31, 2010	**6,582**	**$ 30.96**	**4.4 yrs**	**$ 98,488**

The weighted-average grant date fair value of stock options granted and the total intrinsic value of options exercised (in thousands) during each of the past three fiscal years is as follows:

		Fiscal Year Ended	
	October 31, 2010	*October 25, 2009*	*October 26, 2008*
Weighted-average grant date fair value	**$ 9.09**	$ 5.87	$ 10.38
Intrinsic value of exercised options	**$ 32,378**	$ 5,049	$ 27,669

The fair value of each ordinary option award is calculated on the date of grant using the Black-Scholes valuation model utilizing the following weighted-average assumptions:

		Fiscal Year Ended	

	October 31, 2010	*October 25, 2009*	*October 26, 2008*
Risk-free interest rate	**3.4%**	3.2%	4.0%
Dividend yield	**2.2%**	2.5%	1.8%
Stock price volatility	**22.0%**	22.0%	21.0%
Expected option life	**8 years**	8 years	8 years

As part of the annual valuation process, the Company reassesses the appropriateness of the inputs used in the valuation models. The Company establishes the risk-free interest rate using stripped U.S. Treasury yields as of the grant date where the remaining term is approximately the expected life of the option. The dividend yield is set based on the dividend rate approved by the Company's Board of Directors and the stock price on the grant date. The expected volatility assumption is set based primarily on historical volatility. As a reasonableness test, implied volatility from exchange traded options is also examined to validate the volatility range obtained from the historical analysis. The expected life assumption is set based on an analysis of past exercise behavior by option holders. In performing the valuations for ordinary option grants, the Company has not stratified option holders as exercise behavior has historically been consistent across all employee groups.

The Company's nonvested shares vest after five years or upon retirement. A reconciliation of the nonvested shares (in thousands) as of October 31, 2010, and changes during the fiscal year then ended is as follows:

	Shares	*Weighted-Average Grant-Date Fair Value*
Nonvested at October 25, 2009	98	$ 34.90
Granted	25	39.12
Vested	(20)	33.21
Nonvested at October 31, 2010	**103**	**$ 36.25**

The weighted-average grant date fair value of nonvested shares granted, the total fair value (in thousands) of nonvested shares granted, and the fair value (in thousands) of shares that have vested during each of the past three fiscal years is as follows:

		Fiscal Year Ended	
	October 31, 2010	*October 25, 2009*	*October 26, 2008*
Weighted-average grant date fair value	**$ 39.12**	$ 30.54	$ 38.97
Fair value of nonvested shares granted	**$ 978**	$ 865	$ 974
Fair value of shares vested	**$ 664**	$ 204	$ 43

Stock-based compensation expense, along with the related income tax benefit, for each of the past three fiscal years is presented in the table below:

		Fiscal Year Ended	
(in thousands)	*October 31, 2010*	*October 25, 2009*	*October 26, 2008*
Stock-based compensation expense recognized	**$ 14,402**	$ 12,054	$ 14,691
Income tax benefit recognized	**(5,510)**	(4,633)	(5,611)
After-tax stock-based compensation expense	**$ 8,892**	$ 7,421	$ 9,080

At October 31, 2010, there was $12.5 million of total unrecognized compensation cost from stock-based compensation arrangements granted under the plans. This compensation is expected to be recognized over a weighted-average period of approximately 2.3 years. During fiscal years 2010, 2009, and 2008, cash received from stock option exercises was $22.9 million, $2.4 million, and $11.3 million, respectively. The total tax benefit to be realized for tax deductions from these option exercises was $18.9 million, $1.3 million, and $10.6 million, respectively.

Shares issued for option exercises and nonvested shares may be either authorized but unissued shares, or shares of treasury stock acquired in the open market or otherwise. The number of shares available for future grants (in thousands) was 17,647 at October 25, 2010, 18,998 at October 25, 2009, and 7,161 at October 26, 2008.

Tax Aspects

Compensation expense is deductible for tax purposes when paid but for book purposes when accrued. The recognition of compensation expense for financial accounting purposes over the requisite service period generates a cumulative amount on the accounting records that results in a future tax deduction. This is considered a deductible temporary difference under ASC 718-740-25-2, *Compensation —Stock Compensation: Income Taxes*. ASC 718-740-25-2 requires that the recorded deferred tax asset that is recognized as a result be evaluated for realization and be reduced by a valuation allowance account if evidence indicates that it is more likely than not that all or a part of the deferred tax asset will not be realized.

If the cumulative compensation expense recognized in the accounting records turns out to be less than the deduction reported on the entity's tax return, the amount of realized tax benefits that exceeds the recorded tax asset previously reported should be recognized as additional paid-in-capital.

Deferred Compensation Arrangements

ASC 710-10-05-6 covers the accounting and reporting requirements of deferred compensation contracts. Deferred compensation plans typically include such stipulations as continued employment over a predetermined time period, availability, and noncompetitive clauses. In a deferred compensation arrangement, expected benefits to be paid should be accrued as an expense and liability in the current year as the associated services are performed. If the plan is based on current and future employment, the accrued amount is based only on current-year services. Once the employee has performed all services required to have a vested right to receive the deferred compensation, the amount accrued should then be the discounted (present) value of future benefits to be paid to the worker. Accrued amounts start with the first day of employment.

If the plan pays benefits over the life of a beneficiary, the total liability depends on the life expectancy of the beneficiary or the estimated cost associated with the annuity contract to provide adequate amounts to pay the benefits.

Deferred compensation plans do not apply to pension or to post-retirement benefit plans.

EXAMPLE

An employee is hired on January 1, 2X12. The deferred compensation agreement stipulates a payment of $30,000 at the end of employment. The contract calls for employee services for at least nine months. It is expected that the employee will work three years. The discount rate is 12%.

At year-end 2X12, the employee is still working. Because the employee has worked nine months, he is eligible to cease employment and receive the deferred compensation. The accrual at year-end 2X12 is $23,916 ($30,000 × .79719), which represents the present value of the $30,000 payable at the end of two years at 12%. The two years is the initially expected service of three years less the one year (2X12) already elapsed. The entire amount of accrual is recorded as a deferred compensation cost in 2X12 because the worker is fully eligible by year-end.

Assuming the employee continues working to year-end 2X13, the accrued liability at December 31, 2X13, will be $26,786 ($30,000 × .89286), representing the discounted value of $30,000 at the end of one year at a 12% discount rate.

Thus, the cost to be recorded for 2X13 is $2,870 computed as follows:

Accrual at year-end 2X13	$26,786
Accrual at year-end 2X12	(23,916)
Compensation expense for 2X13	$ 2,870

Advertising Costs

ASC 720-35-25-1, *Other Expenses: Advertising Costs*, requires the expensing of advertising as incurred or when the advertising program first occurs. However, the cost of direct-response advertising may be deferred if the major purpose of the promotion is to elicit sales to customers who respond specifically to the advertising and for which future benefit exists. For example, the former condition is met if the response card is specially coded. The latter condition is satisfied if the resulting future revenues exceed the future costs to be incurred. The deferred advertising is amortized over the expected period of benefit using the revenue method (current-year revenue to total revenue). The cost of a billboard should also be deferred and amortized. Advertising expenditures incurred after revenue is recognized should be accrued. These advertising costs should be expensed when the related revenues are recognized.

Disclosures for advertising follow:

- Accounting policy for recording advertising (e.g., expense versus capitalize).
- Total advertising expense for each period.
- For direct-response advertising: description, amortization period, and amount capitalized each period; asset at each balance sheet date; and amortization expense.

Sales Incentives

According to ASC 605-50-45-12 and 13, *Revenue Recognition: Customer Payments and Incentives*, resellers are allowed to report as a deduction from cost of sales the value of the consideration received for all sales incentive agreements associated with the vendor. Further, footnote disclosure is required by the reseller of the vendor's accounting policies with respect to sales arrangements.

Note: ASC 605-50-45-12 and 13 shifted vendor allowances from advertising expense to cost of sales. Thus, cash consideration received by a customer from a vendor is assumed to reduce the prices of the vendor's products or services, and thus reduce cost of sales when recognized. However, this presumption is overcome in the following two cases:

1. The customer should record the cash consideration received from the vendor as *revenue* if the consideration is for payment for assets or services delivered to the vendor by the customer.

2. The customer should record the consideration received by the vendor as a *reduction of cost of sales* if the receipt is because of a reimbursement of costs.

Insurance Costs

The accounting for insurance costs relate to life insurance and casualty insurance.

Life Insurance

ASC 325-30-05-03, *Investments—Other: Investments in Insurance Contracts*, deals with the accounting for purchases of life insurance. As premiums are paid for a life insurance policy, the premiums may consist of two portions—one for insurance expense for the period applicable to the insurer's assumption of risk and the other for cash surrender value.

Cash surrender value of life insurance is the amount payable when the insured cancels the policy. The insured will obviously receive less than the premium paid. The amount to be received upon cancellation by the insured equals the cash value less borrowings against the policy less any fees associated with surrendering the policy. A change in the cash surrender value during the year is treated as an adjustment to the insurance premiums paid. The cash surrender value may also be used as collateral for a loan from the insurer. As per ASC 210-20-05-01, *Balance Sheet: Offsetting*, the cash value should be directly offset against the loans payable account in the balance sheet. Cash surrender value is usually presented under long-term investments. However, if the policy will be cashed in within the next year, the cash surrender value will be reported under current assets.

EXAMPLE

The difference between the premium paid and the amount attributable to the cash surrender value represents insurance expense. If the premium paid is $20,000 and $4,000 of that amount is attributable to the increase in cash surrender value, the journal entry is:

Life insurance expense	16,000	
Cash surrender value	4,000	
Cash		20,000

When the insured dies, the insurer pays the beneficiary the face value of the policy less any associated borrowings against the policy less any redemption fees.

If insurance premium payments are made in a policy that does not transfer risk to the insurer, the payments are considered deposits receivable and presented as an asset.

ASC 325-30-05-2 through 05-9 and 325-30-35-3 through 5, *Investments— Other: Investments in Insurance Contracts*, require that the determination of the amount realizable under an insurance contract (1) take into account any additional amounts (beyond cash surrender value) included in the policy's contractual terms and (2) be based on assumed surrender at the individual policy or certificate level. If it is probable that contractual restrictions would limit the amount that could be realized, such contractual limitations should be considered and any amounts recoverable at the insurance company's discretion should be excluded from the amount that could be realized.

ASC 715-60-05-15, 715-60-35-181 through 35-183, 715-60-55-178 and 55-180, 715-60-35-184 and 35-185, and 715-60-55-181, *Compensation—Retirement Benefits: Defined Benefit Plans—Other Postretirement*, require an employer to recognize a liability for the postretirement benefit provided by a collateral assignment split dollar life insurance arrangement. An asset may be recognized when appropriate.

Casualty Insurance

Casualty insurance is taken out for fire or flood losses. This insurance reimburses the policy holder for the fair market value of destroyed property. Insurance companies usually have a coinsurance provision so the insured is responsible for a portion of the loss. The insurance reimbursement formula assuming an 80% coinsurance provision follows:

$$\frac{\text{Face of Policy}}{.80 \times \text{Fair Market Value of Insured Property}} \times \text{Fair Value of Loss} = \text{Possible Reimbursement}$$

The insurance recovery is based on the lower of the face of the policy, fair market value of the loss, or possible reimbursement.

EXAMPLE

Case	*Face of Policy*	*Fair Market Value of*	*Fair Market Value of*

		Property	Loss
1	$ 8,000	$20,000	$12,000
2	3,000	5,000	5,000
3	30,000	30,000	12,000

Insurance reimbursement follows:

Case A: $\dfrac{\$8{,}000}{.8 \times \$20{,}000} \times \$12{,}000 = \$6{,}000$

Answer = $6,000

Case B: $\dfrac{\$3{,}000}{.8 \times \$5{,}000} \times \$5{,}000 = \$3{,}750$

Answer = $3,000

Case C: $\dfrac{\$30{,}000}{.8 \times \$30{,}000} \times \$12{,}000 = \$15{,}000$

Answer = $ 12,000

EXAMPLE

A blanket policy of $22,000 relates to machinery A and B. The fair values of the machinery are $45,000 and $25,000, respectively. Machinery B is partly destroyed, causing a fire loss of $5,000.

The policy allocated to machinery B is determined as follows:

	Fair Market Value	*Policy*
Machinery A	$45,000	$14,143
Machinery B	25,000	7,857
Total	$70,000	$22,000

Insurance reimbursement equals:

$$\frac{\$7{,}857}{.8 \times \$25{,}000} \times \$5{,}000 = \$1{,}964$$

Answer = $1,964

When there is fire damage, the destroyed asset must be removed from the accounts, with the ensuring fire loss recorded based on book value. The insurance reimbursement reduces the fire loss. The fire loss is presented as an extraordinary item (net of tax).

EXAMPLE

XYZ Company experienced a fire. Inventory costing $10,000 was completely destroyed. The inventory was not insured. Equipment costing $20,000 with accumulated depreciation of $2,000 and having a fair market value of $14,000 is fully destroyed. The policy is for $20,000. A building costing $60,000 with accumulated depreciation of $6,000 and having a fair market value of $40,000 is half destroyed. The face of the policy is $30,000. The journal entries to record the book loss are:

Fire loss	10,000	
Inventory		10,000
Fire loss	18,000	
Accumulated depreciation	2,000	
Equipment		20,000
Fire loss	27,000	
Accumulated depreciation	3,000	
Building		30,000

Insurance reimbursement totals $32,750, calculated as follows:

Equipment: $\dfrac{\$20,000}{.8 \times \$14,000} \times \$14,000 = \$25,000$

Answer = $14,000

Building: $\dfrac{\$30,000}{.8 \times \$40,000} \times \$20,000 = \$18,750$

Answer = $18,750

The journal entry for the insurance reimbursement is:

cash	32,750	
Fire loss		32,750

The net fire loss is $22,250 ($55,000 - $32,750).

As per ASC 720-20-05-01, *Other Expenses: Insurance Costs*, amounts paid for retroactive insurance should be expensed immediately, and a receivable should be recorded at the same time for anticipated recoveries applicable to the underlying event.

Business Interruption Insurance

ASC 225-30-50-1, *Income Statement: Business Interruption Insurance*, requires disclosure of the event resulting in losses due to business interruption as well as the total amount received from insurance and where such amounts are presented in the income statement.

Restructuring Charges

SEC Staff Accounting Bulletin No. 67 requires restructuring charges to be expensed and presented as an element in computing income from operations.

In general, an expense and liability should be accrued for employee termination benefits in a restructuring. Disclosure should be made of the group and the number of workers laid off.

An exit plan requires the recognition of a liability for the restructuring charges incurred if there is no future benefit to continuing operations. The expense for the estimated costs should be made on the commitment date of the exit plan. Expected gains from assets to be sold in connection with the exit plan should be recorded in the year realized. These gains are *not* allowed to offset the accrued liability for exit costs. Exit costs incurred are presented as a separate item as part of income from continuing operations. Disclosures associated with an exit plan include the terms of the exit plan, description and amount of exit costs incurred, activities to be exited from, method of disposition, expected completion date, and liability adjustments.

Costs Associated With Exit or Disposal Activities

ASC 420-10-05-3, *Exit or Disposal Cost Obligations: Overall*, replaces EITF Consensus Summary No. 94-3. ASC 420-10-05-3 applies to costs (e.g., certain employee service costs, lease termination costs) associated with a discontinued operation, restructuring, plant closing, or other exit or disposal activity. Such costs must be recognized as incurred based on fair value along with the related liability. Thus, the company must actually incur the liabilities before recognition may be made.

The fair value of a liability is the amount the liability can be settled for in a current transaction between willing parties, that is, other than in a forced or liquidation transaction. The best indication of fair value is quoted market prices in active markets.

In years after initial measurement, changes to the liability should be measured based on the credit-adjusted risk-free rate that was used to initially measure the liability. The cumulative effect of a change arising from revising either the timing or the amount of estimated cash flows shall be recognized as an adjustment to the liability in the year of change and reported in the same line item(s) in the income statements used when the associated costs were recognized initially. Changes arising from the passage of time shall be recognized as an increase in the carrying value of the liability and as an expense.

Examples of costs associated with the exit or disposal activity include contract termination costs, one-time employee termination benefits, and costs to consolidate facilities or relocate employees.

Costs applicable to exit or disposal activities are included in income from continuing operations unless they apply to discontinued operations. If there is an occurrence that discharges a company's duty to settle a liability for a cost applicable to an exit or disposal activity recognized in a previous year, the liability and the related costs are reversed.

Footnote disclosure includes:

- A description of the exit or disposal activity and the anticipated completion date.
- For each major type of cost applicable to the exit activity, the total cost anticipated, the amount incurred in the current year, and the cumulative amount to date.
- Reconciliation of the beginning and ending liability balances presenting the changes during the year applicable to costs incurred and charged to expense, costs paid or otherwise settled, and any modifications of the liability along with the reasons of doing so.
- Where in the income statement or the statement of activities the costs are presented.
- If a liability for a cost is not recorded because fair value is not reasonably estimated, that should be noted along with the reasons.

Website Development Costs

As per ASC 350-50-55-1, *Intangibles—Goodwill and Other: Website Development Costs*, Web site development is segregated into three stages (activities) that affect the accounting treatment for expenditures incurred. During the initial stage, planning, the costs incurred are expensed. Development is the second stage, and it is here that the costs for Web application and infrastructure as well as graphics development are capitalized and then amortized once the Web site is ready for its intended use. (Costs to develop the content for the Web site may be capitalized or expensed, depending on the circumstances.) In the third stage of postimplementation, work is performed after the site is put into service (e.g., security, training, administration) and related costs are expensed as incurred. Also in the third stage are expenditures for additional upgrades and features once the Web site is launched; such costs attributable are capitalized if the upgrades and enhancements furnish *additional functionality*.

Income Statement Presentation Starting with Income from Continuing Operations

The income statement is shown in the following form beginning with income from continuing operations before taxes:

Income from continuing operations before taxes
Less: Taxes
Income from continuing operations
Discontinued operations
    Loss or gain from operations of discontinued component (including loss or gain on disposal)
    Less: Taxes
    Loss or gain from discontinued operations
Income before extraordinary item
Extraordinary item (net of tax)
Net income
    Less: Net income attributable to the noncontrolling interest
    Net income attributable to the controlling interest

ASC 260-10-50-1, *Earnings Per Share: Overall*, requires earnings per share disclosures for income from continuing operations, income before extraordinary items, and net income. If an entity has discontinued operations and extraordinary items as well, per share disclosures for those amounts may be shown either on the face of the income statement or in the notes to the financial statements.

Note: Equity in earnings of investees must be presented separately.

Review Questions - Section 1

1. For $50 a month, Abel Co. visits its customers' premises and performs insect control services. If customers experience problems between regularly scheduled visits, Abel makes service calls at no additional charge. Instead of paying monthly, customers may pay an annual fee of $540 in advance. For a customer who pays the annual fee in advance, Abel should recognize the related revenue

A. When the cash is collected.
B. At the end of the fiscal year.
C. At the end of the contract year after all of the services have been performed.
D. Evenly over the contract year as the services are performed.

2. When the right of return exists, all of the following criteria must be met before revenue is recognized EXCEPT that the

A. Amount of future returns can be reasonably estimated.
B. Seller's price to the buyer is substantially fixed at the date of the sale.
C. Buyer's obligation to the seller must be liquidated within 150 days from the date of the sale.
D. Buyer is obligated to pay the seller and the obligation is not contingent on the resale of the product.

3. An extraordinary item should be reported separately on the income statement as an item

A. Net of Income Taxes before Discontinued Operations of a Component of an Entity
B. Net of Income Taxes after Discontinued Operations of a Component of an Entity
C. Before Income Taxes and after Discontinued Operations of a Component of an Entity
D. Before Income Taxes and before Discontinued Operations of a Component of an Entity

4. A transaction that is unusual, but not infrequent, should be reported separately as a(n)

A. Extraordinary item, net of applicable income taxes.
B. Extraordinary item, but not net of applicable income taxes.
C. Component of income from continuing operations, net of applicable income taxes.
D. Component of income from continuing operations, but not net of applicable income taxes.

5. A public entity is required to follow the accounting methods recommended in ASC 718 Thus, its issuance of stock options to its employees, other than in a transaction with an employee stock ownership plan, will be accounted for using

A. A fair-value-based method.
B. An option-pricing model to determine the intrinsic value of the options.
C. An option-pricing model that excludes the stock volatility factor.
D. The Black-Scholes option-pricing model rather than the binomial model.

6. The major problem with option pricing using the Black-Sholes option pricing model in determining the option value is

A. The use of strike price and life span to the option.
B. The use of the stock price and the volatility of the stock.
C. That the true value of the worth of the option is only known when they are cashed in (expensed).
D. The dividend yield.

Discontinued Operations and Related Disposal of Long-Lived Asset Considerations

ASC 205-20-45-3, *Presentation of Financial Statements: Discontinued Operations*, requires that a long-lived asset that is to be sold by a company should be classified as *held for sale* when the following considerations are satisfied. If they are not all met (except as permitted by exceptions), the long-lived asset should be reclassified as held and used. The six considerations are:

1. Management agrees and commits to a plan to sell the asset. It is assumed that management has the requisite authority to approve such a commitment.

2. The asset is available for immediate sale in its present condition, restricted only by conditions that are usual and customary for sales of such assets. For example, an entity commits to sell land and a related building complex. It is believed that the time necessary to vacate the building will take a month, an amount of time that is considered usual and customary for such assets. The assets would be considered available for immediate sale at the plan commitment date. However, this status would not exist if the sale were predicated on the completion of a new building that the entity was planning to move into. The entity could not vacate the old building until the new one was complete. This constraint implies that the available-for-immediate-sale criterion would not have been met and could be met only when the construction of the new building was complete and ready to be moved into.

3. An active program has been initiated by the selling company to complete the sale.

4. Management considers the sale of the asset likely to occur. In addition, the time frame for recognition as a completed sales transaction is within one year unless circumstances beyond the entity's control would extend the period beyond this limit. For example, assuming that a leasing and finance company is currently holding equipment that has recently come off lease, it has not yet been decided whether the equipment should be sold or leased in the future. Because the form of the future transaction (sale or lease) has not yet been determined, the plan-of-sale criterion has not been met. (There is uncertainty as to whether the asset will be sold at all.) Exceptions to the one-year requirement are discussed in the following section.

5. The asset or group is currently being marketed at a price that is reasonable in relation to its fair value.

6. Based on information related to the plan to sell the asset or group, it is improbable that the plan will be withdrawn or that significant modifications will be made.

Exceptions to the One-Year Requirement That Must Exist for Held-for-Sale Classification

The following events and circumstances are considered beyond an entity's control and extend the period that is required by GAAP to complete the sale of a long-lived asset or group beyond one year:

1. An entity commits to a plan to sell a long-lived asset or group and expects that others (other than a buyer) will impose conditions on the transfer that will extend the period required to complete the sale and that (1) these conditions cannot be influenced until after a firm purchase commitment is obtained, and (2) the receipt of the firm purchase commitment is expected to occur within one year. For example, it is assumed that a regional utility plans to sell a group of assets that represents a significant portion of its operation. This action requires regulatory approval and therefore is expected to require more than one year to complete the sale. The one-year sale period requirement clearly will not be satisfied. Nevertheless, because approval of the sale cannot commence until after a buyer is identified and has given a firm purchase commitment, and because the receipt of said purchase commitment is probable within one year, the criteria for extending the sale of the asset beyond one year are satisfied.

2. A firm purchase commitment is obtained, and the buyer or others impose (unexpectedly) conditions on the transfer of the asset already classified as held for sale that will potentially extend the period required to consummate the sale. If (1) responsive actions to the delaying conditions have commenced or will commence on a timely basis, and (2) a favorable outcome to the delaying conditions is expected, then the period required to complete the sale of the asset may be extended beyond one year. For example, management commits to sell a plant and classifies the group of assets as held for sale. After a firm purchase commitment is obtained from the buyer, it is determined that extensive water damage exists as a result of long-term corrosion of the foundation that was previously unknown to the seller or buyer. The buyer requires that the seller repair the damage before the sale can be closed. However, it is estimated that the repairs will extend the period required to complete the sale beyond the one-year limit. The seller has already begun the repair of the damage and there is very little doubt that it will be completed to the total satisfaction of the buyer. The criteria for extending the sale of the asset beyond one year are satisfied.

3. Circumstances arise that were previously considered unlikely during the initial one-year period. As a result, the long-lived asset that was classified as held for sale is not sold at the end of that period, and (1) the entity initiated actions to respond to a change in circumstances within the initial one-year period; (2) the asset is being actively marketed at a price that is considered reasonable given the change of circumstances; and (3) all the criteria for a held-for-sale classification have been met. For example, an asset is held for sale and is not sold at the end of the one-year period because market conditions that existed at the date of classification have deteriorated. The entity did not receive any reasonable offers

to buy the asset during the initial period and, as a result, reduced its asking price. The asset continues to be marketed at a price that is reasonable given the downturn in market conditions. In these circumstances, the asset would continue to be classified as held for sale.

Other Held-for-Sale Considerations

If a newly acquired long-lived asset will be sold rather than held for use, it may be classified as such (held for sale) at the date of acquisition if (1) the one year requirement is met (unless the current circumstances satisfy the exception criteria) and (2) any other of the six criteria required for held-for-sale classification not met on that date are deemed likely to be met within a short period (usually three months) following acquisition.

If the six criteria required for held-for-sale classification are met in the subsequent events period (after the balance sheet date but before the financial statements are issued), the long-lived assets should continue to be classified as held and used in the financial statements when they are issued. If the asset is tested for recoverability on a held-and-used basis as of the balance sheet date, the estimates of future cash flows used in that test, including the cash flow from the future sale of the asset, should be considered as of the balance sheet date. This assessment made as of the balance sheet date should not be revised for a decision to sell the asset after the balance sheet date. In addition, if the carrying value of the asset exceeds its fair value at the balance sheet date, an impairment loss should be recognized.

Held-for-Sale Measurement Considerations

A held-for-sale long-lived asset or group should be measured *at the lower of its carrying amount or fair value less cost to sell* (see next paragraph). If newly acquired, the carrying value should be based on its fair value less cost to sell at the acquisition date. During the time it is classified as held for sale, a long-lived asset should not be depreciated.

Cost to sell includes broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred. These costs do not include any expected future losses associated with the operations of the long-lived asset while it is classified as being held for sale. A loss should be recognized and result in a downward adjustment to the carrying value of a long-lived asset for any initial or subsequent write-down to fair value less cost to sell. The carrying value should be written up for any subsequent increase in fair value less cost to sell but may never exceed the cumulative loss previously recognized. The gain or loss that is realized from the actual sale of a long-lived asset (that has not been previously recognized) should be recognized at the date of sale.

EXAMPLE

X Corporation decides to sell one of its *components* (a component comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity; also see the discussion on components in the subsection titled “Discontinued Operations” presented later) on June 15, 2X12, and classifies this disposal group as “held for sale.” At that date, the company reviews the fair value of the component to determine whether its carrying value needs to be adjusted downward. GAAP requires that a loss and downward adjustment to the carrying value of a long-lived asset group be recognized for any write-down to fair value less cost to sell. The carrying value of the component is $700,000 and its fair value is $700,000. The cost to sell is approximated to be $35,000. A loss of $35,000 and corresponding write-down of carrying value is computed in the following way. The fair value less cost to sell is $665,000 ($700,000 - $35,000), which is less than its carrying value ($665,000<$700,000). Therefore, the carrying value of the component is reduced only by the estimated cost to sell of $35,000. The loss to be recognized is $35,000 and the new carrying value of the disposal group is $665,000 ($700,000 -$35,000).

At the end of the year (December 31, 2X12), the company once again tests to see if the carrying value (adjusted) of the held-for-sale component exceeds fair value less cost to sell. The fair value of the component is now determined to be $685,000 and the estimated cost to sell remains at $35,000. The loss to be recognized is $15,000 ($665,000 - [$685,000 - $35,000]), and the new carrying value of the disposal group is determined to be $650,000. X Corporation would report a total loss for 2X12 relating to its decision to sell its component as $50,000 ($35,000 +$15,000).

Events and circumstances beyond the entity's control extend the period required to complete the sale of the component beyond one year. The fair value of the component at December 31, 2X13, has risen to $765,000. In addition, the estimated cost to sell remains at $35,000. A gain for the period should be recognized for $50,000 ([$765,000 - $35,000] - $650,000 = $80,000, but it is restricted to the previously recognized cumulative loss of $50,000 ($35,000 + $15,000). The adjusted carrying value of the component in this instance is $700,000 ($650,000 + $50,000). ASC 360-10-35 requires that a gain be recognized for any subsequent increase in fair value less cost to sell, but not in excess of the cumulative loss previously recognized for a write-down to fair value less cost to sell. Because the cumulative loss previously recognized (due to a write-down to fair value) was $50,000, the recognized recovery should be limited to this amount even though the fair value rose in excess of the original fair value ($700,000).

Changing the Decision to Sell

If an entity decides not to sell a long-lived asset that it previously had classified as held for sale, the asset should be reclassified as held and used and should be valued at the lower of its carrying value (before the asset was classified as held for sale and adjusted for any depreciation expense that would have been recognized had the assets been continuously classified as held and used) or fair value at the date of the subsequent decision not to sell. The adjustment to the carrying value should be included in income from continuing operations in the period in which the entity changed its decision not to sell. If a component of an entity is reclassified as held and used, it should be included in income from continuing operations for all periods presented.

If an entity decides to remove an individual asset or liability from a disposal group that was classified as held for sale, the remaining assets and liabilities of the disposal group should continue to be measured as a group, as long as the six held-for-sale criteria continue to be satisfied. If said criteria are not satisfied, the remaining assets should be measured individually at the lower of their carrying amounts or fair values less cost to sell at that date.

Discontinued Operations

For purposes of reporting discontinued operations, a component of an entity consists of operations and cash flows that can be clearly distinguished operationally and financially (from a reporting perspective) from the rest of the entity. A component of an entity may be (1) a reportable segment or an operating segment (ASC 280-10-50-10, *Segment Reporting: Overall*); (2) a reporting unit (ASC 350-20-55-1); (3) a subsidiary; or (4) asset group as discussed in this statement. For example, if an entity manufactures and markets consumer products that have several product groups each with different product lines and brands, a product group for that entity is the lowest level at which the operations and cash flow can be clearly distinguished operationally and financially from the rest of the entity. Each product group of the entity would be considered a component of an entity for purposes of reporting in discontinued operations. Other illustrations of components that would and would not qualify for component classification are discussed in the next section.

Classification as a Discontinued Operation

When a component of an entity has been disposed of or is classified as held for sale, its results of operations should be reported in the discontinued operations section of the entity's income statement if the two following criteria are met:

1. 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; and

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

The following are examples of scenarios that do and do not qualify for discontinued operations reporting:

- An entity makes the decision to leave the electronics business and decides to sell its entire product group with its operations. Its electronics business is classified as held for sale at this date. After it is sold, the operations and cash flow of the product group will be eliminated from the ongoing operations of the entity and the entity will not have continuing involvement in the operations of the business. While the electronics business is classified as held for sale, it should be reported in the discontinued operation section of the income statement. If, on the other hand, the company decides not to discontinue its entire electronic business but to sell only the brands of the product group that are losing money, discontinued operations disclosure would not be warranted. The reason for this is that the failing brands are only a part of a larger cash-flow-generating product group of the entity and by themselves could not be so classified. Therefore, the losing brands do not represent a component of the entity and should not be disclosed as a discontinued operation.

- An entity owns and operates a group of small factories around the country that manufactures products for the home. For that entity, each factory represents the lowest level at which operations and cash flows as can be distinguished operational and for financial statement reporting purposes from the rest of the entity. In this situation, each factory represents a component of the entity. The entity decides to expand its operations and open a larger factory that replaces a smaller factory. The larger factory will continue to manufacture the products that the other smaller one did in addition to other related products that were not produced. Although each factory does represent a component of the entity, the closure of a smaller factory should not be reported in the discontinued operations of the entity, because the operations and cash flows from the manufacture of products for the home through the smaller factory will not be eliminated from the ongoing operations of the entity but will be perpetuated in the expanded factory.

- An entity that manufactures sporting goods has several divisions, one of which is a ski division that designs, manufactures, and distributes skis. Each division is the lowest level at which operations and cash flows can be easily distinguished from the ongoing operation of the entity. Therefore, the ski division is a component of the entity. The entity decides to remain in the ski business but outsource the manufacturing operations and commits itself to sell the ski-related manufacturing operations. At that date, the manufacturing facility is classified as held for sale. Because the ski manufacturing facility is only part of the larger cash-generating ski component and therefore by itself not a component of the entity, the manufacturing operations alone would not be disclosed as discontinued operations. In addition, even if the ski manufacturing operations qualified as a component of the entity, the decision to outsource the manufacturing operations alone would not be sufficient to include it in the discontinued operations section of the income statement, because this action would not eliminate the operations and cash flows of the ski division from the ongoing operations of the entity.

Reporting the Gain or Loss from Operations of the Discontinued Component

When the component of an entity either has been disposed of or is classified as held for sale, the income statement of the entity for the current and prior periods should report the results of operations of the component, including any gain or loss on disposal in the discontinued operations section of the income statement. The results of operations of a component classified as held for sale should be reported in discontinued operations in the period in which they occur. In addition, the results of operations less applicable income taxes (benefit) should be reported as a separate component of income after income from continuing operations and before extraordinary items and the cumulative effect of accounting changes if applicable. The following is an example of a format that may be followed:

Income from continuing operations before income taxes	$XXXX	
Income taxes	XXX	
Income from continuing operations		$XXXX
Discontinued operations (note X)		
Loss from operations of the discontinued Component Y (including loss on disposal of $XXX)		XXXX
Income tax benefit		XXX
Loss on discontinued operations		$XXXX
Net income		$XXXX
Less: Net income attributable to the noncontrolling interest		(XXX)
Net income attributable to the controlling interest		$XXX

The gain or loss on disposal may be disclosed either on the face of the income statement (as shown in the preceding example) or in the notes to the financial statements. If the disposal of a component of an entity took place in a prior period and adjustments to this previously reported amount must be made, it should be disclosed separately in the current period in discontinued operations. In addition, the nature and amount of such adjustments must be disclosed (e.g., the settlement of employee benefit plan obligations such as pension, postemployment benefits other than pensions, and other postemployment benefits that are directly related to the disposal transaction).

EXAMPLE

X Corporation's held-for-sale component (discussed in the example from the previous Held-for-Sale Measurement Considerations section) is sold on December 2, 20X3, and meets both criteria for discontinued operations disclosure. The proceeds of the sale of the component is $730,000 (sales price of $765,000 less cost to sell of $35,000). In addition, the results of operations of the discontinued component resulted in a loss of $360,000 during 20X3 (January 1 through December 2, 20X3). The gain on the sale of the discontinued component is $30,000 (net proceeds of $730,000 less carrying value of $700,000 at December 31, 2X13). For disclosure purposes, the loss from operations of the discontinued component nets to $330,000 ($360,000 - $30,000). It would be disclosed in the discontinued operations section of the entity's income statement as follows:

Income from operations before income taxes		$XXXX
Income taxes		XXX
Income from continuing operations		$XXXX
Discontinued operations (note X)		
Loss from operations of discontinued operations (including gain on disposal of $30,000)	$330,000	
Less income tax benefit (40% tax rate)	132,000	
Loss on discontinued operations		198,000

Other considerations. A recognized gain or loss from a disposal that is not considered a component of an entity should be included in income from continuing operations before income taxes. All long-lived assets that are classified as held for sale should be presented separately in the balance sheet. In addition, the assets and liabilities of a disposal group that are classified as held for sale must be presented separately in the asset and liability sections of the balance sheet. They should not be offset and presented as a single amount. The major classes of assets and liabilities classified as held for sale should be separately disclosed either on the face of the balance sheet or in the notes to the financial statements.

ASC 205-20-45-3, *Presentation of Financial Statements: Discontinued Operations*, and 360-10-55-42, *Property, Plant, and Equipment: Overall*, provide guidance on when a component of an entity should be reported in discontinued operations if the entity will have cash flows from, or continuing involvement in, the component that is disposed of or held for sale. Classification of a disposed component is appropriate only if the ongoing entity has *no* continuing direct cash flows and does *not* retain an interest, contract, or other arrangement to enable it to exercise significant influence over the disposed component's operating and financial policies after the disposal transaction.

Reporting and Disclosure—Long-Lived Asset or Disposal Group That Has Been Sold or Is Classified For Sale

The following data should be disclosed in the notes to the financial statements in the period in which a long-lived asset or disposal group either has been sold or is classified for sale:

- A description of the facts and data leading to the expected disposal, the expected manner and timing of that disposal, and if not separately presented on the face of the statement, the carrying amounts of the major classes of assets and liabilities included as part of a disposal group.
- The loss recognized for any initial or subsequent write-down to fair value less cost to sell or the gain recognized for any subsequent increase in fair value less cost to sell, but not in excess of the cumulative loss previously recognized as a result of a write-down to fair value. If the long-lived asset (disposal group) has been sold, the gain or loss not previously recognized from the sale should be recognized at the date of sale. If the gain or loss is not separately presented on the face of the income statement, the disclosure should include the caption in the income statement that includes that gain or loss.
- The amounts of revenue and pretax profit or loss reported in discontinued operations, if applicable.
- The reportable segment in which the long-lived asset or disposal group is reported, if applicable (ASC 280-10-50-1).

Extraordinary Gains and Losses

Extraordinary items are material in nature and are both infrequent (not expected to occur in the foreseeable future) and unusual (abnormal, not typical) given the environment of the company. The corporate environment considers such factors as industry attributes, geographic locality, regulatory requirements, economic characteristics, lines of business, and nature of operations.

Note: An occurrence is not deemed unusual just because it is beyond management's control. Extraordinary items are presented net of tax. Earnings per share is shown on them. What is extraordinary for one company may not necessarily be extraordinary for another. In some cases, amounts reported for extraordinary items are based on estimates and may need adjustment in later years.

Materiality is a concern. In applying materiality, items should be examined individually rather than in the aggregate. However, if the items arise from one particular event, they may be combined.

Examples of extraordinary items follow:

- Gain on troubled debt restructuring.
- Gain on certain types of life insurance proceeds.
- Catastrophe and casualty losses (e.g., earthquake, fire).
- Loss arising from a prohibition because of a new law or regulation.
- Loss from governmental expropriation of property.
- Gain or loss on the disposal of a major part of the assets of the previously separate companies arising from a business combination that are disposed of within two years subsequent to the consummation date.
- Receipt of Federal Home Loan Mortgage Corporation participating preferred stock.
- Write-off of interstate operating rights of motor carriers.

Note: Losses on inventory and receivables relate to the normal operations of a business and thus are not extraordinary. However, such losses would be extraordinary if they arose from a catastrophe (e.g., hurricane) or from government seizure or government-forced destruction (e.g., the government forces a company to destroy its existing inventory of a certain chemical just proven to cause cancer).

The following items are *not* considered extraordinary:

- Impact of a strike.
- Modifications to long-term contracts.
- Costs incurred to defend against a takeover attempt as per ASC 225-20-55-4, *Income Statement: Extraordinary and Unusual Items*.

Disclosures required for extraordinary items include the nature of the transaction and the major considerations in determining the amounts.

For example, Exhibit 7 shows how Keystone Consolidated Industries reported an extraordinary loss.

Exhibit 7: Income Statement Presentation of Extraordinary Items

Keystone Consolidated Industries, Inc.	
Income before extraordinary item	$11,638,000
Extraordinary item—flood loss (Note E)	1,216,000
Net income	$10,422,000

Note E Extraordinary Item. The Keystone Steel and Wire Division's Steel Works experienced a flash flood on June 22. The extraordinary item represents the estimated cost, net of related income taxes of $1,279,000, to restore the steel works to full operation.

FAS-4, *Reporting Gains and Losses from Extinguishment of Debt*, was repealed by ASC 470-50-45-1, *Debt: Modifications and Extinguishments*. As a result, gains and losses from early extinguishment of debt are no longer considered extraordinary. A recent study indicated that the bulk of extraordinary items reported by companies were, in fact, gains and losses from early extinguishment of debt. As a result, very few public companies have reported extraordinary items subsequent to passage of ASC 470-50-45-1.

Earnings per Share

ASC 260-10, *Earnings Per Share: Overall*, covers the computation, reporting, and disclosures associated with earnings per share. It requires public companies to present earnings per share **on the face of the income statement**. (Nonpublic entities are not required to present earnings per share.) If the entity's capital structure is simple—that is, it has no potentially dilutive securities—only basic earnings per share needs to be disclosed. However, if the capital structure is complex (it includes potentially dilutive securities), then presentation of both basic and diluted earnings per share is mandated.

Basic earnings per share takes into account only the actual number of outstanding common shares during the period (and those contingently issuable in certain cases).

Diluted earnings per share includes the effect of common shares actually outstanding and the impact of convertible securities, stock options, stock warrants, and their equivalents if dilutive. Diluted earnings per share should not assume the conversion, exercise, or contingent issuance of securities having an antidilutive effect (increasing earnings per share or decreasing loss per share) because it violates conservatism.

According to ASC 260-10-05-5, *Earnings Per Share: Overall*, under the two-class method, the presentation of basic and diluted earnings per share for all participating securities is not required. ASC 260-10-45, 59A-60, 55 and 71-75 states that a participating security is one that may participate in undistributed earnings with common stock, whether that participation is conditional upon an event happening or not. The participation need *not* be a dividend, so any form of participation in earnings would qualify. Allocation of earnings is based on a predetermined formula with, at times, an upper limit on the extent of participation. EITF requires the two-class method to compute earnings per share for companies with participating securities or multiple classes of common stock.

Basic Earnings per Share

Basic earnings per share equals net income available to common stockholders divided by the weighted-average number of common shares outstanding. Net income available to common stockholders is net income less declared preferred stock dividends for the current year. If the preferred stock is noncumulative, preferred stock dividends are subtracted only if they are declared during the period. On the other hand, if the preferred stock is cumulative, the dividends are subtracted even if they are not declared in the current year. The weighted-average number of common shares outstanding is determined by multiplying the number of shares issued and outstanding for any time period by a fraction, the numerator being the number of months the shares have been outstanding and the denominator being the number of months in the period (e.g., 12 months for annual reporting).

EXAMPLE

On January 1, 2X13, 100,000 shares were issued. On October 1, 2X13, 10,000 of those shares were reacquired. The weighted-average common shares outstanding equals 97,500 shares, computed as follows:

1/1/2X13-9/30/2X13	(100,000 × 9/12)	75,000
10/1/2X13-12/31/2X13	(90,000 × 3/12)	22,500
Weighted outstanding common shares		97,500

EXAMPLE

On January 1, 2X13, 10,000 shares were issued. On April 1, 2X13, 2,000 of those shares were bought back. The weighted-average common stock outstanding is 8,500 shares computed as follows:

1/1/2X13-3/31/2X13	(10,000 × 3/12)	2,500
4/1/2X13-12/31/2X13	(8,000 × 9/12)	6,000
Weighted outstanding common shares		8,500

If a stock dividend or stock split has been issued for the period, it is presumed that such stock dividend or split was issued at the beginning of the period. Thus, stock dividends or stock splits are weighted for the entire period, regardless of the fact that they were issued during the period. Further, when comparative financial statements are prepared, the issuance of a stock dividend or stock split requires retroactive restatement of each previous year's earnings per share to give effect to the dividend or split for those prior years.

EXAMPLE

The following occurred during the year regarding common stock:

Shares outstanding—1/1	30,000
2-for-1 stock split—4/1	30,000
Shares issued—8/1	5,000

The common shares to be used in the denominator of basic EPS is 62,083 shares, computed as follows:

1/1-3/31	30,000 × 3/12 × 2	15,000
4/1-8/1	60,000 × 4/12	20,000
8/1-12/31	65,000 × 5/12	27,083
Total		62,083

EXAMPLE

On December 1, 2X13, a company declared and issued an 8% stock dividend on its 200,000 outstanding common shares. The number of common shares to be used in determining basic EPS is $216,000 (200,000 shares × 108%).

EXAMPLE

In 20X3, a 15% stock dividend occurs. The weighted-average shares used for previous years' computations has to be increased by 15% to make basic EPS comparable.

EXAMPLE

The following information is presented for a company:

Preferred stock, $10 par, 6% cumulative, 30,000 shares issued and outstanding	$300,000
Common stock, $5 par, 100,000 shares issued and outstanding	500,000
Net income	400,000

The company paid a cash dividend on preferred stock. The preferred dividend would therefore equal $18,000 (6% × $300,000). Basic EPS equals $3.82, computed as follows:

EARNINGS AVAILABLE TO COMMON STOCKHOLDERS

Net income	$400,000
Less: preferred dividends	(18,000)
Earnings available to common stockholders	$382,000

Basic EPS = $382,000/100,000 shares = $3.82.

EXAMPLE

On January 1, 2X13, Dauber Company had the following shares outstanding:

6% Cumulative preferred stock, $100 par value	150,000 shares
Common stock, $5 par value	500,000 shares

During the year, the following occurred:

- On April 1, 2X13, the company issued 100,000 shares of common stock.
- On September 1, 2X13, the company declared and issued a 10% stock dividend.
- For the year ended December 31, 2X13, the net income was $2,200,000.

Basic earnings per share for 2X13, equals $2.06 ($1,300,000/632,500 shares), calculated as follows:

EARNINGS AVAILABLE TO COMMON STOCKHOLDERS

Net income		$2,200,000
Less: preferred dividend	(150,000 shares × $6)	(900,000)
Earnings available to common stockholders		$1,300,000

WEIGHTED-AVERAGE NUMBER OF OUTSTANDING COMMON SHARES

1/1/2X13-3/31/2X13	(500,000 × 3/12 × 110%)	137,500
4/1/2X13-8/31/2X13	(600,000 × 5/12 × 110%)	275,000
9/1/2X13-12/31/2X13	(660,000 × 4/12)	220,000
Weighted-average outstanding common shares		632,500

Diluted Earnings per Share

If potentially dilutive securities are outstanding, such as convertible bonds, convertible preferred stock, stock options, or stock warrants, both basic and diluted earnings per share must be presented.

In the case of convertible securities, the *if-converted method* must be used. Under this approach, it is assumed that the dilutive convertible security is converted into common stock at the beginning of the period or date of issue, if later. If conversion is assumed, the interest expense (net of tax) that would have been incurred on the convertible bonds must be added back to net income in the numerator. Any dividend on convertible preferred stock would also be added back (dividend savings) to net income in the numerator. The add-back of interest expense (net of tax) on convertible bonds and preferred dividends on convertible preferred stock results in an adjusted net income figure used to determine earnings per share. Correspondingly, the number of common shares the convertible securities are convertible into (or their weighted-average effect if conversion to common stock actually took place during the year) must also be added to the weighted-average outstanding common shares in the denominator.

ASC 260-10-55-1, *Earnings Per Share: Overall*, provides that issued securities with embedded conversion features (e.g., contingently convertible debt or preferred stock) contingently exercisable upon the occurrence of a market-price condition should be part of the computation of diluted EPS irrespective of whether the market price trigger has been satisfied.

In the case of dilutive stock options, stock warrants, or their equivalent, the *treasury stock method* is used. Under this approach, there is a presumption that the option or warrant was exercised at the beginning of the period, or date of issue if later. The assumed proceeds received from the exercise of the option or warrant are assumed to be used to buy treasury stock at the average market price for the period. However, exercise is presumed to occur only if the average market price of the underlying shares during the period is greater than the exercise price of the option or warrant. This presumption ensures that the assumed exercise of a stock option or warrant will have a dilutive effect on the earnings-per-share computation. Correspondingly, the denominator of diluted earnings-per-share increases by the number of shares assumed issued owing to the exercise of options or warrants reduced by the assumed treasury shares purchased.

EXAMPLE

One hundred shares are under a stock option plan at an exercise price of $10. The average market price of stock during the period is $25. Exercise is presumed to occur because the average market price of the stock for the period ($25) is greater than the exercise price ($10). The assumed issuance of common shares is computed as 60, as follows:

Proceeds from assumed exercise of stock option plan:	100 shares × $10 =	$1,000
Number of shares needed from assumed exercise of stock option plan:		100 shares

Less: Number of shares of treasury stock assumed acquired ($1000/$25)	40 shares
Additional shares that must be issued to satisfy stock option holders	60 shares

Alternatively, the computation may be done using the following formula:

Assumed issuance of additional common shares under the Treasury Stock Method used to satisfy option holders = Average market price of Stock-Exercise Price/Average market price of the stock × Number of shares under the stock option plan

= $25 - $10/$25 × 100 shares

= $15/$25 × 100 shares

= 60 shares

If options are granted as part of a stock-based compensation arrangement, the assumed proceeds from the exercise of the options under the treasury stock method include deferred compensation and the resulting tax benefit that would be credited to paid-in-capital arising from the exercise of the options.

As a result of the if-converted method for convertible dilutive securities and the treasury stock method for stock option plans and warrants, the denominator of diluted-earnings-per-share computation equals the weighted-average outstanding common shares for the period plus the assumed issue of common shares arising from convertible securities plus the assumed shares issued because of the exercise of stock options or stock warrants, or their equivalent.

Exhibit 8 shows in summary form the earnings-per-share fractions.

Exhibit 8: Earnings-per-Share Fractions

BASIC EARNINGS PER SHARE =

$$\frac{\text{Net income available to common stockholders}}{\text{Weighted average number of common shares outstanding}}$$

DILUTED EARNINGS PER SHARE =

Net income available to common stockholders + net of tax
interest and/or dividend savings on convertible securities

Weighted-average number of common shares outstanding + effect of convertible securities + net effect of stock options

EXAMPLE

This example assumes the same information about the Dauber Company given in the example from the previous section, Basic Earnings per Share. It is further assumed that potentially dilutive securities outstanding include 5% convertible bonds (each $1,000 bond is convertible into 25 shares of common stock) having a face value of $5,000,000. There are options to buy 50,000 shares of common stock at $10 per share. The average market price for common shares is $25 per share for 2X13. The tax rate is 30%.

Basic Earnings per Share

$$\frac{\text{Net income available to common stockholders}}{\text{Weighted-average number of common shares outstanding}} =$$

$$\frac{\$1{,}300{,}000}{632{,}500} = \quad \$2.06$$

Diluted Earnings per Share

Income for diluted earnings per share:		
Earnings available to common stockholders		$1,300,000
Interest expense on convertible bonds ($5,000,000 × .05)	$250,000	
Less: tax savings ($250,000 × .30)	(75,000)	
Interest expense (net of tax)		$ 175,000
Income for diluted earnings per share		$1,475,000

Shares outstanding for diluted earnings per share:		
Weighted-average outstanding common shares		632,500
Assumed issued common shares for convertible bonds (5,000 bonds × 25 shares)		125,000
Assumed issued common shares from exercise of option	50,000	
Less: assumed repurchase of treasury shares (50,000 × $10 = $500,000/$25)	(20,000)	30,000
Shares outstanding for diluted earnings per share		787,500

Diluted earnings per share for 2X13 is $1.87 ($1,475,000/787,500 shares). Diluted earnings per share must be disclosed because the two securities (the 5% convertible bond and the stock options) had an aggregately dilutive effect on earnings per share. That is, earnings per share decreased from $2.06 to $1.87. The required disclosures are indicated as follow:

EARNINGS-PER-SHARE DISCLOSURE

Basic earnings per share	$2.06
Diluted earnings per share	$1.87

Antidilutive Securities

In computing earnings per share, all antidilutive securities should be ignored. A security is considered to be antidilutive if its inclusion does not cause earnings per share to go down. In computing earnings per share, the aggregate of all dilutive securities must be considered. However, in order to exclude the ones that should not be used in the computation, it is necessary to ascertain which securities are individually dilutive and which ones are antidilutive. As was previously noted, a stock option will be antidilutive if the underlying average market price of the stock that can be purchased for the period is less than the exercise price of the option. A convertible security is antidilutive if the exercise of the convertible bond or preferred stock causes an increase in the earnings-per-share computation compared to that derived before the assumed conversion. In this situation, the additive effect to the numerator and denominator as a result of the conversion causes earnings-per-share to increase. In both of these situations, the antidilutive securities should be ignored in the calculation.

EXAMPLE

A company's net income for the year is $100,000. A 10% $2,000,000 convertible bond was outstanding all year that was convertible into 2,000 shares of common stock. The weighted-average number of shares of common stock outstanding all year was 200,000. The income tax rate was 30%.

BASIC EARNINGS PER SHARE

$$\frac{\$100{,}000}{200{,}000} = \$.50$$

DILUTED EARNINGS PER SHARE

$$\frac{\$100{,}000 + 200{,}000(1\text{-}30\%)}{200{,}000 + 2{,}000} = \frac{\$240{,}000}{202{,}000} = \$1.19$$

Because earnings per share increased as a result of the inclusion of the convertible bond, the bond is antidilutive and should be excluded from the calculation. Only basic earnings per share should be disclosed here.

EXAMPLE

Davis Company has basic earnings per share of $14 for 2X13. There were no conversions or exercises of convertible securities during the year. However, possible conversion of convertible bonds would have reduced earnings per share by $2. The impact of possible exercise of stock options would have increased earnings per share by $.38. Diluted earnings per share for 2X13 equals $12 ($14-$2). **Note:** The dilutive convertible bonds are considered in deriving diluted earnings per share, but the stock options are ignored because they have an antidilutive effect.

Share-Based Payment Transactions

ASC 260-10-45-61A, *Earnings Per Share: Overall*, provides guidance in calculating earnings per share for share-based payment awards with dividend rights. Unvested share-based payment awards that have nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are considered participating securities and are includable in the EPS calculation under the two-class method.

Earnings per Share and Specialized Disclosures on the Income Statement

When net income of a given period includes specialized activities disclosures, including income or loss from discontinued operations, extraordinary items, and the cumulative effect of change of accounting principle, **earnings-per-share disclosure is required for each of these categories.** GAAP requires that per-share amounts for each of these amounts be shown either on the face of the income statement or in the notes to the financial statements.

Business Combinations

If a subsidiary has been acquired under the purchase or acquisition methods during the year, the weighted-average shares outstanding for the year are used from the purchase date.

Disclosures

Basic earnings per share and diluted earnings per share (if required) for income from continuing operations and net income must be disclosed on the face of the income statement. In addition, the earnings-per-share effects associated with the disposal of a business segment, and extraordinary gains or losses, must be presented either on the face of the income statement or notes thereto.

A reconciliation is required of the numerators and denominators for basic and diluted earnings per share. Disclosure is also mandated for the impact of preferred dividends in arriving at income available to common stockholders.

Other disclosures include:

- Information on the capital structure.
- Assumptions made.
- Number of shares converted.
- Rights and privileges of securities, such as dividend and participation rights, call prices, and conversion ratios.

Review Questions – Section 2

7. For the purpose of reporting discontinued operations, a component of an entity is best defined as

A. An operating segment or one level below an operating segment.
B. A set of operations and cash flows clearly distinguishable from the rest of the entity for operational and financial reporting purposes.
C. A separate major line of business or class of customer.
D. A significant disposal group.

8. With respect to the computation of earnings per share, which of the following would be most indicative of a simple capital structure?

A. Common stock, preferred stock, and convertible debt outstanding.
B. Common stock, convertible preferred stock, and debt outstanding.
C. Common stock, preferred stock, and debt outstanding.
D. Common stock, preferred stock, and stock options outstanding.

9. With regard to stock dividends and stock splits, current authoritative literature contains what general guideline for the computation of EPS?

A. If changes in common stock resulting from stock dividends, stock splits, or reverse splits have been consummated after the close of the period but before completion of the financial report, the per-share computations should be based on the new number of shares.
B. It is not necessary to give recognition to the effect on prior periods' computations of EPS for stock dividends or stock splits consummated in the current period.
C. Computations of EPS for prior periods must give recognition to changes in common shares due to stock splits, but not stock dividends, because stock dividends have an immaterial effect on EPS.
D. Footnote disclosure is necessary for anticipated stock dividends and stock splits and their effect on basic earnings per share and diluted earnings per share.

10. Poe Co. had 300,000 shares of common stock issued and outstanding at December 31, 2X12. No common stock was issued during 2X13. On January 1, 2X13, Poe issued 200,000 shares of nonconvertible preferred stock. During 2X13, Poe declared and paid $75,000 of cash dividends on the common stock and $60,000 on the preferred stock. Net income for the year ended December 31, 2X13 was $330,000. What should be Poe's 2X13 basic earnings per common share?

A. $1.10
B. $0.90
C. $0.85
D. $0.65

11. In computing the weighted-average number of shares outstanding during the year, which of the following midyear events must be treated as if it had occurred at the beginning of the year?

A. Declaration and distribution of a stock dividend.
B. Purchase of treasury stock.
C. Sale of additional common stock.
D. Sale of preferred convertible stock.

12. Deck Co. had 120,000 shares of common stock outstanding at January 1, 2X13. On July 1, 2X13, it issued 40,000 additional shares of common stock. Outstanding all year were 10,000 shares of nonconvertible cumulative preferred stock. What is the number of shares that Deck should use to calculate 2X135 basic earnings per share (BEPS)?

A. 140,000
B. 150,000
C. 160,000
D. 170,000

13. Earnings per share disclosures are required for

A. Companies with complex capital structures only.
B. Companies that change their capital structures during the reporting period.
C. Public companies only.
D. Public and private companies.

14. The income statement presents data for primary and fully diluted per share for which of the following?

A. Discontinued Operations and Extraordinary Items, but not Cumulative Effect of Accounting Changes
B. Extraordinary Items and Cumulative Effect of Accounting Changes, but not Discontinued Operations
C. Discontinued Operations and Cumulative Effect of Accounting Changes, but not Extraordinary Items
D. Discontinued Operations, Extraordinary Items, and Cumulative Effect of Accounting Changes

Comprehensive Income

ASC 220-10-15-2, *Comprehensive Income—Scope and Scope Exceptions*, requires companies (including investment companies) to report comprehensive income and its components in a complete set of financial statements. (**The pronouncement does not apply to nonprofit entities.)** ASC 220-10-45-7 retains the present reporting requirements for net income, including its major components (e.g., income from continuing operations, income from discontinued operations, and extraordinary items), but it considers net income a major element of comprehensive income. A restatement of prior years' financial statements is required when presented for comparative purposes.

Comprehensive income refers to the change in equity (net assets) arising from either transactions or other occurrences with nonowners. Excluded are investments and withdrawals by owners. Hence, a synonymous phrase for comprehensive income is total nonowner changes in equity. **Comprehensive income consists of two components: net income and other comprehensive income.** Other comprehensive income applies to all items of comprehensive income excluding net income. Thus, **net income plus other comprehensive income equals total comprehensive income.**

Other comprehensive income (OCI) items include the following:

- Foreign currency items, including translation gains and losses, and gains and losses on foreign currency transactions designated as hedges of a net investment in a foreign entity;
- Holding losses or gains on available-for-sale securities;
- Gain or loss on a pension plan; and
- Changes in market value of a futures contract that is a hedge of an asset reported at fair value.

ASC 220-10-45-1, 1A, 1B, and 1C discuss the requirements for reporting comprehensive income. These sections require an entity to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements.

If comprehensive income is presented in a single continuous financial statement, then two sections, net income and other comprehensive income, must be disclosed. If two separate but consecutive statements are shown, then an income statement is presented first followed by a statement of other comprehensive income. GAAP requires, in both choices, that the following be presented: (1) each component of net income along with total net income, (2) each component of other comprehensive income along with a total for other comprehensive income, and (3) a total amount for comprehensive income.

A sample presentation of the single continuous financial statement option follows:

X Company
Statement of Comprehensive Income
For the Year Ended December 31, 2X13

Sales revenues			$1,301,000
Expenses			(400,000)
Income from operations			$ 901,000
Other gains and losses			$ 95,000
Income before taxes			$ 996,000
Income tax expense			(196,000)
Net Income			$ 800,000
EPS:			
Basic and diluted	$0.79		
Other comprehensive income, net of tax			
Foreign currency translation gain		$40,000	
Unrealized loss on available-for-sale securities		(5,000)	
Loss on pension plan		(3,000)	
Other comprehensive income			$ 32,000
Comprehensive Income			$ 832,000

A sample presentation of the two statement options is shown below:

X Company
Income Statement
for the Year Ended December 31, 2X13

Sales revenues		$1,301,000
Expenses		(400,000)
Income from operations		$ 901,000
Other gains and losses		$ 95,000
Income before taxes		$ 996,000
Income tax expense		(196,000)
Net Income		$ 800,000
EPS:		
Basic and diluted	$0.79	

X Company Statement of Comprehensive Income

For the Year Ended December 31, 2X13

Net income		$800,000
Other comprehensive income, net of tax		
Foreign currency translation gain	$40,000	
Unrealized loss or gain on available-for-sale securities	(5,000)	
Loss on pension plan	(3,000)	
Other comprehensive income		$ 32,000
Comprehensive Income		$ 832,000

ASC 220-10-45-11 notes that, for both presentations, the elements of other comprehensive income for the year may be presented on either a net-of-tax basis or a before-tax basis, with one amount for the tax effect of all the items of other comprehensive income. In addition, ASC 220-10-45-12 indicates that the amount of income tax expense or benefit allocated to each component of other comprehensive income, including reclassification adjustments, be presented in the statement in which these components are presented or in the notes to the financial statements.

At the end of the period, the total of other comprehensive income should be transferred to a component of stockholders' equity called accumulated other comprehensive income (AOCI) which should be presented in the Statement of Financial Position separately from retained earnings and additional paid in capital. ASC 220-10-45-14A requires that an entity present on the face of the financial statements or as a separate disclosure in the notes, the changes in the accumulated balances for each component of other comprehensive income included in AOCI. The presentation of these changes on the face of the financial statements, for example, may be presented as a reconciliation in the statement of changes in stockholders' equity.

A reclassification adjustment should be made so as not to double-count items reported in net income for the current year that have also been taken into account as part of other comprehensive income in a prior year. An example is the realized gain on an available-for-sale security sold in the current year when an unrealized (holding) gain was also included in other comprehensive income in a prior year. Besides an available-for-sale security, reclassification adjustments may apply to foreign currency translation. The reclassification adjustment associated with foreign exchange translation applies only to translation gains and losses realized from the sale or liquidation of an investment in a foreign entity. ASC 220-10-45-17 requires an entity to present reclassification adjustments and the effect of those adjustments on net income and other comprehensive income in the statement in which the components of net income and the components of other comprehensive income are presented. An illustration of this is shown below:

EXAMPLE

On January 1, 2X12, a company bought 1,000 shares of available-for-sale securities having a market price per share of $100. On December 31, 2X12, the available-for-sale securities had a market price of $150 per share. On January 1, 2X13, the securities were sold at a market price of $130. The tax rate is 30%.

The unrealized gain or loss included in other comprehensive income is computed as follows:

	Before Tax	*Tax Effect at 30%*	*Net of Tax*
2X12 (1000 × $50)*	$50,000	$15,000	$35,000
2X13 (1000 × $20**)	(20,000)	(6,000)	(14,000)
Total gain	$30,000	$ 9,000	$21,000

* $150 - $100 = $50

** $150 - $130 = $20

The presentation in the income statement for 2X12 and 2X13 follows:

	2X12	*2X13*
Net income		
Gross realized gains in available-for-sale securities		$30,000
Tax expense		9,000
Net realized gain		$21,000
Other comprehensive income:		
Unrealized gain or loss after tax	$35,000	(14,000)
Reclassification adjustment net of tax		(21,000)
Net gain included in other comprehensive income	$35,000	($35,000)
Total effect on comprehensive income	$35,000	($14,000)

In interim financial statements issued to the public, ASC 220-10-45-18 requires a company to present the components of net income and other comprehensive income, as well as total comprehensive income in condensed financial statements of interim periods.

IFRS CONNECTION

The statement of equity must not report the components of comprehensive income.

Disclosures Associated with Operations

Disclosure should be provided about the company's primary products and services, including major markets by geographic area. This information enables a proper assessment of an entity's nature of operations. In addition, ASC 275-10-55-3, *Risks and Uncertainties: Overall*, requires disclosure of major risks and uncertainties facing the business. It also requires disclosure in the significant accounting policies footnote that the financial information presented is based on management's estimates and assumptions. Reference should also be made that actual results may differ from such estimates.

Personal Financial Statements

AICPA Statement of Position (SOP) 82-1**,** *Accounting and Financial Reporting for Personal Financial* Statements, requires personal financial statements to present assets at their estimated current values. The estimated current value of an asset is defined as “the amount at which the item could be exchanged between a buyer and seller, each of whom is well informed and willing, and neither of whom is compelled to buy or sell.” Material costs of disposal should be considered in making the estimate. Current value may be based on discounted cash flow, market price, appraisal value, or other basis depending on the asset. Appraisal value is appropriate for works of art. SOP 82-1 further specifies that investments in life insurance be reported at their cash values minus the amount of any outstanding loans.

Liabilities, including payables, should be presented at their estimated current amounts at the date of the statement. The estimated current amount of a liability is the discounted amount of cash to be paid. The interest rate is the rate implicit in the transaction in which the debt was incurred. But if the amount at which the debt can currently be discharged is lower, that amount should be used.

SOP 82-1 requires that personal financial statements include at least a statement of financial condition. This statement presents estimated current values of assets, estimated current amounts of liabilities, estimated income taxes, and net worth (total assets - total liabilities - estimated income taxes) at a given date. SOP 82-1 also requires that, personal financial statements include the estimated tax on the difference between the book values of assets and liabilities and their respective tax bases as if they had been recovered or settled.

SOP 82-1 further recommends, but **does not require**, a statement of changes in net worth (a presentation of the major sources of increases and decreases in net worth) and comparative financial statements. A personal statement of cash flows, however, is **neither** required **nor** recommended.

- Assets and liabilities and changes in them are recognized on the accrual basis, not the cash basis.

- The recommended presentation of assets and liabilities is by order of liquidity and maturity.

Personal financial statements may be prepared for an individual or family to reveal financial position. Personal financial statements show both business and personal interests. Accrual accounting must be followed. Such statements may be used in financial planning, in loan applications, and for governmental compliance mandates.

The statement of financial condition is prepared as follows:

- No segregation is made between current and noncurrent classifications.

- Assets are presented at estimated current values and are listed in liquidity (maturity) order. Current values may be based on appraisals, present value of future cash flows, and inflation-adjusted historical cost. If assets are jointly owned, the person's beneficial interest should be presented. Receivables should be presented at the discounted amounts expected to be collected using the appropriate interest rate. The investment in life insurance is at the cash value of the policy less the amount of any loans against it. Option prices may not be available to value options. In such a case, the estimated current value may be based on the asset values subject to option, taking into account exercise prices and option periods. Intangible assets are presented at the present value of future net cash flows to be derived from them. Nonforfeitable rights to receive future sums should be presented at their discounted amounts.

- Liabilities are presented at current amounts in maturity order. Liabilities are typically shown at principal plus accrued interest due.

- Estimated taxes payable are presented as a liability, including provision for unpaid taxes of prior years. The tax obligation is reduced by withholding and estimated tax payments.

EXAMPLE

An illustrative Statement of Financial Condition follows:

Mr. and Mrs. Paul Jones
Statement of Financial Condition
December 31, 2X13

ASSETS	
Cash	$ 7,000
Interest and dividend receivable	1,000
Trading securities	12,000
Equity interest in a closely held business	5,000
Cash surrender value of life insurance	2,000
Real estate	185,000
Personal property	40,000
Total assets	$252,000
LIABILITIES	
Credit cards	$ 13,000
Income taxes payable	14,000
Loans payable	20,000
Mortgage payable	50,000
Total liabilities	$ 97,000
Estimated taxes on the differences between estimated current values of assets and liabilities	28,000
Net worth	$127,000
Total liabilities and net worth	$252,000

Preparation of a statement of changes in net worth is optional. Items increasing net worth include income, increases in the current value of assets, decreases in the current amounts of liabilities, and decreases in estimated taxes on the difference between estimated current asset values and liability amounts and their tax bases. Of course, items decreasing net worth are the opposite.

Comparative financial statements are optional.

The following should be footnoted:

- Individuals or family involved.
- Nature of joint ownership of assets.
- Information about receivables and payables, including collateral, maturities, and interest rates.
- Noncancellable commitments, such as particulars of leasing arrangements.
- Major investments by type.
- Listing of intangibles with anticipated lives.
- Approach followed in computing current values.
- Method and assumptions used in determining income taxes.

- Nonforfeitable rights (e.g., pension rights).
- Face amount of life insurance.
- Names of companies/industries and estimated current values of any significant investments relative to other assets.
- Percentage equity in a closely held company, including the type of business activities, summarized financial information, and accounting basis used.

IFRS connection

As in U.S. GAAP, the income statement is a required statement for IFRS. In addition, the content and presentation of an IFRS income statement is similar to the one used for U.S. GAAP. IAS 1, Presentation of Financial Statements, provides general guidelines for the reporting of income statement information. Subsequently, a number of international standards have been issued that provide additional guidance to issues related to income statement presentation. Specifically,

- Under IFRS, companies must classify expenses by either nature or function. Classification by nature leads to descriptions such as the following: salaries, depreciation expense, utilities expense, and so on. Classification by function leads to descriptions like administration, distribution, and manufacturing. If a company uses the functional expense method on the income statement, disclosure by nature is required in the notes to the financial statements.
- Presentation of the income statement under U.S. GAAP follows either a single-step or multiple-step format. IFRS does not mention a single-step or multiple-step approach. In addition, under U.S. GAAP, companies must report an item as extraordinary if it is unusual in nature and infrequent in occurrence. Extraordinary items are prohibited under IFRS.
- Under IFRS, companies are required to prepare as a primary financial statement either a statement of stockholders' equity similar to the one prepared under U.S. GAAP or a statement of recognized income and expense (called a SoRIE).
- Both IFRS and U.S. GAAP have items that are recognized in equity as part of comprehensive income but do not affect net income. U.S. GAAP provides three possible formats for presenting this information: single income statement, combined income statement of comprehensive income, in the statement of stockholders' equity. IFRS allows either the statement of stockholders' equity approach or the SoRIE format.
- Under IFRS revaluation of land, buildings, and intangible assets is permitted. The effect of this difference is that application of IFRS results in more transactions affecting equity but not net income.
- The accounting for various forms of stock-based compensation under IFRS is found in IFRS 2, Share-Based Payment. This standard was recently amended, resulting in significant convergence between IFRS and U.S. GAAP in this area. The IFRS standard addressing accounting and reporting for earnings per share computations is IAS 33, Earnings per Share.
- The calculation of basic and diluted earnings per share is similar between IFRS and U.S. GAAP, the Boards are working to resolve the few minor differences in EPS reporting. One proposal in the FASB

project concerns contracts that can be settled in either cash or shares. IFRS requires that share settlement must be used, while U.S. GAAP gives companies a choice. The FASB project proposes adopting the IFRS approach, thus converging U.S. GAAP and IFRS in this regard.

- Other EPS differences relate to (1) the treasury-stock method and how the proceeds from extinguishment of a liability should be accounted for, and (2) how to compute the weighted-average of contingently issuable shares.
- Personal financial statements are not specifically addressed by IFRS.

Review Questions – Section 3

15. Comprehensive income includes which of the following?

A. Both Loss on Discontinued Operations and Investments by Owners
B. Loss on Discontinued Operations, but not Investments by Owners
C. Investments by Owners, but not Loss on Discontinued Operations
D. Neither Loss on Discontinued Operations nor Investments by Owners

16. When a full set of general-purpose financial statements is presented, comprehensive income and its components should

A. Appear as a part of discontinued operations, extraordinary items, and cumulative effect of a change in accounting principle.
B. Be reported net of related income tax effects, in total and individually.
C. Appear in a supplemental schedule in the notes to the financial statements.
D. Be displayed in a financial statement that has the same prominence as other financial statements.

17. Which of the following items should be reported as a component of other comprehensive income (OCI)?

A. Unrealized loss on an investment classified as a trading security.
B. Unrealized loss on an investment classified as an available-for-sale security.
C. Realized loss on an investment classified as an available-for-sale security.
D. Cumulative effect of a change in accounting principle.

18. Rock Co.'s financial statements had the following balances at December 31: Extraordinary gain = $ 50,000; Foreign currency translation gain = $100,000; Net income = $400,000; and Unrealized gain on available-for-sale equity securities = $20,000. What amount should Rock report as comprehensive income for the year ended December 31?

A. $400,000
B. $420,000
C. $520,000
D. $570,000

19. Personal financial statements should report assets and liabilities at

A. Estimated current values at the date of the financial statements and, as additional information, at historical cost.
B. Estimated current values at the date of the financial statements.
C. Historical cost and, as additional information, at estimated current values at the date of the financial statements.
D. Historical cost.

20. SOP 82-1 requires or recommends which of the following personal statements?

A. Changes in Net Worth, and Cash Flows, but not Financial Condition.
B. Financial Condition, but not Changes in Net Worth nor Cash Flows.
C. Financial Condition and Changes in Net Worth, but not Cash Flows.
D. Financial Condition, Changes in Net Worth, and Cash Flows.

Glossary

Accounting Principles Board (APB). An accounting rule-making board which provided official pronouncements, called APB Opinions, from 1959 through 1973.

Antidilutive securities. Securities which upon conversion or exercise increase earnings per share (or reduce the loss per share).

APB Opinions. The APBs official pronouncements issued from 1959 through 1973 which were intended to be based mainly on research studies and be supported by reasons and analysis.

Binomial model One of lattice-based option pricing model. Unlike Black-Scholes, the binomial method divides the time from the option's grant date to the expiration date into small increments.

Black-Scholes model. A model used to determine the value of option securities prices based on the relationship between six variables—the current underlying asset price, the option strike price, the option time-to-expiration, the riskless return, the underlying asset payout return, and the underlying asset volatility—work together to determine the value of a standard option.

Book value approach. A method used for determining the issue price of stock when bonds are converted into stock which records the stock issued using the book value of the bonds at the issue date.

Complex capital structure. When a corporation's capital structure includes securities that could have a dilutive effect on earnings per common share.

Comprehensive income. An income amount that includes all revenues and gains, expenses and losses reported in net income, and in addition it includes gains and losses that by pass net income bet affect stockholders' equity.

Convertible bonds. A security that combines the benefits of a bond with the privilege of exchanging it for stock at the holder's option.

Convertible preferred stock. Preferred stock which is convertible into common stock at the holder's option.

Detachable stock warrants. Warrants that can be sold separately from their bonds.

Diluted earnings per share. Earnings per share based on the number of common shares outstanding plus all contingent issuances of common stock that could reduce earnings per share.

Dilutive securities. Securities that are not common stock in form, but enable their holders to obtain common stock upon exercise or conversion. Examples include convertible bonds, convertible preferred stocks, stock warrants, and contingent shares.

Discontinued operations. The disposal of a significant segment of a business.

Earnings per share. The net income earned by each share of outstanding common stock.

Extraordinary items. Nonrecurring material items that differ significantly from the entity's typical business activities.

Financial Accounting Concepts. A series of pronouncements issued by the FASB with the purpose of setting forth fundamental objectives and concepts that the FASB will use in developing future standards of financial accounting and reporting.

FASB Technical Bulletins. Pronouncements issued by the FASB which are guidelines on implementing or applying FASB Standards or Interpretations, APB Opinions, and Accounting Research Bulletins.

Grant date. The date someone receives stock options.

If-converted method. The method used to measure the dilutive effect of convertible securities which assumes (1) the conversion of the convertible securities at the beginning of the period (or at the time of issuance of the security, if issued during the period), and (2) the elimination of interest, net of tax or preferred dividend.

Incentive stock option plan. A stock option where the market price of the stock and the option price at the date of grant are equal.

Induced conversion. When an issuer wishes to induce prompt conversion of its convertible debt to equity securities, the issuer may offer some form of additional consideration (such as cash or common stock).

Intraperiod tax allocation. The procedure of associating income taxes with the specific item that directly affects the income taxes for the period.

Lattice model. An option pricing model that take into account assumptions that reflect the conditions under which employee options are typically granted. The binomial model is the most commonly used lattice-based method..

Market value approach. A method used for determining the issue price of stock when bonds are converted into stock which records the stock issued using its market price at the issue date.

Measurement date. The first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price.

Multiple-step income Statement. An income statement that shows numerous steps in determining net income (or net loss), including operating and nonoperating sections.

Nondetachable stock warrants. Warrants that cannot be sold separately form their bonds.

Nonqualified stock option plan. A stock option plan where the market price exceeds the option price at the date of grant.

Prior period adjustments. Items of income or loss related to correction of errors in the financial statements of a prior period.

Service period. The period in which the employee performs the service for which he or she is being compensated.

Simple capital structure. When a corporation's capital structure consists only of common stock or includes no potentially dilutive convertible securities, options, warrants, or other rights that upon conversion or exercise could in the aggregate dilute earnings per common share.

Single step income Statement. An income statement that shows only the one step of deducting expenses from revenues to determine net income (or net loss).

Stock appreciation rights (SARs). Similar to a stock option plan except executives do not have to purchase the stock but instead are given a right to receive the excess of the market price of the stock at the date of exercise over a pre-established price.

Stock option. A warrant which gives selected employees the option to purchase common stock at a given price over an extended period of time.

Stock option plans. Long-term compensation plans which attempt to develop in executives a strong loyalty toward the company by giving them an equity interest based on changes in long-term measures such as increases in earnings per share, revenues, stock price, or market share.

Stock rights. Existing stockholders have the right (preemptive privilege) to purchase newly issued shares in proportion to their holdings.

Stock warrants. Certificates entitling the holder to acquire shares to stock at a certain price within a stated period.

Sweetener. The additional consideration offered by an issuer that wishes to set up an induced conversion.

Treasury stock method. The method used to measure the dilutive effect of options and warrants which assumes (1) the options or warrants are exercised at the beginning of the year (or date of issue if later), and (2) the proceeds from the exercise of options and warrants are used to purchase common stock for the treasury.

Unusual gains and losses. Items that are unusual or infrequent but not both.

Weighted average number of outstanding. The basis for the per share amounts reported which shares reflects shares issued or purchased during the period by calculating the number of shares outstanding by the fraction for the period they are outstanding.

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Appendix

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14. Stock-Based Compensation Plans

On April 26, 2005, U.S. Steel's stockholders approved the 2005 Stock Incentive Plan (the “2005 Stock Plan”). The aggregate number of shares of U.S. Steel common stock that may be issued through April 26, 2020 under the 2005 Stock Plan is 15,450,000 shares, of which 10,090,652 shares are available as of December 31, 2010 for future grants. Generally, a share issued under the Plan pursuant to an award other than a stock option will reduce the number of shares available under the Stock Plan by 1.64 shares. The purposes of the 2005 Stock Plan are to attract, retain and motivate employees and non-employee directors of outstanding ability, and to align their interests with those of the stockholders of U.S. Steel. The Compensation & Organization Committee of the Board of Directors (the Compensation Committee) administers the plan pursuant to which they may make grants of stock options, restricted stock, restricted stock units (RSU's), performance awards, and other stock-based awards. Also, shares related to awards (i) that are forfeited, (ii) that terminate without shares having been issued or (iii) for which payment is made in cash or property other than shares are again available for awards under the plan; provided, however, that shares delivered to U.S. Steel or withheld for purposes of satisfying the exercise price or tax withholding obligations shall not again be available for awards.

The following table summarizes the total stock-based compensation awards granted during the years 2010, 2009 and 2008:

	Stock Options	*Restricted Stock*	*Restricted Stock Units*	*Performance Awards*
2010 Grants	**612,270**	-	**359,960**	**105,640**
2009 Grants	1,026,580	-	564,210	116,410
2008 Grants	281,200	1,000	118,420	32,870

Stock-based compensation expense

The following table summarizes the total compensation expense recognized for stock-based compensation awards:

(In millions, except per share amounts)	**Year Ended December 31, 2010**	Year Ended December 31, 2009	Year Ended December 31, 2008
Stock-based compensation expense recognized:			
Cost of sales	**$ 9**	$ 10	$ 11
Selling, general and administrative expenses	**20**	27	24
Total	**29**	37	35
Related deferred income tax benefit	**11**	14	13
Decrease in net income	**$ 18**	$ 23	$ 22
Decrease in basic earnings per share	**$ 0.13**	$ 0.17	$ 0.19
Decrease in diluted earnings per share	**$ 0.13**	$ 0.17	$ 0.18

As of December 31, 2010, total future compensation cost related to nonvested stock-based compensation arrangements was $34 million, and the average period over which this cost is expected to be recognized is approximately 12 months.

Stock options

Compensation expense for stock options is recorded over the vesting period based on the fair value on the date of grant, as calculated by U. S. Steel using the Black-Scholes model and the assumptions listed below. The 2010, 2009 and 2008 awards vest ratably over a three-year service period and have a term of ten years. Options are issued at the market price on the date of the grant. Upon exercise of stock options, shares of U. S. Steel stock are issued from treasury stock.

Black-Scholes Assumptions	***2010 Grants***	*2009 Grants*	*2008 Grants*
Price per share of option award	**$ 45.65**	$ 29.81	$ 169.23
Expected annual dividends per share	**$ 0.20**	$ 0.20	$ 1.00
Expected life in years	**5.0**	4.5	4.5
Expected volatility	**64%**	62%	43%
Risk-free interest rate	**2.1%**	2.6%	3.2%
Average grant date fair value per share of unvested option awards as calculated from above	**$ 24.31**	$ 14.87	$ 64.51

The expected annual dividends per share are based on the latest annualized dividend rate at the date of grant; the expected life in years is determined primarily from historical stock option exercise data; the expected volatility is based on the historical volatility of U. S. Steel stock; and the risk-free interest rate is based on the U.S. Treasury strip rate for the expected life of the option.

The following table shows a summary of the status and activity of stock options for the year ended December 31, 2010:

	Shares	*Weighted-Average Exercise Price (per share)*	*Weighted-Average Remaining Contractual Term (in years)*	*Aggregate Intrinsic Value (in millions)*
Outstanding at January 1, 2010	2,220,957	$ 56.92		
Granted	612,270	45.65		
Exercised	(145,254)	29.93		
Forfeited or expired	(47,683)	45.31		
Outstanding at December 31, 2010	2,640,290	$ 56.00	9.1	$ 6
Exercisable at December 31, 2010	1,351,989	$ 65.76	5.3	-
Exercisable and expected to vest at December 31, 2010	2,552,699	$ 56.38	8.9	$ 5

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (difference between our closing stock price on the last trading day of 2010 and the exercise price, multiplied by the number of in-the-money options). Intrinsic value changes are based on the fair market value of our stock. Total intrinsic value of options outstanding at December 31, 2009 was zero because generally the options were out-of-the-money at December 31, 2009.

During the years ended December 31, 2010, 2009 and 2008, the total intrinsic value of stock options exercised (i.e., the difference between the market price at exercise and the price paid by the employee to exercise the option) was $3 million, $0.3 million and $29 million, respectively. The total amount of cash received by U. S. Steel from the exercise of options during the year ended December 31, 2010 was $4 million and the related net tax benefit realized from the exercise of these options was immaterial.

Stock awards

Compensation expense for nonvested stock awards is recorded over the vesting period based on the fair value at the date of grant.

Restricted stock awards and RSU's vest ratably over three years. Their fair value is the market price of the underlying common stock on the date of grant.

Performance awards vest at the end of a three-year performance period as a function of U. S. Steel's total shareholder return compared to the total shareholder return of a peer group of companies over the three-year performance period. Performance awards can vest at between zero and 200 percent of the target award.

The following table shows a summary of the performance awards outstanding as of December 31, 2010, and their fair market value on the respective grant date:

Performance Period	*Fair Value (in millions)*	*Minimum Shares*	*Target Shares*	*Maximum Shares*
2010 - 2013	**$ 6**	-	**105,640**	**211,280**
2009 - 2012	$ 5	-	116,410	232,820
2008 - 2011	$ 7	-	32,870	65,740

The following table shows a summary of the status and activity of nonvested stock awards for the year ended December 31, 2010:

	Restricted Stock	*Restricted Stock Units*	*Performance Awards*[a]	*Total*	*Weighted-Average Grant-Date Fair Value*
Nonvested at January 1, 2010	47,178	608,870	190,605	846,653	$ 58.96
Granted	-	359,960	105,640	465,600	48.23
Vested	(45,859)	(212,298)	(33,767)	(291,924)	69.65
Performance adjustment factor[b]	-	-	(20,078)	(20,078)	143.60
Forfeited or expired	(1,319)	(22,799)	(569)	(24,687)	42.80
Nonvested at December 31, 2010	-	733,733	241,831	975,564	$ 49.30

[a] The number of shares shown for the performance awards is based on the target number of share awards.

[b] Consists of adjustments to vested performance awards to reflect actual performance. The adjustments were required since the original grants of the awards were at 100 percent of the targeted amounts.

The following table presents information on restricted stock, RSU's and performance awards granted:

	2010	*2009*	*2008*
Number of shares (or RSU's) granted	**465,600**	680,620	152,290
Weighted-average grant-date fair value per share	**$ 48.23**	$ 31.61	$ 174.28

During the years ended December 31, 2010, 2009, and 2008, the total fair value of shares vested was $20 million, $19 million, and $12 million, respectively.

Microsoft

2009 Annual Report

Note 3. Other Income (Expense)

The components of other income (expense) were as follows:

(In millions)			
Year Ended June 30,	*2009*	*2008*	*2007*
Dividends and interest	$ 706	$ 888	$1,319
Net recognized gains (losses) on investments	(125)	346	650
Net gains (losses) on derivatives	(558)	226	(358)
Net gains (losses) on foreign currency remeasurements	(509)	226	56
Other	(56)	(143)	(4)
Total	$(542)	$1,543	$1,663

Effective July 1, 2008, we began presenting gains and losses resulting from foreign currency remeasurements as a component of other income (expense). Prior to July 1, 2008, we included gains and losses resulting from foreign currency remeasurements as a component of sales and marketing expense. We changed our presentation because this better reflects how we manage these foreign currency exposures, as such gains and losses arising from the remeasurement of foreign currency transactions are incidental to our operations. For fiscal year 2009, $509 million of losses were reported as other income (expense). For fiscal years 2008 and 2007, $221 million and $86 million of gains, respectively, were previously recorded as a component of sales and marketing expense and have been recast as other income (expense).

Net recognized gains (losses) on investments included other-than-temporary impairments of $862 million, $312 million, and $25 million in fiscal years 2009, 2008, and 2007, respectively. Realized gains and losses from sales of available-for-sale securities (excluding other-than-temporary impairments) were $1.6 billion and $897 million, respectively, in fiscal year 2009, $751 million and $93 million, respectively, in fiscal year 2008, and $851 million and $176 million, respectively, in fiscal year 2007.

Schlumberger

2009 Annual Report

3. Charges and Credits

Schlumberger recorded the following Charges and Credits in continuing operations during 2009, 2008 and 2007:

2009

Second quarter of 2009:

- Schlumberger continued to reduce its global workforce as a result of the slowdown in oil and gas exploration and production spending and its effect on activity in the oilfield services sector. As a result of these actions, Schlumberger recorded a pretax charge of $102 million ($85 million aftertax), which is classified in Cost of revenue in the Consolidated Statement of Income. These workforce reductions were completed by the end of 2009.

- As a consequence of these workforce reductions, Schlumberger recorded pretax non-cash pension and other postretirement benefit curtailment charges of $136 million ($122 million after-tax). These costs are classified in Cost of revenue in the Consolidated Statement of Income. Refer to Note 19 - Pension and Other Benefit Plans for further details.

The following is a summary of these charges:

(Stated in millions)	*Pretax*	*Tax*	*Net*
Workforce reductions	$102	$(17)	$ 85
Postretirement benefits curtailment	136	(14)	122
	$238	$(31)	$207

2008

Fourth quarter of 2008:

- Due to the continuing slowdown in oil and gas exploration and production spending and its effect on activity in the oilfield services sector, Schlumberger took actions to reduce its global workforce. As a result of these actions, Schlumberger recorded a pretax charge of $74 million ($65 million after-tax), which is classified in Cost of revenue in the Consolidated Statement of Income.

- Schlumberger wrote off certain assets, primarily accounts receivable relating to one client with liquidity issues. Accordingly, Schlumberger recorded a pretax charge of $42 million ($28 million after-tax and noncontrolling interest). $32 million of the pretax charge is classified in Cost of revenue in the Consolidated Statement of Income, with the remaining $10 million classified in Interest and other income, net.

The following is a summary of these charges:

	Pretax	*Tax*	*Non-controlling*	*Net*

			Interests	
Workforce reduction	$ 74	$ (9)	$ -	$65
Provision for doubtful accounts	32	(8)	(6)	18
Other	10	-	-	10
	$116	$(17)	$(6)	$93

2007

Fourth quarter of 2007:

- Schlumberger sold certain workover rigs for $32 million, resulting in a pretax gain of $24 million ($17 million after-tax) which is classified in Interest and other income, net in the Consolidated Statement of Income.

Tyco International

2009 Annual Report

5. Other Expense, Net

Other expense, net was $7 million in 2009 compared to $224 million in 2008 and $255 million in 2007. Other expense, net in 2009 primarily relates to a $14 million charge recorded as a result of a decrease in the receivables due from Covidien and Tyco Electronics under the Tax Sharing Agreement, which was partially offset by income of $5 million relating to a gain on derivative contracts used to economically hedge the foreign currency risk related to the Swiss franc denominated dividends.

Other expense, net during 2008, includes $258 million on extinguishment of debt related to the consent solicitation and exchange offers and termination of the bridge loan facility offset by income of $6 million recorded in connection with the settlement of its 3.125% convertible senior debentures and related financial instruments. See Notes 12 and 14. The Company also recorded other-than-temporary impairments and realized losses on the sale of investments of $6 million related primarily to investments in corporate debt. See Note 9. Additionally, the Company recorded $40 million of income as a result of an increase in the receivables due from Covidien and Tyco Electronics under the Tax Sharing Agreement in connection with the adoption of the guidance pertaining to the accounting for uncertain income taxes. The Company also recorded $6 million of expense for other activity in accordance with the Tax Sharing Agreement during 2008.

During 2007, other expense, net consisted primarily of a $259 million loss on early extinguishment of debt incurred in connection with debt tender offers undertaken in connection with the Separation, for which no tax benefit is available. This charge consists primarily of premiums paid and the write-off of unamortized debt issuance costs and discounts. The total loss on early extinguishment of debt was $647 million, with $259 million included in continuing operations and $388 million allocated to Covidien and Tyco Electronics and included in discontinued operations.

Kellogg's

2008 Annual Report

Note 3. Exit or Disposal Activities

The Company views its continued spending on cost reduction initiatives as part of its ongoing operating principles to provide greater visibility in achieving its long-term profit growth targets. Initiatives undertaken are currently expected to recover cash implementation costs within a five-year period of completion. Each cost-reduction initiative is normally up to three years in duration. Upon completion (or as each major stage is completed in the case of multi-year programs), the project begins to deliver cash savings and/or reduced depreciation.

Cost summary

The Company recorded $27 million of costs in 2008 associated with exit or disposal activities comprised of $7 million of asset write offs, $17 million of severance and other cash costs and $3 million related to pension costs. $23 million of the 2008 charges were recorded in cost of goods sold within the Europe operating segment, with the balance recorded in selling, general and administrative (SGA) expense in the Latin America operating segment.

For 2007, the Company recorded charges of $100 million, comprised of $7 million of asset write offs, $72 million for severance and other exit costs including route franchise settlements, $15 million for other cash expenditures, and $6 million for a multiemployer pension plan withdrawal liability. $23 million of the total 2007 charges were recorded in cost of goods sold within the Europe operating segment results, with $77 million recorded in SGA expense within the North America operating results.

For 2006, the Company recorded charges of $82 million, comprised of $20 million of asset write offs, $30 million for severance and other exit costs, $9 million for other cash expenditures, $4 million for a multiemployer pension plan withdrawal liability, and $19 million for pension and other postretirement plan curtailment losses and special termination benefits. $74 million was recorded in cost of goods sold within SGA expense within corporate results. The Company's operating segments were impacted as follows (in millions): North America-$46; Europe-$28.

Exit cost reserves at January 3, 2009 were $2 million related to severance payments. Exit cost reserves were $5 million at December 29, 2007, consisting of $2 million for severance and $3 million for lease termination payments.

Specific initiatives

During the fourth quarter of 2008, the Company executed a cost-reduction initiative in Latin America that resulted in the elimination of approximately 120 salaried positions. The cost of the program was $4 million and was recorded in Latin America's SGA expense. The charge related primarily to severance benefits which were paid by the end of the year. There were no reserves as of January 3, 2009 related to this program.

The Company commenced a multi-year European manufacturing optimization plan in 2006 to improve utilization of its facility in Manchester, England and to better align production in Europe. The project resulted in an elimination of approximately 220 hourly and salaried positions from the Manchester facility through voluntary early retirement and severance programs. The pension trust funding requirements of these early retirements exceeded the recognized benefit expense by $5 million which was funded in 2006. During this program certain manufacturing equipment was removed from service.

All of the costs for the European manufacturing optimization plan have been recorded in cost of goods sold within the Company's Europe operating segment. The following tables present total project costs and a reconciliation of employee severance reserves for this initiative. All other cash costs were paid in the period incurred. The project was completed in 2008.

Project costs to date (millions)	*Employee Severance*	*Other Cash Costs*[(a)]	*Asset Write-Offs*	*Retirement Benefits*[(b)]	*Total*
Year ended December 30, 2006	$12	$ 2	$5	$9	$28
Year ended December 29, 2007	7	8	4	-	19
Year ended January 3, 2009	5	3	(3)	3	8
Total project to date	$24	$13	$6	$12	$55

(a) Primarily includes expenditures for equipment removal and relocation, and temporary contracted services to facilitate employee transitions.

(b) Pension plan curtailment losses and special termination benefits recognized under SFAS No. 88, “Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits.”

Employee severance reserves to date (millions)	*Beginning of Period*	*Accruals*	*Payments*	*End of Period*
Year ended December 29, 2007	$12	$7	$(19)	$
Year ended December 3, 2009	$	$5	$ (3)	$2

In October 2007, management committed to reorganize certain production processes at the Company's plants in Valls, Spain and Bremen, Germany. Commencement of this plan followed consultation with union representatives at the Bremen facility regarding the elimination of approximately 120 employee positions. This reorganization plan improved manufacturing and distribution efficiency across the Company's continental European operations, and has been completed as of the end of the Company's 2008 fiscal year.

All of the costs for European production process realignment have been recorded in cost of goods sold within the Company's Europe operating segment.

The following tables present total project costs and a reconciliation of employee severance reserves for this initiative. All other cash costs were paid in the period incurred.

Project costs to date (millions)	*Employee Severance*	*Other Cash Costs*[a]	*Asset Write-Offs*	*Total*
Year ended December 29, 2007	$2	$1	$ 1	$ 4
Year ended January 3, 2009	4	1	10	15
Total project costs	$6	$2	$11	$19

[a] Primarily includes expenditures for equipment removal and relocation, and temporary contracted services to facilitate employee transitions.

Employee severance reserves to date (millions)	*Beginning of Period*	*Accruals*	*Payments*	*End of Period*
Year ended December 29, 2007	$	$2	$	$2
Year ended January 3, 2009	$2	$4	$(6)	$

In July 2007, management commenced a plan to reorganize the Company's direct store-door delivery (DSD) operations in the southeastern United States. This DSD reorganization plan was intended to integrate the Company's southeastern sales and distribution regions with the rest of its U.S. DSD operations, resulting in greater efficiency across the nationwide network. The Company exited approximately 517 distribution route franchise agreements with independent contractors. The plan also resulted in the involuntary termination or relocation of approximately 300 employee positions. Total project costs incurred were $77 million, principally consisting of cash expenditures for route franchise settlements and to a lesser extent, for employee separation, relocation, and reorganization. Exit cost reserves were $3 million as of December 29, 2007 and were paid in 2008. This initiative is complete.

During 2006, the Company commenced several initiatives to enhance the productivity and efficiency of its U.S. cereal manufacturing network, primarily through technological and sourcing improvements in warehousing and packaging operations. In conjunction with these initiatives, the Company offered voluntary separation incentives, which resulted in the retirement of approximately 80 hourly employees by early 2007. During 2006, the Company incurred approximately $15 million of total up-front costs, comprised of approximately 20% asset write-offs and 80% cash costs, including $10 million of pension and other postretirement plan curtailment losses. These initiatives were complete by the end of 2007.

Also during 2006, the Company undertook an initiative to improve customer focus and selling efficiency within a particular Latin American market, leading to a shift from a third-party distributor to a direct sales force model. As a result of this initiative, the Company paid $8 million in cash during 2006 to exit the existing distribution arrangement.

During 2008 the Company finalized its pension plan withdrawal liability related to its North America snacks bakery consolidation which was executed in 2005 and 2006. The final liability was $20 million, $16 million of which was recognized in 2005 and $4 million in 2006; and was paid in the third quarter of 2008.

Goodyear Tire and Rubber

2008 Annual Report

Note 3. Other (Income) and Expense

(In millions)	*2008*	*2007*	*2006*
Interest income	$(68)	$(128)	$(86)
Asset sales	(53)	(15)	(40)
Financing fees and financial instruments	97	106	40
General and product liability—discontinued products	30	15	26
Foreign currency exchange	57	31	(2)
Royalty income	(32)	(15)	(8)
Subsidiary liquidation loss	16	-	-
Fire loss expense	3	12	-
Miscellaneous	9	2	(7)
	$59	$ 8	$(77)

Interest income consisted primarily of amounts earned on cash deposits. The decrease in 2008 compared to 2007 was due primarily to lower average cash balances and interest rates during the year.

Net gains on asset sales in 2008 were $53 million ($50 million after-tax or $0.21 per share) and included a gain of $20 million on the sale of property in EMEA, a gain of $10 million on the sale of property, buildings and equipment in Asia Pacific Tire, a gain of $11 million on the sale of property in North American Tire, a gain of $5 million on the sale of property and buildings in Latin American Tire, and net gains of $7 million on the sales of other assets in North American Tire.

Net gains on asset sales in 2007 were $15 million ($11 million after-tax or $0.05 per share) and included a gain of $19 million on the sale of our Washington, UK facility in EMEA, a gain of $19 million on the sale of warehouses and other property and equipment in North American Tire, a gain of $7 million on the sale of property in Asia Pacific Tire, and net gains of $6 million on the sales of other assets primarily in EMEA and North American Tire.

Net gains were partially offset by the loss of $36 million on the sale of substantially all of the assets of North American Tire's tire and wheel assembly operation in the fourth quarter of 2007. Net gains on asset sales in 2006 were $40 million ($31 million after-tax or $0.17 per share) and included a gain of $21 million on the sale of a capital lease in EMEA, a gain of $9 million on the sale of the Fabric business, and net gains of $10 million on the sales of other assets primarily in EMEA.

Financing fees and financial instruments in 2008 included $43 million related to the redemption of $650 million of long term debt, of which $33 million was a cash premium paid on the redemption, $9 million was deferred financing fee write-offs, and $1 million was bond discount write-offs. Also included was a $10 million charge related to the interest rate basis swap on our $1.2 billion term loan and a $5 million valuation allowance on our investment in The Reserve Primary Fund.

Financing fees and financial instruments in 2007 included $33 million related to the redemption of $315 million of long term debt, of which $28 million was a cash premium paid on the redemption, and $5 million was deferred financing fee write-offs. Also included was a $17 million charge related to the exchange offer for our outstanding 4% convertible senior notes and $14 million of debt issuance costs written-off in connection with our refinancing activities in April 2007.

General and product liability-discontinued products includes charges for claims against us related to asbestos personal injury claims, and for liabilities related to Entran II claims, net of probable insurance recoveries. During 2008, $3 million of expenses were related to Entran II claims and $27 million of net expenses were related to asbestos claims ($28 million of expense and $1 million of probable insurance recoveries). During 2007, $4 million of expenses were related to Entran II claims and $11 million of net expenses were related to asbestos claims ($25 million of expense and $14 million of probable insurance recoveries). During 2006, $9 million of expenses were related to Entran II claims and $17 million of net expenses were related to asbestos claims ($39 million of expense and $22 million of probable insurance recoveries).

During 2008, we incurred $57 million of foreign currency exchange losses primarily as a result of the weakening Canadian dollar, euro, South African rand and Australian dollar against the U.S. dollar.

During 2007, we incurred $31 million of foreign currency exchange losses primarily as a result of the strengthening euro, Chilean peso and Brazilian real against the U.S. dollar.

Royalty income increased in 2008 and included royalties from licensing arrangements related to divested businesses, including recognition of deferred income from a trademark licensing agreement related to our Engineered Products business that was divested in the third quarter of 2007.

We liquidated our subsidiary in Jamaica in the fourth quarter of 2008 and recognized a loss of $16 million primarily due to the recognition of accumulated foreign currency translation losses.

In 2007, there was a fire in our Thailand facility, which resulted in a loss of $12 million, net of insurance proceeds.

Included in 2006 miscellaneous income is a $13 million gain in Latin American Tire resulting from the favorable resolution of a legal matter.

Texas Instruments

2008 Annual Report

2. Restructuring Activities

We record severance-related expenses in accordance with the provisions of SFAS No. 112, Employer's Accounting for Post-Employment Benefits; SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities and SFAS No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits. The determination of when we accrue for involuntary severance costs and which standard applies depends on whether the termination benefits are provided under an ongoing benefit arrangement as described in SFAS 112 or under a one-time benefit arrangement as defined by SFAS 146. We record involuntary severance-related expenses related to an ongoing benefit arrangement in accordance with the provisions of SFAS No. 112 once they are probable and the amounts are estimable. One-time, involuntary termination benefits are recorded under the provisions of SFAS No. 146 when the benefits have been communicated to employees. Voluntary termination benefits are accounted for under the provisions of SFAS No. 88 and are recorded when the employee accepts the offered benefit arrangement.

When the decision to commit to a restructuring plan requires an asset impairment review, we evaluate such impairment issues under the provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Because the impairment is a direct result of the restructuring, the impairment amount is included in the restructuring expense line item in the income statement and is recorded as an adjustment of the basis of the asset, not as a liability relating to a restructuring charge. When we commit to a plan to abandon a long-lived asset before the end of its previously estimated useful life, we accelerate the recognition of depreciation to reflect the use of the asset over its shortened useful life. When an asset is to be sold, we write the carrying value down to its net realizable value and cease depreciation.

2008 and 2009 actions

In October 2008, we announced actions that, when complete, will reduce annualized expenses by more than $200 million in our Wireless segment, especially our cellular baseband operation. About 650 jobs are expected to be eliminated. The total restructuring charges related to this action will be approximately $110 million and are expected to be complete by June 2009.

In January 2009 we announced actions that include employment reductions to align our spending with demand that has weakened in the slowing economy. Our employment will be reduced 12 percent through 1,800 layoffs and 1,600 voluntary retirements and departures. The total restructuring charges for this action will be about $300 million and will continue through the third quarter of 2009. Combined with the Wireless actions described above, our annualized costs will be reduced by more than $700 million.

In the fourth quarter of 2008, we recognized $230 million in restructuring charges related to these actions, which included $121 million for a portion of the actions announced in January 2009 and $109 million for the Wireless actions announced in October 2008. The restructuring costs consisted of $218 million for severance and benefits costs and $12 million related to impairments of long-lived assets. We also fully impaired $24 million of assets that were held for sale related to a 2007 action discussed below.

As of December 31, 2008, $2 million has been paid for these actions to terminated employees for severance and benefits.

2007 actions

In January 2007, we announced plans to change how we develop advanced digital manufacturing process technology. Instead of separately creating our own core process technology, we work collaboratively with our foundry partners to specify and drive the next generations of digital process technology. Additionally, we stopped production at an older digital factory. These actions are complete and as a result, about 300 jobs were eliminated by year-end 2007.

Operating profit for 2007 included a charge of $52 million related to these actions, which consisted of severance and benefits costs of $31 million and acceleration of depreciation on the impacted facilities' assets of $21 million. These amounts have been reclassified from cost of revenue ($37 million), R&D ($14 million) and SG&A ($1 million) to the restructuring expense line on the income statement to conform to the 2008 presentation.

As of December 31, 2008, $19 million has been paid for these actions to terminated employees for severance and benefits.

Boeing

2007 Annual Report

Note 3. Earnings Per Share

The weighted-average number of shares outstanding (in millions) for the years ended

December 31, used to compute earnings per share are as follows:

	2007	*2006*	*2005*
Weighted-average shares outstanding	**750.5**	760.5	779.4
Participating securities	**8.8**	10.5	9.1
Basic weighted-average shares outstanding	**759.3**	771	788.5
Diluted potential common shares	**13.2**	16.6	14.4
Diluted weighted-average shares outstanding	**772.5**	787.6	802.9

The numerator used to compute diluted earnings per share is as follows:

	2007	*2006*	*2005*
Net earnings	**$4,074**	$2,215	$2,572
Expense related to diluted shares	**2**	27	
Total numerator	**$4,076**	$2,242	$2,572

Expense related to diluted shares in the amount of $2 and $27 in 2007 and 2006 represented mark-to-market adjustment of vested performance shares to employees terminated as of December 31, 2005.

Basic earnings per share is calculated by the sum of (1) net income less declared dividends divided by the basic weighted average shares outstanding and (2) declared dividends divided by the weighted average shares outstanding.

The weighted-average number of shares outstanding for the year ended December 31 (in millions), included in the table below, is excluded from the computation of diluted earnings per share because the average market price did not exceed the exercise/threshold price. However, these shares may be dilutive potential common shares in the future.

	2007	2006	2005
Stock options			0.2
Stock units		0.1	
Performance shares	**0.7**	4.0	24.9
Performance awards	**3.0**	1.4	
Share value trust	**25.8**	24.6	33.9

Note 4. Income Taxes

The components of earnings before income taxes were:

Years ended December 31,	***2007***	*2006*	*2005*
U.S.	**$5,901**	$3,067	$2,605
Non-U.S.	**217**	127	214
	$6,118	$3,194	$2,819

Income tax expense/(benefit) consisted of the following:

Years ended December 31,	***2007***	*2006*	*2005*
Current tax expense			
U.S. federal	**$1,260**	$193	$(276)
Non-U.S.	**139**	35	58
U.S. state	**164**	(58)	(86)
	1,563	170	(304)
Deferred tax expense			
U.S. federal	**487**	750	547
Non-U.S.	**(6)**	(6)	(120)
U.S. state	**16**	74	134
	497	818	561
Total income tax expense	**$2,060**	$988	$257

The following is a reconciliation of the U.S. federal statutory tax rate of 35% to our recorded income tax expense/(benefit):

Years ended December 31,	***2007***	*2006*	*2005*
U.S. federal statutory tax	**35%**	35%	35%
Global settlement with U.S. Department of Justice		6.7	
Foreign sales corporation/extraterritorial income tax benefit		(5.8)	(5.6)
Research benefit	**(2.4)**	(0.7)	(1.2)
Federal audit settlement		(1.5)	(13.1)
State income tax provision, net of effect on U.S. federal tax	**1.6**	0.4	1.1
Change in valuation allowances	**0.3**	(3.2)	
Other provision adjustments	**(0.8)**	(3.2)	(3.9)
Income tax expense	**33.7%**	30.9%	9.1%

Significant components of our deferred tax assets, net of deferred tax liabilities, at December 31 were as follows:

	2007	*2006*
Retiree health care accruals	**$2,581**	$3,257
Inventory and long-term contract methods of income recognition	**209**	640
Other employee benefits accruals	**1,476**	1,473
In-process research and development related to acquisitions	**108**	124
Net operating loss, credit, and charitable contribution carryovers (net of valuation allowance of $20 and $2)	**275**	319
Pension asset	**(1,648)**	(397)
Customer and commercial financing	**(1,587)**	(1,517)
Unremitted earnings of non-U.S. subsidiaries	**(48)**	(48)
Other net unrealized losses	**(18)**	37
Net deferred tax assets[1]	**$1,348**	$3,888

[1] Of the deferred tax asset for net operating loss and credit carryovers, $151 expires in years ending from December 31, 2008 through December 31, 2027 and $125 may be carried over indefinitely.

Net deferred tax assets at December 31 were as follows:

	2007	*2006*
Deferred tax assets	**$ 9,640**	$ 12,174
Deferred tax liabilities	**(8,272)**	(8,284)

Valuation allowance	**(20)**	(2)
Net deferred tax assets	**$ 1,348**	$ 3,888

We recorded net deferred tax liabilities of $11 and $171 in 2007 and 2006, which were primarily due to acquisitions.

As required under SFAS 123R, deferred tax liabilities of $79 and $306 were reclassified to Additional paid in capital in 2007 and 2006. This represents the tax effect of the net excess tax pool created during 2007 and 2006 due to share awards paid with a fair market value in excess of the book accrual for those awards.

Included in the net deferred tax assets at December 31, 2007 and 2006 are deferred tax assets in the amounts of $3,169 and $5,240 related to other comprehensive income.

Net income tax payments/(refunds) were $711, $28 and ($344) in 2007, 2006 and 2005, respectively.

We have provided for U.S. deferred income taxes and foreign withholding tax in the amount of $48 on undistributed earnings not considered permanently reinvested in our non-U.S. subsidiaries. We have not provided for U.S. deferred income taxes or foreign withholding tax on the remainder of undistributed earnings from our non-U.S. subsidiaries because such earnings are considered to be permanently reinvested and it is not practicable to estimate the amount of tax that may be payable upon distribution.

FASB Interpretation No. 48

Effective January 1, 2007, we adopted FIN 48 which prescribes a more-likely-than-not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, accounting for income taxes in interim periods and income tax disclosures. The cumulative effects of applying this interpretation have been recorded as a decrease of $11 to Retained earnings, an increase of $125 to Deferred income taxes and an increase of $136 to Income taxes payable as of January 1, 2007.

In conjunction with adoption of FIN 48, we classified uncertain tax positions as non-current income tax liabilities unless expected to be paid in one year. We also began reporting income tax-related interest income in Income tax expense in our Consolidated Statement of Operations. In prior periods, such interest income was reported in Other income. Within the Consolidated Statements of Operations, Other income included interest of $16 in 2006 and $100 in 2005 related to federal income tax settlements for prior years. Penalties and tax-related interest expense are reported as a component of Income tax expense. As of December 31 and January 1, 2007, the amount of accrued income tax-related interest and penalties included in the Consolidated Statement of Financial Position was as follows:

interest of $143 and $63, and penalties of $17 and $1. The amounts of interest and penalties accrued during 2007 are $108 and $17 respectively.

We are subject to examination in the U.S. federal tax jurisdiction for the 1998-2007 tax years.

We are also subject to examination in major state and foreign jurisdictions for the 2001-2007 tax years, for which no individually material unrecognized tax benefits exist. During the third quarter of 2007 we received an Internal Revenue Service (IRS) audit report for the 2002-2003 tax years and have filed an appeal. We have also filed appeals with the IRS for the 1998-2001 tax years. We believe appropriate provisions for all outstanding issues have been made for all jurisdictions and all open years.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

Unrecognized Tax Benefits—January 1, 2007	**$1,097**
Gross increases—tax positions in prior periods	181
Gross decreases—tax positions in prior periods	(85)
Gross increases—current-period tax positions	89
Lapse of statute of limitations	(10)
Unrecognized Tax Benefits—December 31, 2007	**$1,272**

As of December 31 and January 1, 2007, the total amount of unrecognized tax benefits was $1,272 and $1,097, of which $1,032 and $905 would affect the effective tax rate, if recognized. These amounts are primarily associated with U.S. federal tax issues such as the tax benefits from the Foreign Sales Corporation/Extraterritorial Income (FSC/ETI) tax rules, the amount of research and development tax credits claimed, U.S. taxation of foreign earnings, and valuation issues regarding charitable contributions claimed. Also included in these amounts are accruals for domestic state tax issues such as the allocation of income among various state tax jurisdictions and the amount of state tax credits claimed.

It is reasonably possible that within the next 12 months we and the IRS will resolve some of the matters presently under consideration at appeals for 1998-2003 which may increase or decrease unrecognized tax benefits for all open tax years. Settlement could increase earnings in an amount ranging from $0 to $130 based on current estimates. Audit outcomes and the timing of audit settlements are subject to significant uncertainty.

The Research and Development credit expired on December 31, 2007. The credit provided a 2.4% and a 0.7% reduction in the 2007 and 2006 effective tax rate. Congress is currently considering bills that will extend the credit. If the Research and Development credit is not legislatively enacted there could be an unfavorable impact on our 2008 effective income tax rate.

Review Question Answers

Section 1

1. For $50 a month, Abel Co. visits its customers' premises and performs insect control services. If customers experience problems between regularly scheduled visits, Abel makes service calls at no additional charge. Instead of paying monthly, customers may pay an annual fee of $540 in advance. For a customer who pays the annual fee in advance, Abel should recognize the related revenue

A. Incorrect. Recognition when cash is collected is appropriate when the cash basis is used.
B. Incorrect. The revenue should be recognized evenly over the contract year.
C. Incorrect. The revenue should be recognized uniformly over the contract period.
D. **Correct.** Accrual-based revenue should be recognized when realized or realizable and earned. These conditions are usually met when services are rendered. Because these services entail monthly visits for monthly fees, the annual payment should be recognized evenly over the period in which services are performed.

2. When the right of return exists, all of the following criteria must be met before revenue is recognized EXCEPT that the

A. Incorrect. One criterion for revenue recognition is: there is a reasonable basis to estimate returns.
B. Incorrect. Selling price being known or determinable is a criterion for revenue recognition.
C. **Correct.** ASC 605 requires sales revenue and cost of sales to be reduced by expected returns when goods are sold with a right of return. Before revenue can be recognized, the following conditions must exist: the buyer must be independent of the seller (have economic substance apart from the seller), the price must be determined (substantially fixed), risk of loss must rest with the buyer, the buyer must have paid or be obligated to pay and the obligation is not contingent on resale, the seller has no significant future obligation to bring about resale, and returns can be reasonably estimated. No time limit for liquidation of the buyer's obligation is established; the buyer should simply have an obligation to pay at some future time.
D. Incorrect. The buyer must pay for merchandise even if he or she is not able to resell it. For example, a wholesaler buying goods from a manufacturer does not have the right to return the goods if he or she cannot find a retailer.

3. An extraordinary item should be reported separately on the income statement as an item

A. Incorrect. An extraordinary item is presented net of tax after discontinued operations.

B. **Correct.** Extraordinary items should be shown separately in the income statement, net of tax, after results of discontinued operations but before the cumulative effect of a change in accounting principle.
C. Incorrect. A transaction that is unusual in nature and infrequent in occurrence (extraordinary items) should be reported separately net of tax as a component of income before cumulative effect of accounting changes and after discontinued operations of a component unit.
D. Incorrect. An extraordinary item is presented net of tax after discontinued operations of a component if an entity.

4. A transaction that is unusual, but not infrequent, should be reported separately as a(n)

A. Incorrect. An extraordinary item must be both unusual and infrequent.
B. Incorrect. A transaction that is unusual in nature and infrequent in occurrence is an extraordinary item.
C. Incorrect. The item should not be presented net of tax.
D. **Correct.** In order to be classified as an extraordinary item, a transaction must be both unusual in nature and infrequent in occurrence within the environment in which the business operates. If an item meets one but not both of these criteria, it should be presented separately as a component of income from continuing operations. It should not be reported on the face of the income statement net of income taxes or in any other manner that might imply that it is an extraordinary item.

5. A public entity is required to follow the accounting methods recommended in ASC 718 Thus, its issuance of stock options to its employees, other than in a transaction with an employee stock ownership plan, will be accounted for using

A. **Correct.** Adoption of a fair-value-based method of accounting for employee stock compensation plans is required.
B. Incorrect. An option-pricing model (e.g., the Black-Scholes model or a binomial model) is used to determine the fair value of stock options. The intrinsic value (or built-in value) is the difference between the stock price and the exercise price at the measurement date.
C. Incorrect. The elements of an option-pricing model used to estimate fair value are the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the stock and its dividends, and the risk-free interest rate over the life of the option. However, a nonpublic entity, not a public entity, may exclude the stock volatility factor.
D. Incorrect. The entity may use either model.

6. The major problem with option pricing using the Black-Sholes option pricing model in determining the option value is

A. Incorrect. The use of stock price and life span to the option is an element used in evaluating employee's options.
B. Incorrect. The standard black-Scholes model is not adjusted to account for the added restrictions of employee options, such as vesting and lack of transferability, but it uses stock price and volatility to estimate future value.
C. **Correct.** The major problem with option pricing using the Black-Sholes option pricing model in determining the value is that the true value of the worth of the option is only known when they are cashed in (expensed). Corporations cannot predict what will happen to share prices, which will leave the company before their options are vested, and which options will expire with no value.
D. Incorrect. The dividend yield is an element used in evaluating employee's options. Dividend yield is one of the factors used to estimate option value by this option pricing model.

Section 2

7. For the purpose of reporting discontinued operations, a component of an entity is best defined as

A. Incorrect. The term "component of an entity" was broadly defined to improve the usefulness of information by requiring more frequent reporting of discontinued operations. Thus, a component of an entity is not restricted to a reporting unit, that is, an operating segment or one level below an operating segment.
B. **Correct.** A component of an entity is a set of operations and cash flows clearly distinguishable from the rest of the entity for operational and financial reporting purposes. A component may be a(n) (1) reportable segment, (2) operating segment, (3) reporting unit, (4) subsidiary, or (5) asset group (a disposal group if it is to be disposed of).
C. Incorrect. Reporting of a discontinued operation no longer is limited to a separate major line of business or class of customer.
D. Incorrect. The criteria for the reporting of discontinued operations do not emphasize either the significance of a component or any quantitative threshold.

8. With respect to the computation of earnings per share, which of the following would be most indicative of a simple capital structure?

A. Incorrect. A simple capital structure does not include convertible securities.
B. Incorrect. Convertible securities are a part of a complex capital structure.

C. **Correct.** ASC 260-10, *Earnings Per Share: Overall* , defines a simple capital structure as one that has only common stock outstanding. A complex capital structure is one that contains potential common stock. Potential common stock includes options, warrants, convertible securities, contingent stock requirements, and any other security or contract that may entitle the holder to obtain common stock.
D. Incorrect. Stock options is potential common stock.

9. With regard to stock dividends and stock splits, current authoritative literature contains what general guideline for the computation of EPS?

A. **Correct.** When a stock dividend, stock split, or reverse split occurs at any time before issuance of the financial statements, restatement of EPS is required for all periods presented. The purpose is to promote comparability of EPS data among reporting periods.
B. Incorrect. The effect of stock dividends and stock splits on prior-period earnings must be calculated, and EPS data should be restated for all periods presented in the financial statements.
C. Incorrect. Stock dividends and stock splits are treated the same for EPS purposes regardless of their amounts.
D. Incorrect. A stock dividend or stock split is not accounted for or disclosed until it occurs.

10. Poe Co. had 300,000 shares of common stock issued and outstanding at December 31, 2X12. No common stock was issued during 2X13. On January 1, 2X13, Poe issued 200,000 shares of nonconvertible preferred stock. During 2X13, Poe declared and paid $75,000 of cash dividends on the common stock and $60,000 on the preferred stock. Net income for the year ended December 31, 2X13 was $330,000. What should be Poe's 2X13 basic earnings per common share?

A. Incorrect. $1.10 assumes no preferred dividends were declared.
B. **Correct.** Basic earnings per common share are equal to the amount of earnings available to the common shareholders divided by the weighted-average number of shares of common stock outstanding during the year. To calculate earnings available to holders of common stock, dividends on cumulative preferred stock must be subtracted from net income whether or not the dividends were declared. Earnings per common share for 2X12 thus amounted to $0.90. ($330,000 - $60,000) / 300,000 shares = $0.90.
C. Incorrect. $0.85 assumes the common but not the preferred dividends were subtracted from the numerator.
D. Incorrect. $0.65 assumes all dividends are subtracted from the numerator.

11. In computing the weighted-average number of shares outstanding during the year, which of the following midyear events must be treated as if it had occurred at the beginning of the year?

A. **Correct.** The weighted-average number of common shares outstanding is determined by relating the portion of the reporting period that the shares were outstanding to the total time in the period. Weighting is necessary because some shares may have been issued or reacquired during the period. However, a stock dividend increases the shares outstanding (the number of parts into which ownership is divided) with no effect on the company's net assets and therefore future earnings. Accordingly, unlike sales or purchases of shares, that is, transactions affecting net assets and future earnings, stock dividends must be accounted for retroactively for the sake of comparability. GAAP therefore requires that the increase in shares resulting from a stock dividend be given retroactive recognition in the EPS computations for all periods presented. Nonretroactive treatment of stock dividends would create a dilution in EPS of the current period compared with prior periods that would give the false impression of a decline in profitability.
B. Incorrect. Purchase of treasury stock is accounted for currently but not retroactively in the EPS computations. They affect the net assets and future earnings of the corporation.
C. Incorrect. Sale of additional common stock is accounted for currently but not retroactively in the EPS computations. They affect the net assets and future earnings of the corporation.
D. Incorrect. Sale of preferred convertible stock is accounted for currently but not retroactively in the EPS computations. They affect the net assets and future earnings of the corporation.

12. Deck Co. had 120,000 shares of common stock outstanding at January 1, 2X13. On July 1, 2X13, it issued 40,000 additional shares of common stock. Outstanding all year were 10,000 shares of nonconvertible cumulative preferred stock. What is the number of shares that Deck should use to calculate 2X135 basic earnings per share (BEPS)?

A. **Correct.** Basic earnings per share (BEPS) is used to measure earnings performance based on common stock outstanding during the period. BEPS equals income available to common shareholders divided by the weighted-average number of common shares outstanding. The weighted-average number of common shares outstanding relates the portion of the period that the shares were outstanding to the total time in the period. Consequently, the number of shares used to calculate BEPS is 140,000 {120,000 shares outstanding throughout the period + [40,000 shares x (6 months ÷ 12 months)]}.
B. Incorrect. 150,000 includes the preferred shares.
C. Incorrect. 160,000 includes the unweighted number of additional shares.
D. Incorrect. 170,000 includes the preferred shares and does not weight the additional common shares.

13. Earnings per share disclosures are required for

A. Incorrect. Public companies with either complex or simple capital structures must disclose EPS.
B. Incorrect. Whether companies change their capital structure during the reporting period is irrelevant to whether they must make EPS disclosures.

C. **Correct.** ASC 260 applies to companies with publicly traded common stock or potential common stock. It also applies to companies that have filed or are in the process of filing with a regulatory body in preparation for issuing such securities. Furthermore, if EPS data are presented by nonpublic companies, they must comply with ASC 260. EPS disclosures are therefore required only for public companies.
D. Incorrect. Private entities need not present EPS data.

14. The income statement presents data for primary and fully diluted per share for which of the following?

A. Incorrect. EPS data are presented for cumulative effect of accounting changes.
B. Incorrect. EPS data are presented for discontinued operations.
C. Incorrect. EPS data are presented for extraordinary items.
D. **Correct.** Earnings per share data are presented for both primary and fully diluted EPS for each period presented for each of the following, if they exist: income from continuing operations, discontinued operations, extraordinary items, cumulative effect of accounting changes, and net income.

Section 3

15. Comprehensive income includes which of the following?

A. Incorrect. Comprehensive income does not include investments by owners.
B. **Correct.** Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period, *except* those resulting from investments by owners and distributions to owners.
C. Incorrect. Comprehensive income refers to the change in equity (net assets) arising from either transactions or other occurrences with non-owners. Excluded are investments and withdrawals by owners.
D. Incorrect. Comprehensive income includes all changes in equity except those resulting from investments by owners and distributions to owners.

16. When a full set of general-purpose financial statements is presented, comprehensive income and its components should

A. Incorrect. Discontinued operations, extraordinary items, and cumulative effect of a change in accounting principle are components of net income, which is itself a component of comprehensive income.
B. Incorrect. The components of OCI are displayed either (1) net of related tax effects or (2) before the related tax effects with one amount shown for the aggregate tax effect related to the total of OCI. No amount is displayed for the tax effect related to total comprehensive income.
C. Incorrect. Comprehensive income and its components must be displayed in a financial statement given the same prominence as other financial statements included in the full set of financial statements.
D. **Correct.** If an enterprise that reports a full set of financial statements has items of OCI, it must display comprehensive income and its components in a financial statement having the same prominence as the other statements included in the full set. No particular format is required, but net income must be shown as a component of comprehensive income in that statement.

17. Which of the following items should be reported as a component of other comprehensive income (OCI)?

A. Incorrect. Unrealized gains and losses on trading securities are included in net income.
B. **Correct.** Comprehensive income includes all changes in equity of a business entity except those changes resulting from investments by owners and distributions to owners. Comprehensive income includes two major categories: net income and OCI. Net income includes the results of operations classified as income from continuing operations, discontinued operations and extraordinary items. Components of comprehensive income not included in the determination of net income are included in OCI, for example, unrealized gains and losses on available-for-sale securities (except those that are hedged items in a fair value hedge).
C. Incorrect. Realized gains and losses on available-for-sale securities are included in net income.
D. Incorrect. An amount for the cumulative effect of a change in accounting principle is not recognized in current net income.

18. Rock Co.'s financial statements had the following balances at December 31: Extraordinary gain = $ 50,000; Foreign currency translation gain = $100,000; Net income = $400,000; and Unrealized gain on available-for-sale equity securities = $20,000. What amount should Rock report as comprehensive income for the year ended December 31?

A. Incorrect. Foreign currency items and unrealized gains on available-for-sale equity securities are components of OCI.
B. Incorrect. A foreign currency translation gain is a component of OCI.
C. **Correct.** Comprehensive income includes all changes in equity of a business enterprise except those changes resulting from investments by owners and distributions to owners. Comprehensive income includes two major categories: net income and other comprehensive

income (OCI). Net income includes the results of continuing and discontinued operations and extraordinary items. Components of comprehensive income not included in the determination of net income are included in OCI, for example, unrealized gains and losses on available-for-sale securities (except those that are hedged items in a fair value hedge) and foreign currency items. Thus, Rock's comprehensive income equals $520,000 ($400,000 net income + $100,000 translation gain + $20,000 unrealized gain on available-for-sale securities).

D. Incorrect. The extraordinary gain is already included in the net income amount of $400,000.

19. Personal financial statements should report assets and liabilities at

A. Incorrect. The historical cost of assets and liabilities does not have to be reported.
B. **Correct.** AICPA Statement of Position (SOP) 82-1, *Accounting and Financial Reporting for Personal Financial Statements*, requires personal financial statements to present assets at their estimated current values. Liabilities should be presented at their estimated current amounts at the date of the statement. The estimated current value of an asset is defined as the amount at which the asset could be exchanged between informed and willing sellers and buyers, neither of whom is compelled to buy or sell. Estimated current amounts of liabilities are defined as the lower of either the amount of future cash to be paid discounted at the interest rate implicit in the transaction in which the debt was incurred or the amount at which the debt could currently be discharged.
C. Incorrect. The historical cost of assets and liabilities does not have to be reported.
D. Incorrect. Estimated current values should be used.

20. SOP 82-1 requires or recommends which of the following personal statements?

A. Incorrect. SOP 82-1 requires a statement of financial condition, but not that of cash flows.
B. Incorrect. SOP 82-1 recommends changes in net worth.
C. **Correct.** SOP 82-1 requires that personal financial statements include at least a statement of financial condition. It further recommends, but does not require, a statement of changes in net worth and comparative financial statements. A personal statement of cash flows, however, is neither required nor recommended.
D. Incorrect. Statements of financial condition and changes in net worth, but not of cash flows, should be included.