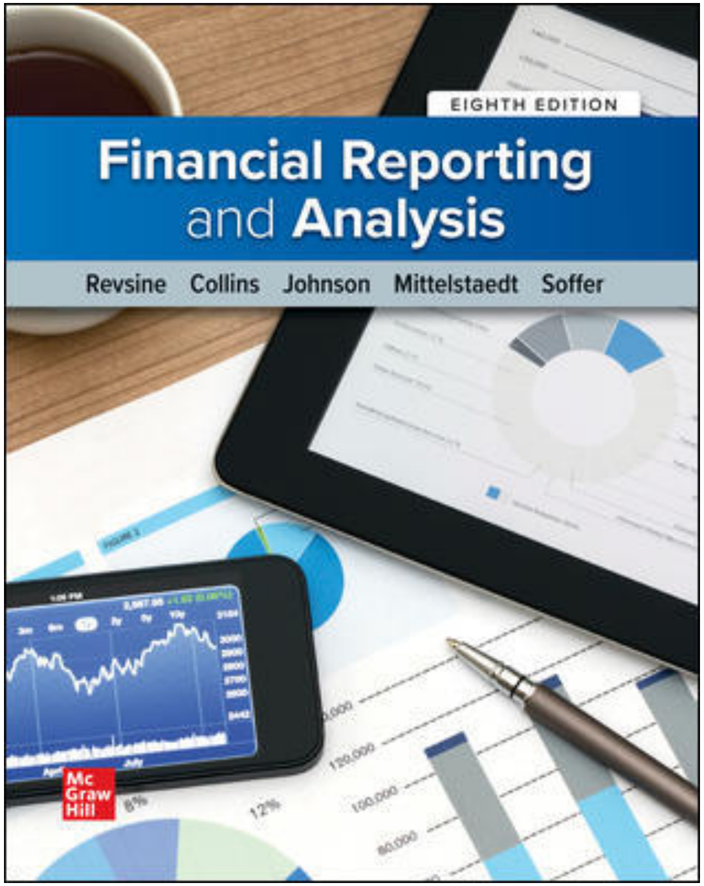
Accrual Accounting and Income Determination



Revsine/Collins/Johnson/Mittelstaedt/Soffer: Chapter 2

5 major Accounts types:

Assets, liab, Eq, Rev, Exp

↓

RE

−

Div

(Dr)

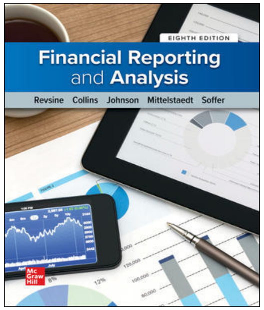
Balance sheet = St of financial position

B.S ⟹ A = L + E

(Permenant account)

St of cash flows: cash in, cash out

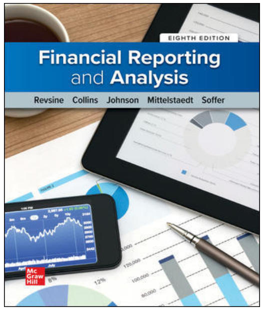
Dr	Cr



Learning Objectives

After studying this chapter, you will understand:

1. The distinction between cash-basis versus accrual income and why accrual-basis income generally is a better measure of operating performance.
2. The general concept behind revenue recognition under accrual accounting.
3. The matching principle and how it is applied to recognize expenses under accrual accounting.
4. The difference between traceable and period costs.
5. The format and classifications for a multiple-step income statement and how the statement format is designed to differentiate earnings components that are more sustainable from those that are more transitory.
6. The presentation of discontinued operations and unusual or infrequently occurring items.
7. The presentation of net income attributable to non-controlling interests.

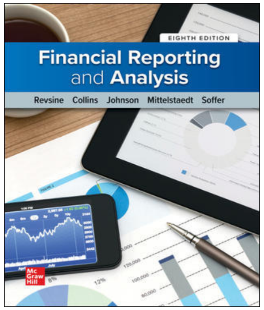


Learning Objectives, continued

After studying this chapter, you will understand:

8. The distinction between basic and diluted earnings per share (EPS) and required EPS disclosures.
9. What comprises comprehensive income and how it is displayed in financial statements.
10. Other comprehensive income differences between IFRS and U.S. GAAP.
11. How the flexibility in GAAP invites “earnings management.”
12. The procedures for preparing financial statements and how to analyze T-accounts.

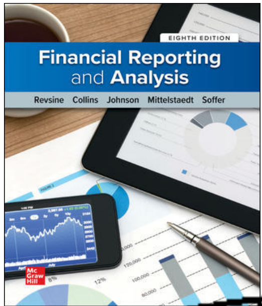
$$EPS = \frac{NI - Div_{Pref}}{\text{\# of shares outstanding}}$$



Key Concepts And Practices that Govern the Measurement of Income

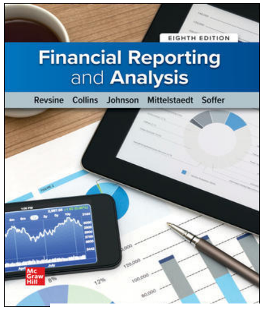
Under accrual accounting:

- Revenues are recorded (recognized) when the seller has transferred control over goods or services to a buyer, which entitles the seller to the benefits represented by the revenues.
- Expenses are expired costs or assets that are used to produce those revenues.
  - Expense recognition is tied to revenue recognition – commonly referred to as the "matching principle."
  - Expenses are recorded in the same accounting period in which the related revenues are recognized.



Cash Flow Versus Accrual Income Measurement

- Accrual accounting decouples measured earnings (i.e., revenues minus expenses) from the amount of cash generated from operations.
  - Accrual accounting revenues generally do not correspond to cash receipts for the period, nor do accrual expenses always correspond to cash outlays for the period.
  - Accrual accounting can produce large discrepancies between measured earnings and the amount of cash generated from operations (cash-basis earnings).
- Accrual accounting better matches economic benefit with economic effort, thereby producing a measure of operating performance—accrual earnings— that provides a more realistic picture of past economic activities.
- Many believe that accrual accounting numbers also provide a better basis for predicting future performance of an enterprise.



Canterbury Publishing

n = 3

- In January 20X1, Canterbury Publishing sells a three-year subscription to its quarterly magazine to 1,000 customers.
- Customers pay the full subscription price ($300 = 12 issues x $25 per issue) up front.

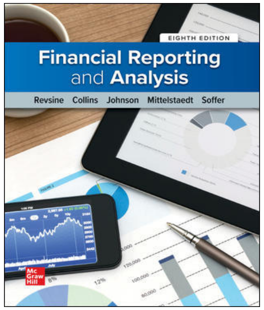
non operatg

- Canterbury takes out a $100,000 three-year loan. Interest at 10% per year is payable at maturity on December 31, 20X3. end of y3
- The cost of publishing and distributing the magazine is $60,000 each year, and is paid in cash at the time of publication.

exp

Operating Cash Inflows and Outflows

	20X1	20X2	20X3
Cash inflows	$300,000		
Cash outflows			
Production and distribution	(60,000)	(60,000)	(60,000)
Loan interest			($33,100)



Canterbury: Cash-Basis Summary

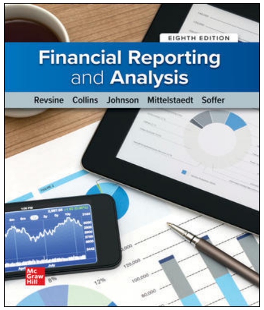
Cash-Basis Income Determination

	20X1	20X2	20X3
Cash inflows	$300,000	$0	$0
Cash outflows for production and distribution	(60,000)	(60,000)	(60,000)
Cash outflow for interest on loan	0	0	(33,100)
Operating cash flow	**$240,000**	**($60,000)**	**($93,100)**

$100,000 \times (1.10)^3 = 33,100$ int Exp

*$300 x 1000 = 300,000 total Rev

*3 year x 4 quard = 12 issues x 25 $ price $300



Canterbury: Accrual-Basis Journal and Adjusting Entries

we adjust temp Acc

Rev Exp

Transactions for 20X1

y1

DR Cash $50,000
  CR Common Stock $50,000

DR Cash $100,000
  CR Loan payable $100,000

DR Cash $300,000
  CR Deferred subscription revenue $300,000
  unearned

DR Publishing and distribution expense $60,000
  CR Cash $60,000

Adjusting entries on December 31, 20X1

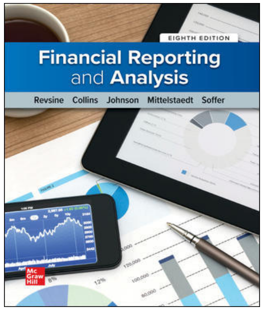
Int / unearned rev

$\frac{300,000}{3y}$

DR Deferred subscription revenue $100,000
  CR Subscription revenue → recognized $100,000

DR Interest expense $10,000
  CR Interest payable $10,000

100,000 X 10% = 10,000



Journal entry: to record each transaction as it occurs and at the end of each year to adjust for the passage of time.

Cash

dr	cr
50,000	60,—
100,—	
300,—	

Loan Pay

	100,—

unearned rev

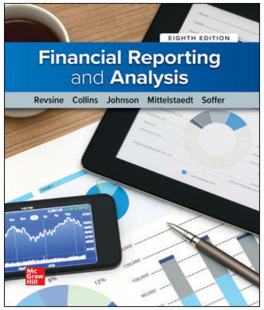
100,—	300,—
	200,— end of year

Exp

60,—	

Int Exp

10,000	



Canterbury: Accrual-Basis Journal and Adjusting Entries

Transactions for 20X2

DR Publishing and distribution expense	$60,000	
CR Cash	$60,000	

Adjusting entries on December 31, 20X2

DR Deferred subscription revenue	$100,000	
CR Subscription revenue		$100,000
DR Interest expense *[($100,000 + $10,000) x 10%]*	$11,000	
CR Interest payable		$11,000

100,— x (1 + 10%) =

Transactions for 20X3

DR Publishing and distribution expense	$60,000	
CR Cash	$60,000	

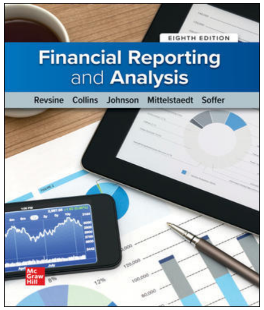
(100 + 10) x 10%

Exp

To calc Int Exp Y2, = (Principle + Int Exp total) x I%

or 100 x $(1+I)^n$

100,000 x $(1 + 10\%)^1$ = 11,000



Canterbury: Accrual-Basis Journal and Adjusting Entries

Adjusting entries on December 31, 20X3

100 +10 +11

DR Deferred subscription revenue	$100,000	
CR Subscription revenue		$100,000
DR Interest expense *[($110,000 + $11,000) x 10%]*	$12,100	
CR Interest payable		$12,100

Additional transaction on December 31, 20X3

DR Loan payable		$100,000
DR Interest payable		$33,100
CR Cash	$133,100	

close

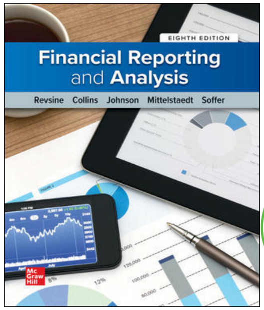
$100,- \times (1+10\%)^2$ → End of Year

$= 12,100 + 11 + 10$

loan pay 100,- Princ.

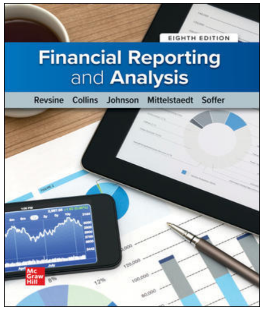
int pay 33 100

cash 133100



Canterbury Publishing Accrual-Basis Income Statements

	20X1	20X2	20X3
Subscription revenue	**$100,000**	**$100,000**	**$100,000**
Expenses:			
Publishing and distribution	**(60,000)**	**(60,000)**	**(60,000)**
Interest	**(10,000)**	**(11,000)**	**(12,100)**
Net Income	**$30,000**	**$29,000**	**$27,900**

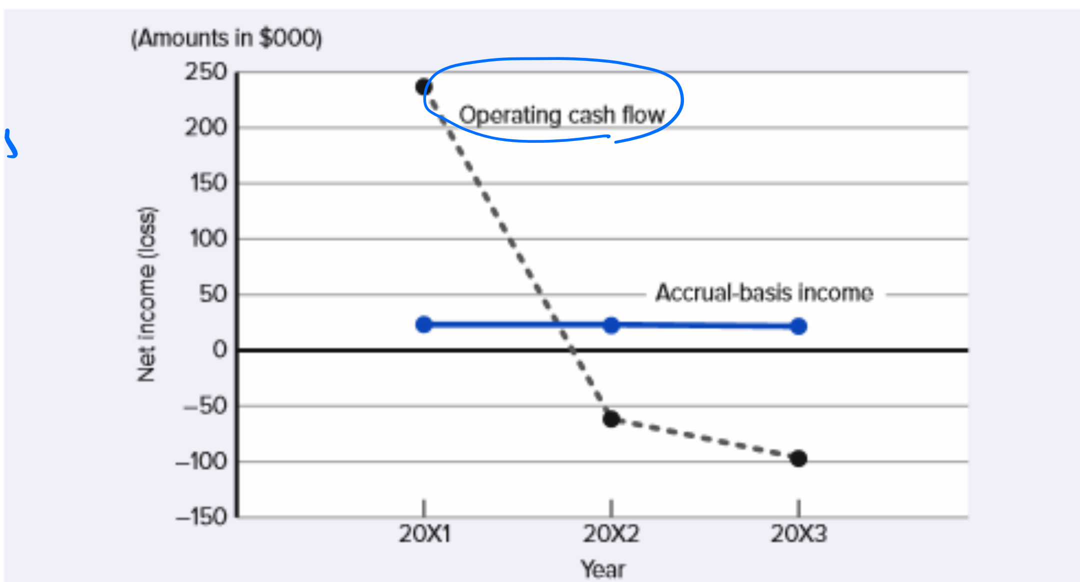


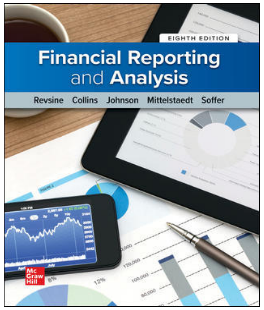
Canterbury: Observations about Accrual-Basis

- Accrual accounting:
  - Decouples earnings measurement from operating cash flows.
  - Better matches economic benefit (revenue from subscriptions) with economic effort (magazine publication and distribution expenses and interest costs).
  - Produces a measure of operating performance that provides a more realistic picture of past economic activities.

– Provides a better basis for predicting future performane.

based on consumption of resources not the timing of cashflows





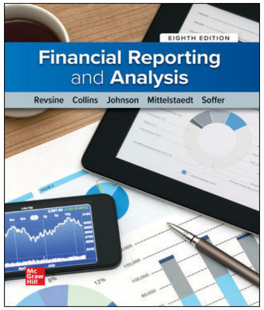
Articulation of Income Statement and Balance Sheet

- Two things happen when income is recognized in the financial statements:
  1. Owners' equity is increased by the amount of the income.
  2. Net assets (that is, gross assets minus gross liabilities) are increased by an identical amount.
- Thus there are two identical ways of thinking about income recognition:

ASSETS – LIABILITES		**OWNERS' EQUITY**
Income increases net assets	=	Income (revenues minus expenses) increases owners' equity

RG

- Net asset valuation and income determination are interrelated.



Statement of Cash Flows:
Direct / indirect method
important for MT / Final / Comp

Inc. St — Bal. Sheet

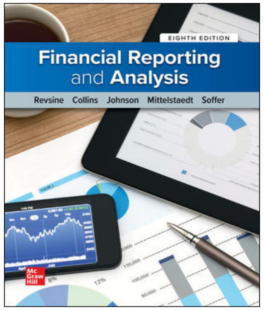
if Inc is rec ↑ + → net asset ↑ +, R.E ↑(+)

(Asset − L)

if ~ ↓ (−) → net. A ↓(−). RE ↓(−)

Retained earnings: is a component of owners Equity, It is the accumulation of all the company's earnings since its inception, net of dividends.

BV an account reported on a Comp. balance sheet



How Income Affects the Balance Sheet

Step 1: Revenue recognition

Assets	=	Liabilities	+	Owners' equity
+$130 Cash				+$130 Sales revenue

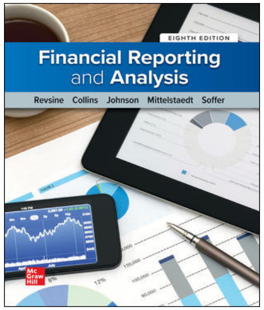
Step 2: Expense matching

Assets	=	Liabilities	+	Owners' equity
−$100 Inventory				−$100 Cost of goods sold

because part of NI

SUBSEQUENT BALANCE SHEET

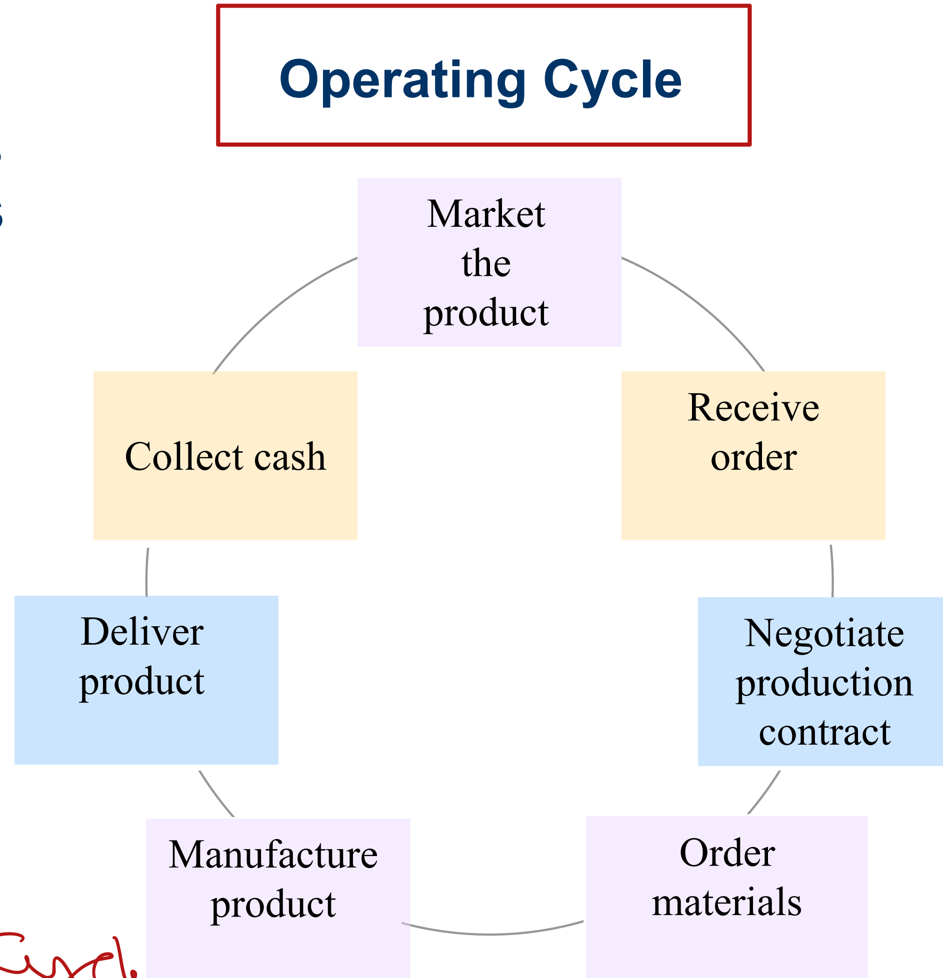
Assets		Liabilities + Owners' equity	
Cash	$130	Liabilities	$ —
Inventory	—	Initial equity	$100
		+ increase in equity:	
		Income (+$130 − $100)	30
	$130		$130



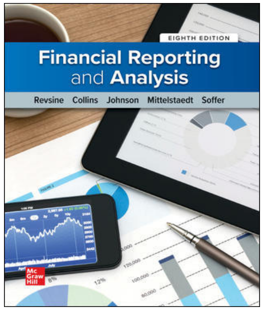
A Critical Accounting Question

At what point is it appropriate to recognize that a firm's net assets have increased in value and thus recognize income?

- Step 1: Revenue is recognized when an entity satisfies its contractual obligation to provide goods and services to a customer.
- Step 2: The matching principle associates costs (expenses) with the revenues recognized in a period.



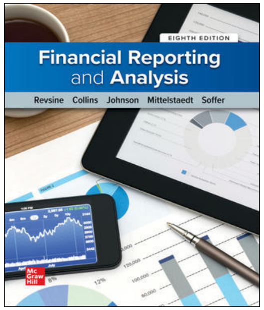
every bus. has diff op. cycle
it about time used to generate Rev from Ope.



Revenue Recognition—General Concepts

IFRS

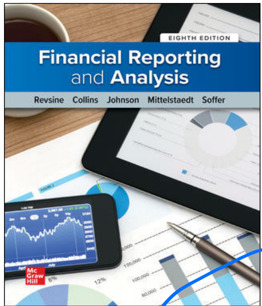
- Recently, the FASB and IASB issued a joint pronouncement that revamped the standards for revenue recognition.
  - The new standard replaced a patchwork of rules, many of which were industry-specific, with a single framework for when revenue is to be recognized.
    (We explore this standard in detail in Chapter 3.)
- For now, think of the point at which revenue is to be recognized as the point at which the entity has satisfied its obligation to provide goods or services to a customer.



Expense Recognition

- Once revenue for a period has been determined, the next step in determining income is to accumulate and record the costs associated with generating the revenue.
- There are two types of costs associated with generating revenue:
  1. **Traceable costs** are easily traced to the revenue earned.
  2. **Period costs** are also clearly important in generating revenue, but their contribution to a specific sale is difficult, if not impossible, to quantify.

cost



1

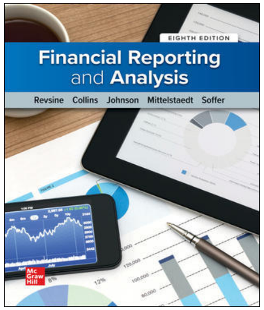
Traceable Costs

Rev

Exp.

NI

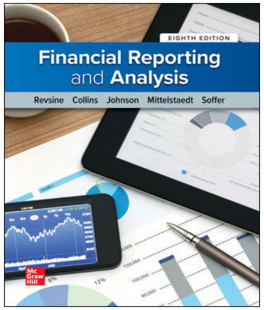
- **Matching** process: Traceable costs are recognized in expense in the same period as the corresponding revenue is recognized.
- **Product costs:**
  - Costs of physically producing a good.
  - Often constitute a large portion of the traceable costs.
  - Also include manufacturing overhead (factory maintenance, insurance, depreciation, etc.)
    - It is difficult to associate overhead costs with specific units of production.
    - Generally allocated to inventory costs (and thus expensed as part of cost of goods sold) on some rational basis.



Canterbury's Traceable Costs

- Recall that Canterbury Publishing sells subscriptions to its quarterly magazine to customers.
- Canterbury's product costs:
  - The cost of physically producing each copy of the magazine is traceable to the revenue for that copy.
- Canterbury's other traceable costs:
  - The distribution costs are assumed also to be traceable.
    - It is possible to identify the delivery costs with the physical delivery of the magazines.
    - These are not product costs, but they are still recognized as expense in the same period as the revenue to which they are traced.

matched

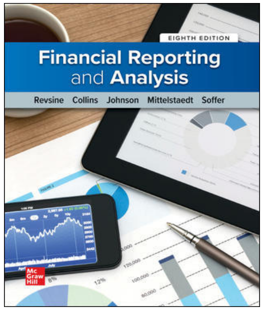


2

Canterbury's Period Costs

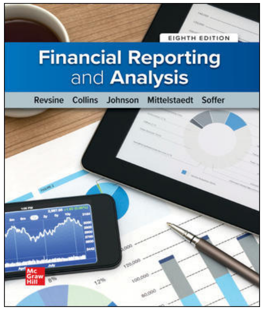
Recall that Canterbury Publishing also incurred interest expense.

- Canterbury's period costs:
  - Although interest is a necessary cost, it is not possible to associate interest with specific copies of the magazine.
    - Thus, it is a period cost and it is expensed in the period the benefit was derived.
- Period costs are not expensed on a cash basis.
  - The interest was all paid in 20X3, but it was still expensed over the years the loan was outstanding, which is the period of time Canterbury benefited from the use of the borrowed funds.



Income Statement Format and Classification

- Virtually all decision models in modern corporate finance are based on expected future cash flows.
- Financial reporting seeks to satisfy users' needs by providing financial information in a format that gives users reliable and representative baseline numbers for generating *their own* forecasts of future cash flows.
- The income statement separates earnings into two components:
  - Continuing operations $\xrightarrow{\text{ovr}}$ FOC VS
    - "Sustainable" or likely to be repeated in future reporting periods
  - Discontinued operations
    - "transitory"



"Transitory" Earnings

Material events that arise from a firm's ongoing, continuing activities that are unusual in nature or infrequent in occurrence

EXHIBIT 2.2 Mythical Corporation

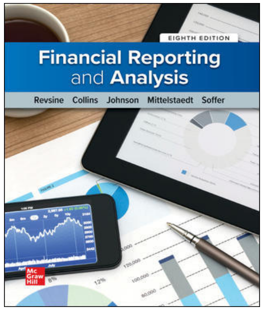
Income Statements for the Years Ended Dece... 31,

($ in millions)	20X3	20X2	20X1
Net sales	$ 3,957	$ 3,478	$3,241
Costs of goods sold	(1,364)	(1,189)	(1,096)
Gross profit	2,593	2,289	2,145
Selling, general, and administrative expenses	(1,093)	(949)	(922)
① Unusual or infrequently occurring items (Note 1)	(251)	–	–
Income from continuing operations before income taxes	1,249	1,340	1,223
Income tax expense	(262)	(281)	(257)
② Income from continuing operations	987	1,059	966
③ Discontinued operations (Note 2)			
Income from discontinued operations, net of tax	243	450	568
Gain on disposal of discontinued business segment, net of tax of $32	119	–	–
Net income	$ 1,349	$ 1,509	$1,534

Income from Continuing Operations

Unusual or Infrequently Occurring Items

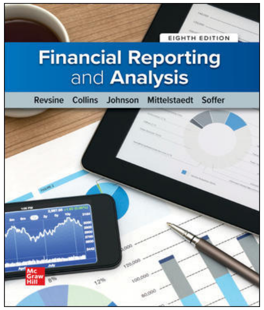
Transactions related to certain operations the firm intends to discontinue or has already discontinued



Unusual or Infrequently Occurring Items

- **Unusual or infrequently occurring items**
  - Gains and losses (usually losses) that arise from a firm's continuing operations, but that are not typical, recurring costs.
  - Reported as separate line items in the continuing operations section of the income statement.
  - Examples:
    - Write-downs or write-offs of receivables, inventory, equipment leased to others, and intangibles
    - Gains or losses from the exchange or translation of foreign currencies
    - Gains or losses from the sale or abandonment of property, plant or equipment
    - Special one-time charges from corporate restructurings
    - Gains or losses from the sale of investments
    - Losses from floods, fires, or other disasters

Continuing

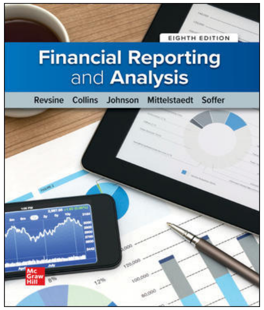


different than unusual

Discontinued Operations

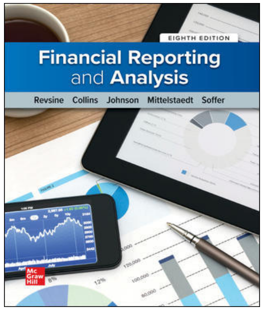
its a business decision.

- Transactions related to certain operations the firm intends to discontinue or has already discontinued are separated from other income statement items.
- Discontinued operations will not generate *future* operating cash flows.
- Classification on income statement:
  - The operating results of discontinued operations are excluded from continuing operations in the current period when the decision to discontinue was made.
  - In addition, they are excluded from continuing operations in any prior years for which comparative data are provided.
  - Net income for those prior years are the same as originally reported; the amounts removed from continuing operations are reclassified to discontinued operations.



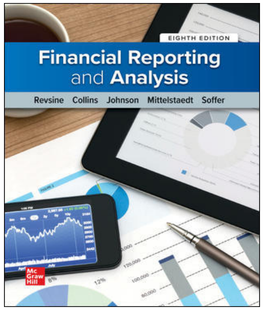
Discontinued Operations: Criteria

- The **component of an entity** must comprise operations and cash flows that can be clearly distinguished from the rest of the entity.
  - If component has been disposed of:
    - It is treated as a discontinued operation if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results.
  - If the component has not yet been disposed of:
    - It must first be determined whether it is classified as **held for sale.**
    - If the component is deemed to be held for sale, then it also must meet the strategic shift criterion to be given discontinued operations treatment.



Held for Sale

- A disposal group is considered **held for sale** if the following six conditions are met:
  - Management has committed to a plan to sell the component.
  - The component is available for immediate sale in its present condition subject only to terms that are usual and customary.
  - An active program to locate a buyer has been initiated, as have all other necessary actions.
  - The sale is probable, and is expected to be completed within one year (subject to certain exceptions).
  - The component is being actively marketed at a reasonable price.
  - It is unlikely that significant changes will be made to the disposal plan or that it will be withdrawn.



Amounts Reported When Disposal Group Has Been Sold

- When the discontinued component is sold before the end of the reporting period, companies report two elements as part of discontinued operations:
  - Operating income or loss (that is, revenue minus expenses) from operating the component from the beginning of the reporting period to the disposal date, net of related tax effects.
  - Gain or loss on disposal computed as the net sale price minus book value of net assets disposed of, net of related tax effects.

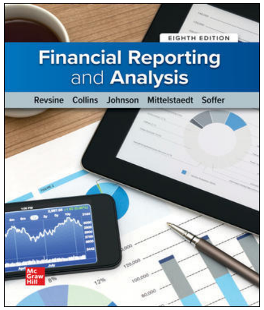
P – BV

can be used for CF's statement

① اصلا. op me الي يكون فيه طول ما اشتغلها

② الربح او الخسارة من انتهاء صفقة. P – BV

net of tax → SW



Amounts Reported When Disposal Group Is Considered "Held for Sale"

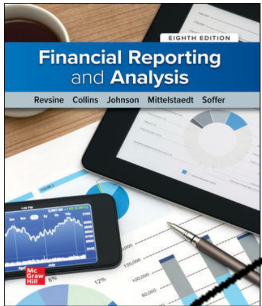
- If a component becomes a discontinued operation in a reporting period but has not been sold by the end of the period, the income effects of the discontinued operations are reported in two elements:
  - Operating income or loss (that is, revenue minus expenses) from operating the component, net of tax effects.
  - An impairment loss (net of tax effects) if the book value of the net assets in the disposal group is more than the net assets' fair value minus cost to sell.

2. an impairment loss when

Book value

if BV > N.A FV

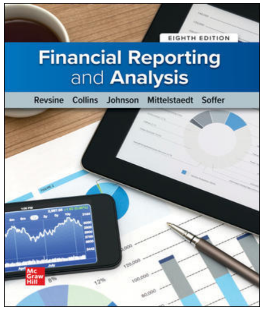
of N.A - Cost to sell



Reporting as Net of Tax Effects

- "Net of tax" treatment is called **intraperiod income tax allocation.**
  - The income (loss) from operating the discontinued component is reported net of tax effects.
  - Any gain (loss) from disposal or impairment are reported net of tax effects.
- Intraperiod income tax allocation matches the income tax burden or benefit with the item giving rise to it.

why : to match the income tax burden or benefit with the item giving rise to it.



Proportion of Firms Reporting Nonrecurring Items

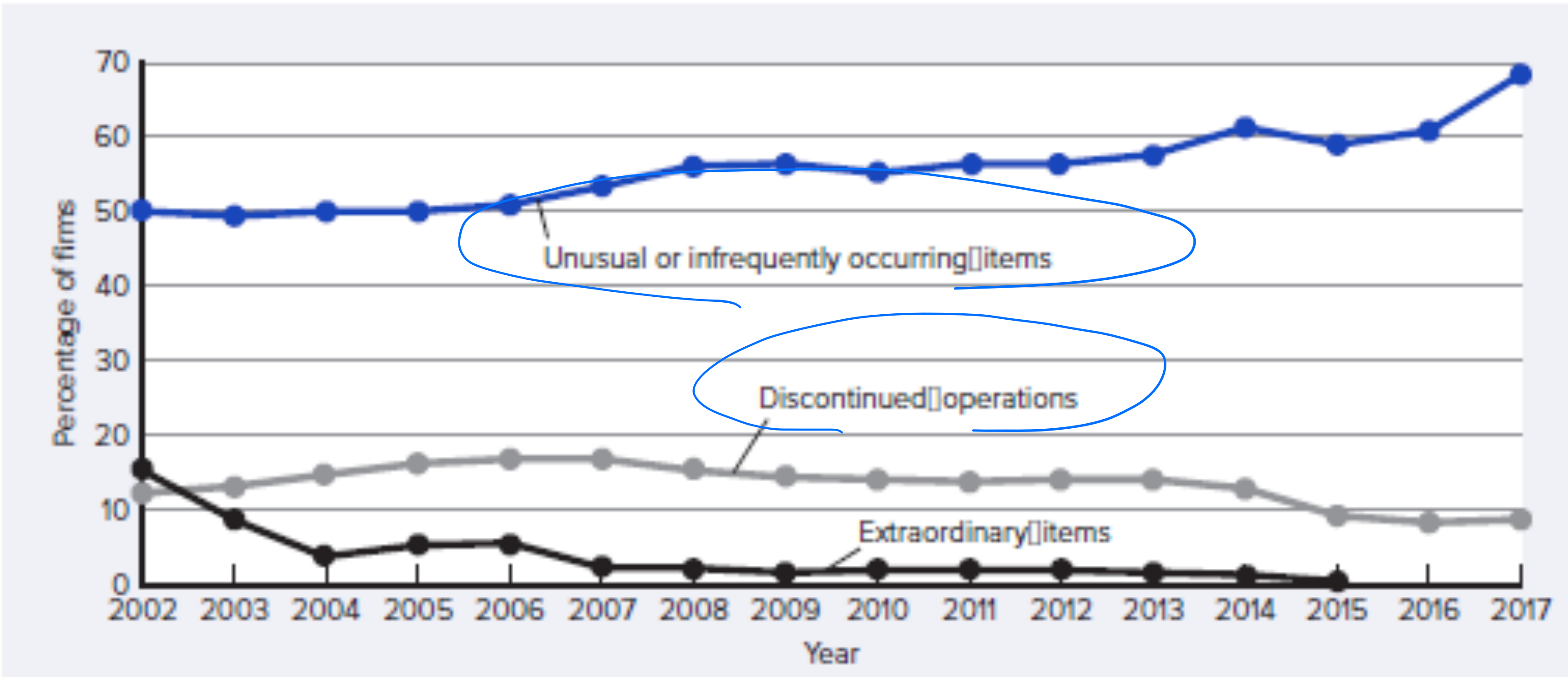
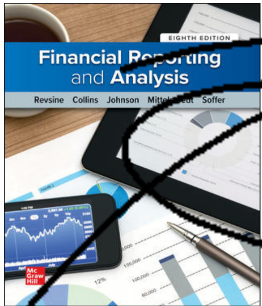


Figure 2.2 PROPORTION OF FIRMS REPORTING NONRECURRING ITEMS (2002–2017)

SOURCE: Standard and Poor's Compustat® Annual Industrial File as data source; methodology not verified or controlled by Standard & Poor's.



interesting تقول ان

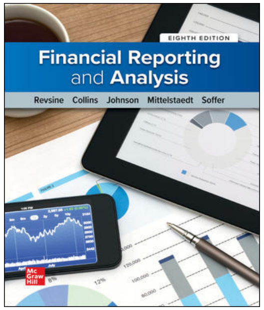
Earnings Management

- Applying the criteria for revenue and expense recognition still leaves room for considerable latitude and judgment
  - Managers can sometimes exploit the flexibility in GAAP to manipulate reported earnings in ways that mask the company's underlying performance.
  - Some managers have even resorted to outright financial fraud (but this is relatively rare).
- Earnings management has become increasingly common because of pressure to meet analysts' earnings forecasts.
- The representational faithfulness and predictive usefulness of the resultant accounting numbers may then be compromised.

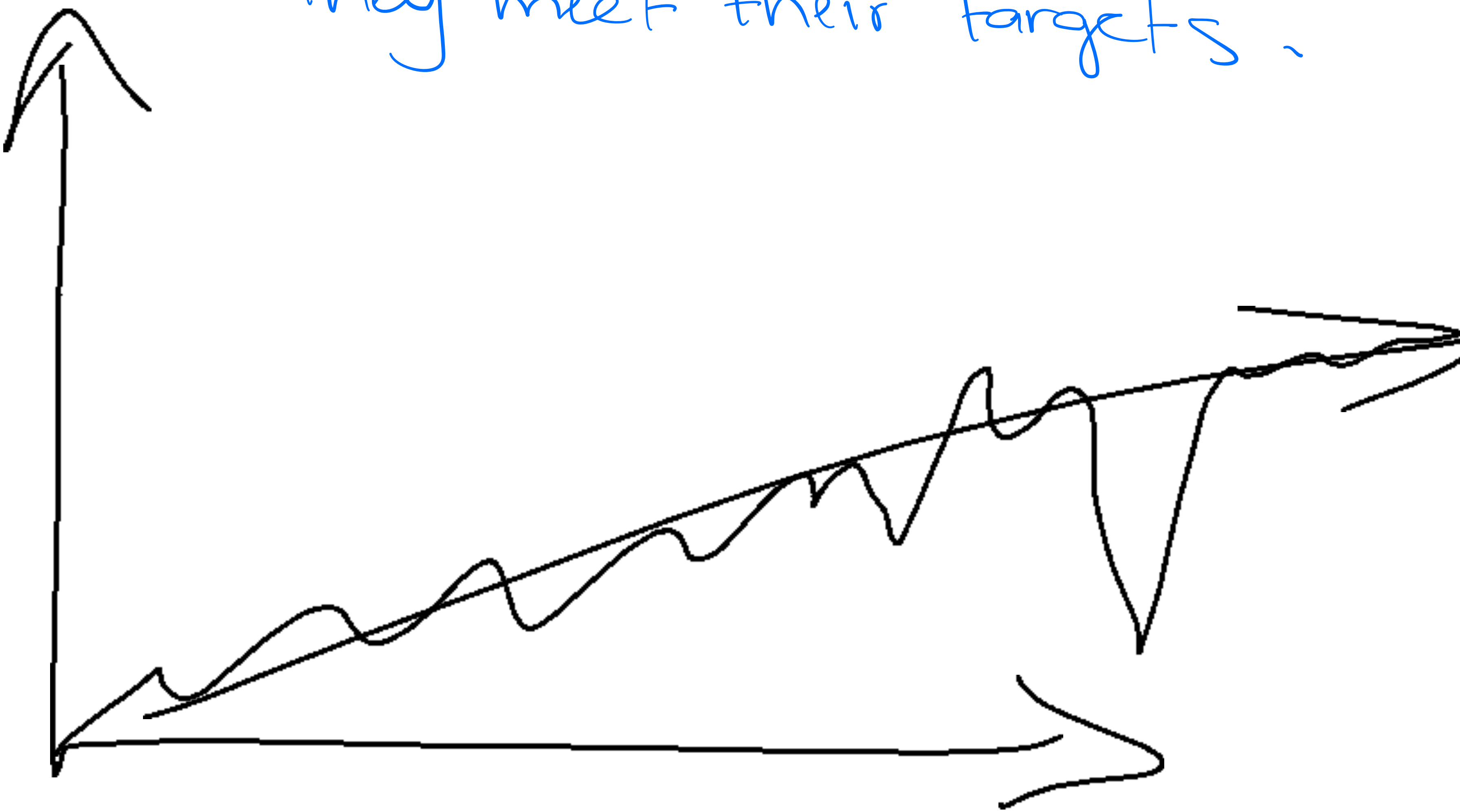
IFRS

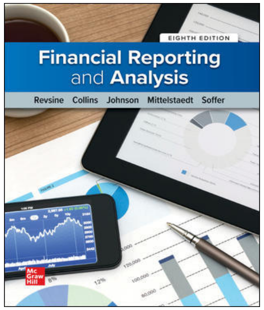
as a user of fin. st, I should be aware of manag incentives to distort reported earning and ways in which this is done.

- faithfulness / predictive usefulness



- compensasion based on budgets or targets can lead managers to manipulate both setting of target & how they meet their targets.

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Financial Reporting and Analysis
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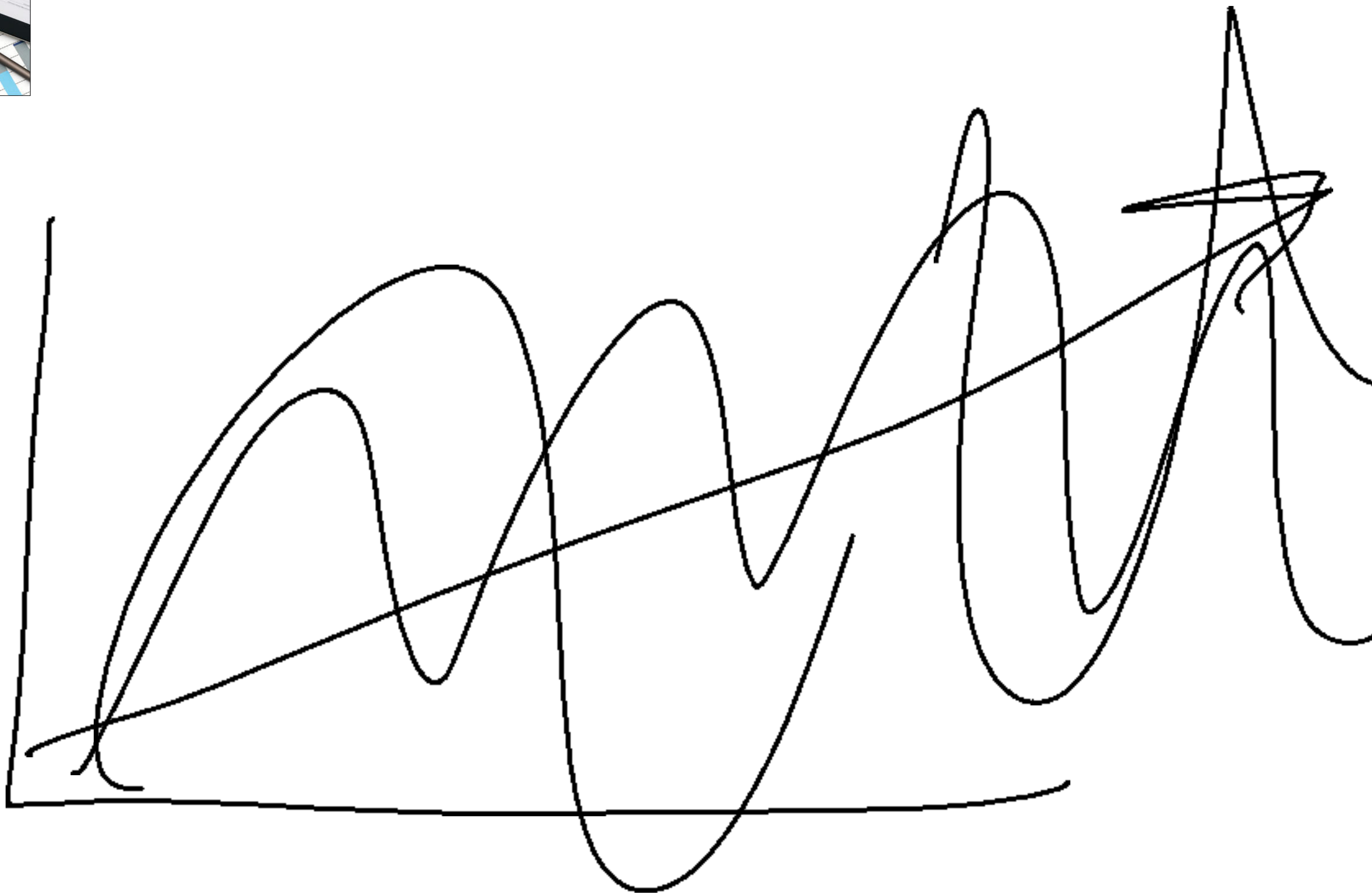
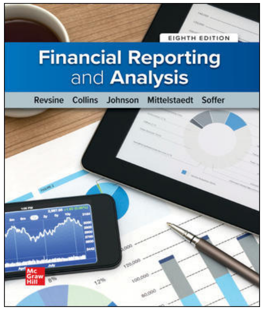
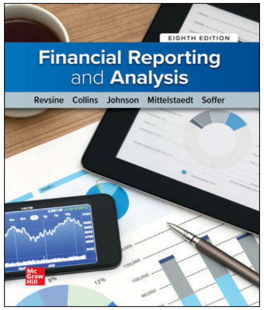
Mc Graw Hill





Popular Earnings Management Devices: "Big Bath" Restructuring Charges

- **"Big bath" restructuring charges** are taken in an effort to "clean up" company balance sheets, managers have often taken excessive restructuring write-offs and overstated estimated charges for future expenditures.
  - The restructuring charges and liability reserves are sometimes reversed in future years to boost net income in those years.
  - The FASB now requires that a liability must actually have been incurred before recording a liability and taking an associated restructuring charge.
  - Because of the subjectivity of restructuring charges and the ability to take charges by writing down assets, overstatement of restructuring charges cannot be completely eliminated.

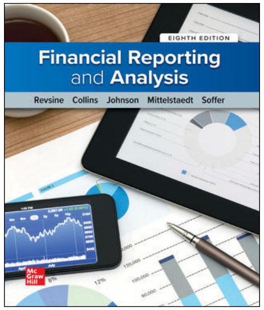


Popular Earnings Management Devices: “Cookie Jar Reserves”

IFRS

2

- **Miscellaneous “cookie jar reserves”** are recorded for bad debts, loan losses, warranty costs, and reserves for various future expenditures related to corporate restructuring.
  - Some companies use unrealistic assumptions to arrive at these estimated charges.
  - They over-reserve in good times and cut back on estimated charges, or reverse previous charges, in bad times.
  - A convenient income smoothing device.
    - One critique of IFRS is that it might offer more opportunities for “cookie jar reserves” accrual accounting than U.S. GAAP.



Popular Earnings Management Devices: Intentional Errors and Misstated Estimates

3

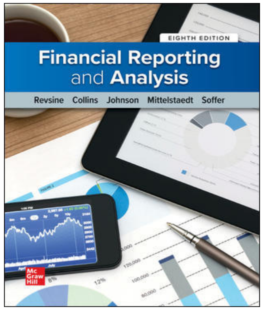
- Companies make **intentional errors** deemed to be “immaterial” and intentional bias in estimates.
  - Materiality thresholds are another way of using financial reporting flexibility to inflate earnings.
  - A series of “immaterial” errors spread across several accounts can, in the aggregate, have a material effect on earnings.

4

- Management can often **intentionally misstate** estimates.
  - Estimates abound in accrual accounting.
  - Management can often shade these estimates in one direction or the other to achieve a desired earnings target.

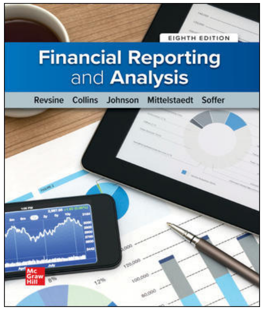
20

It could be a series of immaterial intentional error that over time will eventually become material bec. it has an effect of changing EPS (this method is used to inflate earnings)



Popular Earnings Management Devices: Revenue Recognition Abuses

- Another abuse is **premature or aggressive revenue recognition**.
- Under existing GAAP, revenue may be recognized at the point in time that the economic benefits of the goods or services being sold have been transferred to the customer.
- SEC Staff Accounting Bulletin (SAB) No. 104 illustrates troublesome areas of revenue recognition.



Earnings Per Share

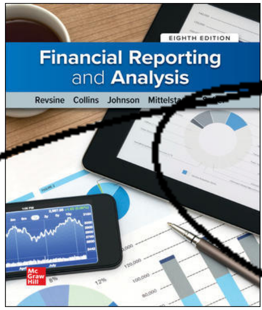
- Earnings per Share is one of the most commonly reported measures of a company's operating performance.
- All publicly traded companies must report EPS numbers on the face of their income statements.

- **Basic EPS** uses the weighted-average number of common shares outstanding for the period.
- **Diluted EPS** reflects what basic EPS would have been if all potentially dilutive (i.e., EPS reducing) securities were converted into common shares

$$\frac{\text{Income available to common shareholders}}{\text{Weighted-average common shares outstanding}}$$

for companies with complex capital structure, like firms with convertable debt, co. pref. stock options or warrants outstanding basic earning per share = $\dfrac{\text{NI} - \text{Prefered div}}{\text{\# of shares outstanding}}$ → = Inc Avail to common shareholders

↳ weighted avrg



Comprehensive Income and Other Comprehensive Income

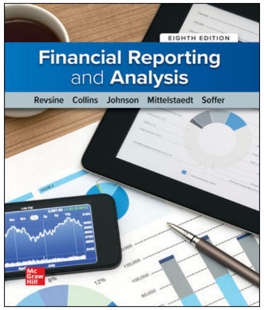
(net assets)

- **Comprehensive income** is the change in equity that occurs from transactions or events from non-owner sources.
- Most of the items included in comprehensive income result from **completed** or **closed transactions** with outside parties.
  - Closed transactions are those whose ultimate payoffs result from events that have already occurred and whose dollar flows can be predicted fairly accurately.
- All items of comprehensive income are categorized as net income or **other comprehensive income (OCI)**.
  - An item of comprehensive income is considered part of net income unless GAAP specifically designates it as part of OCI.
  - When it is part of OCI, no gain or loss is reported in net income; instead, the gain or loss is included in OCI for the year.

Ex: sale of inv. securities held by firm for years

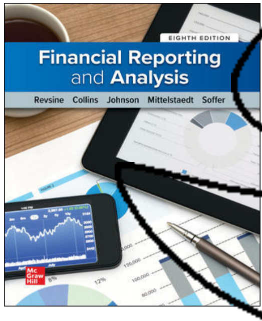
comp Inc

- NI
- OCI



Comprehensive Income and Other Comprehensive Income, continued

- A feature of U.S. GAAP is that OCI amounts are "recycled" when the incomplete transaction that gave rise to OCI becomes complete.
  - The recognition and subsequent recycling of OCI allows net income and comprehensive income to differ year by year.
- Under current GAAP, OCI arises from:
  - Certain foreign currency gains and losses
  - Gains and losses on marketable securities classified as available-for-sale
  - Certain other-than-temporary impairments
  - Certain gains and losses related to retirement plans
  - Gains and losses on certain hedging contracts



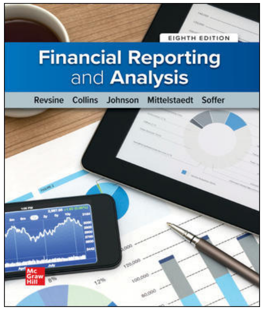
Comprehensive Income and Other Comprehensive Income, concluded

- U.S. GAAP requires firms to report comprehensive income in a statement that is displayed with equal prominence to other financial statements.
- Firms are permitted to display the components of other comprehensive income in a:

OCI

OCI

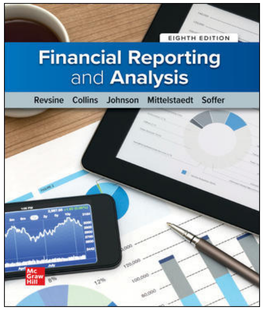
  - Single-statement format
    - Net income and other comprehensive income are both presented and their sum, comprehensive income, is the bottom line.
  - Two-statement format.
    - A traditional income statement is followed immediately on the next page of the report by a statement of comprehensive income that begins with net income and shows the individual other comprehensive income components, followed by comprehensive income.



Global Vantage Point

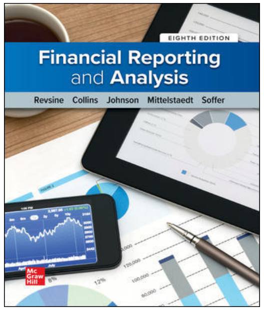
more flex

- U.S. GAAP and IFRS for OCI differ in many respects.
  - IFRS allows more opportunities for managers to change the balance sheet valuation of certain assets even when managers have no intention to sell or dispose of these assets.
  - IFRS allows managers to revalue property, plant, and equipment to an appraised fair value periodically.
  - With regards to defined benefit pension plans, both U.S. GAAP and IFRS require companies to report actuarial valuation changes in OCI each period; however, IFRS does not require firms periodically to re-categorize (“recycle”) a portion of these OCI changes into periodic net income.
  - Under IFRS, entities are required to group items within OCI based on whether they will be reclassified subsequently into net income (“recycled”).



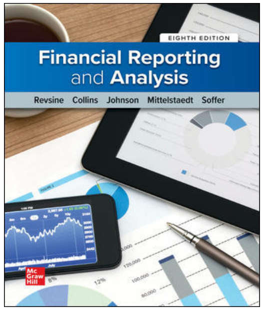
Review of Accounting Procedures and T-Account Analysis

- Appendix 2A:
  - Uses the basic accounting equation to show how various transactions affect its components.
  - Depicts the basic accounting equation in T-account form and show how debits and credits operate to reflect increases or decreases to various accounts.
  - Reviews adjusting entries relating to prepayments, deferred revenues, accrued expenses, and accrued revenues.
  - Describes the posting of journal entries to accounts and the preparation of financial statements.
  - Reviews the closing process.
  - Explains the use of T-account analysis as an analytical technique.



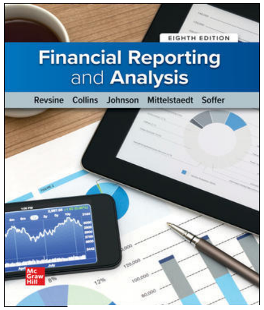
Summary

- Key differences between cash and accrual income measurement:
  - In most instances, accrual-basis revenues do not equal cash receipts and accrual expenses do not equal cash disbursements.
  - The principles that govern revenue and expense recognition under accrual accounting are designed to alleviate the mismatching of effort and accomplishment that would occur under cash-basis accounting.
  - The matching principle determines how and when the assets that are used up in generating the revenue or that expire with the passage of time are expensed.
  - Relative to current operating cash flows, accrual earnings generally provide a more useful measure of firm performance and serve as a more useful benchmark for predicting future cash flows.



Summary, continued

- Predicting future cash flows and earnings is critical to assessing the value of a firm's shares and its creditworthiness.
- Multiple-step income statements are designed to facilitate this forecasting process by isolating the more recurring or sustainable components of earnings from the nonrecurring or transitory earnings components.
- Auditors and financial statement users must be aware of the incentives to manage earnings and the ways in which this is accomplished.
- Public companies must report EPS numbers on the face of their income statements. All firms report basic EPS, while firms with complex capital structures also disclose diluted EPS.



Summary, concluded

- Certain changes in net assets resulting from incomplete or open transactions bypass the income statement and are reported as direct adjustments to stockholders' equity.
  - These direct adjustments are called *other comprehensive income components.*
  - Under U.S. GAAP, firms are required to report the components of other comprehensive income in either a single-statement format or a two-statement format.