
CHAPTER 1

**THE RESPONSIBILITIES OF THE
CONTROLLER**

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Although the responsibilities of the controller and the treasurer may overlap between different companies, the controllership functions, themselves, remain basically similar between industries and companies. The controller may provide financial information to diverse users, including internal management, stockholders, creditors (including banks and suppliers), stock exchanges, employees, customers, the public at large, U.S. government agencies (e.g., the Securities and Exchange Commission, Internal Revenue Service, Department of Commerce, Department of Labor, and the Federal Trade Commission), and state and local tax and other agencies.

RESPONSIBILITIES

The role of the controller is changing. Businesses growing in size and complexity, intervention by the government, and more diverse means of raising capital have added to the functions and responsibilities of the controller, and these functions

continue to change rapidly. Traditionally, the controller has been thought of as the chief accounting officer and financial planner of a corporation. Indeed, *Webster's Dictionary* defines the word *controller* in just those terms. The typical controller was the executive in charge of the record keeping for a company, the preparer of financial statements, and the person responsible for internal controls. Though still responsible for these functions, controllers today have expanded responsibilities and are becoming more involved with strategic planning.

Strategic planning entails becoming involved with the decision-making processes of the organization. The controller is in the unique position to do this, as he or she has knowledge of the company plus the financial know-how that few others in the corporation possess. As more chief executive officers begin to rely on the controller's office for information and for input into planning decisions, the controller will likely become an even more valuable member of the management team. No longer is it sufficient for a controller to just add up the numbers; most executives expect more.

Controllers can do more than gather the data of past performance and pump out reports. They can use the information collected to become involved in the dynamics of running the business. Controllers have already gathered much of the information required to improve profits and operations, reduce costs, and develop strategies for the company. Moreover, they have a "hands-on" feel of the operating environment, such as the interrelationships among management, production, and sales. The accounting function, by its very nature, provides a large percentage of the information needed by executives. The trick is to put this information to use for the future and not just report on the past. Where is the company headed? Although controllers must not turn their backs on the traditionally assigned accounting tasks, they must apply a vast body of knowledge to the future prospects of the organization. It is in this regard that controllers will prove useful and valuable to any company.

The controller is usually the head officer of an accounting department whose size varies by company. He or she is responsible for the products of the accounting department as well as for running an efficient and effective department. Maintaining the company records for accounts payable, accounts receivable, inventory, and other pertinent areas has traditionally been considered the primary function of the controller. All transactions must be recorded properly and in a timely manner, either manually or using computer software. Along with record keeping, the controller is responsible for the preparation of financial statements and, if required, interpreting these statements for management. In doing so, the controller may work closely with the independent auditors to ascertain that the statements are presented fairly in accordance with generally accepted accounting principles (GAAP). The controller will also work hand-in-hand with the auditors as they perform the year-end independent audit and may require his or her staff to assist the auditors in certain tasks. Furthermore, the controller may play an important role in terms of involvement with the audit committee. In addition to assisting with the external audit, the controller is involved with internal auditing on a year-round basis: evaluating the company's internal control structure in order to determine that

it is operating effectively and efficiently, making improvements in the structure if it is determined that there are deficiencies; and reporting to the audit committee or board of directors—perhaps on a regular basis—the status of the internal control structure. Addressing the needs of management is another important aspect of the controller's role. It must not be overlooked that the goal of business is to realize a profit. Without information about the costs of production and distribution, management cannot determine how to proceed in regard to marketing decisions.

The controller must construct reports relating to production costs and distribution costs. To help management determine the most profitable course to follow, the controller should be acquainted with break-even analyses, cost-volume-profit relationships, and standard cost methods. Adequate reporting to management to enable intelligent decision making requires knowledge not only of cost accounting but of responsibility accounting and exception reporting. The controller must be able to report historical data as well as develop trends and relationships from existing data. In addition, the controller should know how to make use of financial relationships, determine the trend of ratios, present the ratios in suitable form, and interpret the data in a comprehensive report.

Tax returns and other tax matters that pertain to the corporation are also handled by the controller. Although some companies refer tax matters to the public accountants, it is still the responsibility of the controller to avoid excess taxes. The controller must be fully informed about tax matters, particularly federal income taxes. Identifying and analyzing tax implications of a given transaction are important functions of the controller because the controller's role is not limited to verifying the validity of tax computations. Most important, to minimize the tax obligation, tax planning is crucial. The controller must recognize tax problems in the making—that is, before the transactions are complete.

Any statistical reports that are needed by management are usually prepared in the controller's department. Therefore, the controller must be familiar with the operational flow of the company as well as the needs of its executives so that useful information can be developed and presented. The controller must prepare a variety of reports for distribution to different levels of management, depending on their needs. These reports enable various managerial objectives to be attained and can include weekly sales reports segregated by territories, salespeople, or products, and labor reports based on actual and standard costs that can be presented by product, division, material usage, or other important variables. The annual budget, an important planning tool, is generally prepared by the controller's office. The construction of the budget and its basic guidelines are determined by the controller. The controller is expected to analyze the plan to ascertain that it is reasonable and reliable. In addition, proposing suggestions for improvements is vital to a company's growth. The budget may be flexible, fixed, or zero based and the controller must be knowledgeable in these areas. Once prepared, the budget becomes a control device, and the controller analyzes variances and advises management to take corrective action, if necessary.

The controller may also be expected to determine whether the company is carrying adequate insurance on properties and other assets. It is important to

maintain adequate records of all contracts and leases and it is the controller's function to determine that they are recorded properly. The controller is also responsible for determining that the entity is satisfying all regulations prescribed by governmental agencies. If the board of directors sets any goals regarding financial transactions, these are listed in the minutes of the board, and it is the obligation of the controller's office to ensure that they are acted upon.

The passing of the Foreign Corrupt Practices Act in 1977 required corporations to maintain financial records and to establish and maintain an effective internal control structure. The controller must be aware of this Act and its requirements and realize that maintaining reasonable records and adequate controls is now a matter of law. The controller must be familiar with the mechanics of establishing a sound internal control structure as well as understand the cost/benefit relationships in establishing and monitoring the structure. Failure to do so will lead to problems such as that experienced by Enron and others.

The reporting function of the controller's job is not limited to just internal uses. The controller will be called upon to assist in the formulation of the annual report to stockholders and to prepare other reports for government agencies such as the Securities and Exchange Commission (SEC). The information in the annual report must be easily understood and well written and should frequently use graphical and other illustrative material. The financial information contained therein is typically prepared by the controller who will be responsible for its content. There should always be adequate disclosure and the information must conform to GAAP and to SEC requirements.

SKILLS

To cope with all these various tasks, the controller must possess certain skills, the most important being a knowledge of current accounting principles and practices and an ability to communicate effectively to management the impact of recent promulgations. The controller also must keep abreast of any significant changes to GAAP. This can usually be accomplished by receiving advice from the independent auditor or by referring to published sources. The controller must know how to communicate ideas both orally and through written representations. A forward-looking controller understands that information should be presented in a useful and understandable format. He or she always considers future consequences and directions.

The ability to motivate and organize subordinate staff members is essential. As the head of the accounting department, the controller must be able to direct the members of the department so that they are responsible for their own work. It is important to be fair and reasonable when dealing with subordinates.

In addition, the controller must be able to interact with people at all levels of the organization. Because the controller's position requires the providing of information to many levels of management, it is crucial that the controller possess a basic understanding of the problems faced by the business as a whole and the problems faced by individual departments within the company. Although the controller is not expected to become an expert in engineering or production, it is

important to be familiar with these areas in order to anticipate the needs of all departments. To be effective, the controller has to get involved to some extent with the day-to-day operations of the company. After formulating suggestions, the controller must be able to market them. Gaining respect from other executives will enable this. If others see that the controller wants to help, they will actually seek his or her advice.

A wise controller knows the limits of his or her prescribed functions and knowledge base. The preparation of voluminous reports that are never read may make it appear that the controller is working to his or her utmost capacity, but in reality very little is being accomplished. Certain areas of reporting would more properly be done by managers with expertise in other areas, such as engineering or sales. Without the proper support staff, the controller cannot function at the level he or she would like to.

CONTROLLER VERSUS TREASURER

Unlike the controller, the treasurer's responsibility is mostly custodial in nature and involves obtaining and managing the company's capital; he or she primarily deals with "money management" activities. The treasurer's activities are *external*, primarily involving financing matters and mix; he or she is involved with creditors (e.g., bank loan officers), stockholders, investors, underwriters for equity (stock) and bond issuances, and governmental regulatory bodies (such as the SEC). The treasurer is responsible for managing corporate assets (e.g., accounts receivable and inventory), debt, credit appraisal and collection, planning the finances, planning capital expenditures, obtaining funds, dividend disbursement, managing the investment portfolio, and pension management.

In some organizations the duties of the controller and treasurer overlap, with the treasurer being, in effect, the controller's superior.

CONTROLLER'S REPORTS

A successful controller will possess the ability to communicate ideas to various interested parties through the preparation of various types of reports. Prospective financial information is often needed to enable departments and segments to plan the future effectively. In this regard, planning reports are often issued by the controller. Information reports, analytical and control reports, as well as exception reports prepared by the controller enable analysis of a diverse amount of information and situations. Reports prepared for the board of directors must address specific policy matters and general trends in revenue and profits. These reports must enable the Board to establish and attain specified goals. Reports prepared for other company employees must be useful and timely. Reports to stockholders and relevant stock exchanges must be informative and complete. The controller's role in reporting information, therefore, cannot be overstated.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Inasmuch as the controller is primarily responsible for the entity's accounting functions, he or she should be fully cognizant of recent promulgations in financial accounting. It is critical that the controller be able to prepare detailed and meaning-

ful financial statements. There are a host of reporting mandates applicable to the income statement, balance sheet, and statement of cash flows. To inform readers properly, disclosures should be made of all important items not presented in the body of the financial statements.

Note: On July 1, 2009, the *FASB Accounting Standards Codification*SM (ASC) became the one source of authoritative U.S. GAAP. Effective after September 15, 2009, the Codification supercedes all present accounting standards as the single official source of authoritative U.S. GAAP.

The Codification changes the manner in which U.S. GAAP is documented, updated, referenced, and accessed. All authoritative literature applicable to a particular topic is in one place.

The Codification includes standards issued by the following standard setters:

- Financial Accounting Standards Board (FASB)
- American Institute of Certified Public Accountants (AICPA)
- Securities and Exchange Commission (SEC)
- Emerging Issues Task Force (EITF)
- Derivative Implementation Group (DIG) Issues
- Accounting Principles Board (APB) Opinions
- Accounting Research Bulletins (ARB)
- Accounting Interpretations (AIN)

The Codification does not change generally accepted accounting principles (GAAP). Rather, it takes the individual pronouncements that presently comprise GAAP and reorganizes them into approximately 90 accounting Topics and displays them using a consistent structure.

To locate information about a specific issue in the Codification:

1. Go to the Topic itself (e.g., Accounts Receivable) and expand the Topic outline to find the appropriate material.
2. Use a word search.
3. Go directly to the paragraph if the reference is known.

MANAGEMENT ACCOUNTING

The controller truly serves as a financial advisor to management. He or she must be familiar with a wide variety of managerial accounting concepts and tools.

There are many basic cost concepts, classifications, and product costing systems. Knowledge of job order costing, process costing, direct costing, standard costing, and just-in-time manufacturing may be needed. Focus is also placed on cost analysis for planning, control, and decision making.

Regression analysis and mixed cost analysis may be required. The controller should be equipped with tools for sales mix analysis and what-if analysis.

In budgeting and financial modeling, the controller should use innovative and sophisticated techniques to maximize corporate objectives.

Knowledge of responsibility accounting and cost allocation is also needed. How has the performance of the responsibility centers been? Why? It is suggested that the controller be familiar with gross profit analysis, segment reporting, and contribution analysis. How may problems be identified and corrective action taken? Transfer pricing is also needed to determine divisional profit. Once such profit has been computed, the controller can calculate and analyze return on investment and residual income. In what ways may profit be improved? There must be efficient and effective analysis of company projects, proposals, and special situations. Consideration must therefore be given to time value concepts, capital rationing, capital budgeting, and mutually exclusive investments.

Quantitative applications in managerial accounting cannot be overlooked by the controller. The controller must understand decision theory and be able to make decisions under conditions involving uncertainty. Linear programming, shadow prices, and the learning curve should not be ignored in fulfilling the role of controllership. A controller familiar with Program Evaluation and Review Techniques (PERT) and inventory planning models is in a position to further assist senior-level management. Multiple regression and correlation analysis depict previous relationships that will aid in making future predictions.

INTERNAL AUDITING AND CONTROL

The controller is often called upon to establish, monitor, and analyze the internal control structure of the company. In this regard, an internal control questionnaire may be useful. It is important to keep in mind that every company is different and, therefore, the internal control questionnaire should be tailored to the particular needs and peculiarities of each company. Internal controls should be put in place in conjunction with the outside auditors to facilitate their function and lessen audit costs.

In connection with the internal audit function, controllers must identify financial statement assertions, select appropriate audit procedures, and develop audit programs. Audit programs may be used for all accounts, including cash, receivables, inventory, fixed assets, payables, equity accounts, income, and expenses.

FINANCIAL ANALYSIS

A truly effective controller is equipped with tools for financial analysis. Risk and reward have to be considered. Techniques for analyzing and managing risk must be employed. Insurance policies must be scrutinized because proper financial management includes securing adequate insurance coverage in terms of insurance type and dollar amounts. Adequate insurance records must be kept for major assets.

Once financial statements are prepared, they must be analyzed for proper internal use. Attention should be given to horizontal and vertical analysis, evaluation of liquidity, examining corporate solvency, balance sheet analysis, and appraisal of income statement items.

Legal exposure of the firm must be monitored, and means to minimize litigation undertaken. An example is product liability insurance.

CHAPTER 8

**FINANCIAL STATEMENT REPORTING: THE
INCOME STATEMENT**

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Income statement preparation involves proper revenue and expense recognition. There are many methods available to recognize revenue, including specialized methods for particular industries. Extraordinary and nonrecurring items require separate presentation. The income statement format is highlighted along with the earnings-per-share computation.

INCOME STATEMENT FORMAT

The format of the income statement, starting with income from continuing operations follows:

Income from continuing operations before tax
Less: Taxes
Income from continuing operations after tax
Discontinued operations:
Income for discontinued operations (net of tax)
Loss or gain on disposal of a division (net of tax)
Income before extraordinary items
Extraordinary items (net of tax)
Net income

Note: Earnings per share is shown on these items as well.

Comprehensive Income

ASC 220, *Comprehensive Income*, requires companies to report comprehensive income and its elements in a full set of financial statements. ASC 220 keeps the current reporting requirements for net income, but it considers net income a major element of comprehensive income. A restatement of previous years' financial statements is needed when presented for comparative purposes.

Comprehensive income applies to the change in equity (net assets) arising from either transactions or other occurrences with nonowners. Excluded are investments and withdrawals by nonowners. Comprehensive income is made up of two components (1) net income and (2) other comprehensive income. Other comprehensive income relates to all items of comprehensive income excluding net income. Thus, net income plus other comprehensive income equals total comprehensive income. Other comprehensive income includes 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.
- Unrealized losses or gains on available-for-sale securities.
- Minimum pension liability adjustments applying to the amount by which the additional pension liability exceeds the unrecognized prior service cost.
- Changes in market value of a futures contract that is a hedge of an asset reported at fair value.

ASC 220 provides flexibility on how comprehensive income may be shown in the financial statements. Two allowable options for reporting other comprehensive income and its components are as follows:

1. Below the net income figure in the income statement, or
2. In a separate statement of comprehensive income beginning with net income.

Options 1 and 2 are income-statement-type formats.

A sample presentation under option 1 within the income statement follows.

Statement of Income and Comprehensive Income	
Net income	\$600,000
Other comprehensive income:	
Foreign currency translation loss	(\$50,000)
Unrealized gain on available-for-sale securities	70,000
Minimum pension liability adjustment	(10,000)
Total other comprehensive income	<u>10,000</u>
Total comprehensive income	<u>\$610,000</u>

Under option 2, a separate statement of comprehensive income is presented. The reporting follows.

Income Statement	
Net income	<u>\$600,000</u>
Statement of Comprehensive Income	
Net income	<u>\$600,000</u>
Other comprehensive income:	
Foreign currency translation loss	(\$50,000)
Unrealized gain on available-for-sale securities	70,000
Minimum pension liability adjustment	(10,000)
Total other comprehensive income	<u>10,000</u>
Total comprehensive income	<u>\$610,000</u>

The components of other comprehensive income for the period may be presented on a before-tax basis with one amount for the tax impact of all the items of other comprehensive income.

A reclassification adjustment may be required so as not to double-count items reported in net income for the current period when they have also been considered as part of other comprehensive income in a prior period. An example is the realized gain on an available-for-sale security sold in the current year when a holding gain was also included in other comprehensive income in a prior year. Reclassification adjustments may also apply to foreign currency translation. The reclassification adjustment applicable to a foreign exchange translation applies only to translation gains and losses realized from the sale or liquidation of an investment in a foreign entity.

Reclassification adjustments may be presented with other comprehensive income or in a footnote. The reclassification adjustment may be shown on a gross or net basis (except that the minimum pension liability adjustment must be presented on a net basis).

EXAMPLE 1: On January 1, 2X11, a company purchased 1,000 shares of available-for-sale securities having a market price per share of \$100. On December 31, 2X11, the available-for-sale securities had a market price of \$150 per share. On January 1, 2X12, the securities were sold at a market price of \$130 per share. The tax rate is 30%.

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

	Before Tax	Tax Effect at 30%	Net of Tax
20X5 (1,000 × \$50*)	\$50,000	\$15,000	\$35,000
20X6 (1,000 × \$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 2X11 and 2X12 is as follows:

	20X5	20X6
Net income:		
Gross realized gain on 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)

	20X5	20X6
Net gain included in other comprehensive income	\$35,000	\$(35,000)
Total effect on comprehensive income	\$35,000	\$(14,000)

According to Accounting Standards Update (ASU) No. 2011-05 (June 2011), *Comprehensive Income* (Topic 220), *Presentation of Comprehensive Income*, a company has the option to present total comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements.

The company must present reclassification adjustments for items reclassified from other comprehensive income to net income in the statement(s) where the components of net income and other comprehensive income are presented.

Tax effects must also be presented in the statement or related footnotes.

Companies no longer have the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. This ASU eliminates that option.

In Accounting Standards Update (ASU) No. 2013-02 (February 2013), *Comprehensive Income* (Topic 220), *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*, a company must provide information regarding the amounts reclassified out of accumulated other comprehensive income by component. A company must also present significant amounts reclassified out of accumulated other comprehensive income on the face of the statement where net income is presented or in the notes.

In interim financial statements issued to the public, ASC 220 requires a business to present total comprehensive income. However, it is not required for interim reporting to present the individual components of other comprehensive income.

U.S. GAAP allows for both multi-step and single-step income statement formats, while IFRS does not permit the single-step format. U.S. GAAP has four elements in the income statement: revenue, expenses, gains and losses. IFRS has two elements: income and expenses. Under IFRS, all items are reported as income from operations, ignoring unusual or irregular activity. IFRS prohibits the reporting of extraordinary items, but the reporting of discontinued operations is allowed.

Extraordinary Items

Extraordinary items are both unusual in nature and infrequent in occurrence. Unusual in nature means the event is abnormal and not related to the typical operations of the entity. The environment of a company includes consideration of industry characteristics, geographic location of operations, and extent of government regulation. Infrequent in occurrence means the transaction is not expected to take place in the foreseeable future, taking into account the corporate environment. Materiality is considered by judging the items individually and not in the aggregate. However, items arising from a single specific event or plan should be aggregated.

Extraordinary items are shown net of tax after income from discontinued operations. Extraordinary items include:

- Casualty losses.
- Losses on expropriation of property by a foreign government.
- Gain on life insurance proceeds.
- Gain on troubled debt restructuring.
- Loss from prohibition under a newly enacted law or regulation.
- Gain or loss on disposal of a major part of the assets of a previously separate company in a business combination when sale is made within two years subsequent to the combination date.

Losses on receivables and inventory occur in the normal course of business and therefore are not extraordinary. There is an exception, however: losses on receivables and inventory are extraordinary if they relate to a casualty loss (e.g., earthquake) or governmental expropriation (e.g., banning of product because of a health hazard).

Nonrecurring Items

Nonrecurring items are either unusual in nature or infrequent in occurrence. They are shown as a separate line item before tax in arriving at income from continuing operations. An example is the gain or loss on the sale of a fixed asset.

Discontinued Operations

A business segment is a major line of business or customer class. A discontinued operation is an operation that has been discontinued during the year or will be discontinued shortly after year-end. A discontinued operation may be a segment that has been sold, abandoned, or spun off. Even though it may be operating, there exists a formal plan to dispose. Footnote disclosure regarding the discontinued operation should include an identification of the segment, the disposal date, the manner of disposal, and a description of remaining net assets of the segment at year-end.

ASC 360, *Impairment or Disposal of Long-Lived Assets* (ASC 360-10-05-4), requires the following accounting and presentation to report discontinued operations:

- In a year in which a *component* of a company either has been disposed of or is considered held for sale, the income statement for the current and previous years must separately present the profit (loss) of the component, including any gain or loss recognized in discontinued operations.
- The profit (loss) of a component classified as held for sale is presented in discontinued operations in the year(s) in which they take place. Thus, phase-out operating losses are *not* accrued.
- The net of tax effect of the results of discontinued operations are reported as a separate component of income before extraordinary items and the cumulative effect of a change in accounting principle.

- The profit (loss) of a component of a company that either has been disposed of or is held for sale is reported in discontinued operations only if *both* of the following criteria are satisfied:
 - The company will *not* have any material continual involvement in the operations of the component subsequent to the disposal transaction.
 - The cash flows and operations of the component have been (or will be) eliminated from the continual operations of the company because of the disposal transaction.

In general, gain or loss from operations of the discontinued component should include operating gains or losses incurred and the gain or loss on disposal of a component incurred in the current year. Gains should not be recognized until the year actually realized.

EXAMPLE 2: Davis Company produces and sells consumer products. There are a number of product groups, each with different product lines and brands. For this company, a product group is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the company. Thus, each product group is a component of the company.

The company has incurred losses in its beauty care products group and has decided to exit it. Therefore, Davis Company is committed to a plan to sell this group. The product group is classified as held for sale. The cash flows and operations of the beauty care products group will be eliminated from the ongoing operations because of the sale transaction, and the company will *not* have any continuing involvement in the operations of the product group once sold.

As a result of the aforementioned, Davis Company should present in discontinued operations the operations of the product group while it is classified as held for sale.

Assume the company decided to continue in the beauty care business but discontinued the brands with which the losses are associated. Because the brands are part of a larger cash-flow-generating product group and, in the aggregate, do not constitute a group that on its own is a component of Davis Company, the conditions for reporting in discontinued operations the losses associated with the brands that are discontinued would not be satisfied.

ASC 205, *Presentation of Financial Statements* (ASC 205-20-55-4; 360-10-05-4), provides guidance as to when a component of a company should be shown in discontinued operations if the business 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 suitable only if the ongoing entity has no continuing direct cash flows and does not retain an interest, contract, or other arrangement to allow it to have material influence over the disposed component's operating and financial policies subsequent to the disposal transaction.

CHAPTER 31

FINANCIAL STATEMENT ANALYSIS

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Under the Sarbanes-Oxley Act, annual reports are due within 60 days of year-end. Quarterly reports are due within 35 days. The rules apply to public companies having a market value capitalization of \$75 million or more.

Financial statement analysis is an appraisal of a company's previous financial performance and its future potential. It looks at the overall health and operating performance of the business. This chapter covers analytical tools to be followed in appraising the balance sheet, analyzing the income statement, and evaluating financial structure. Financial management analyzes the financial statements to see how the company looks to the financial community and what corrective steps and policies can be initiated to minimize and solve financial problems. Areas of risk are identified. Means to efficiently utilize assets and earn greater returns are concentrated on. Financial statement analysis aids in determining the appropriateness of mergers and acquisitions.

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A company's financial health has a bearing upon its price-earnings ratio, bond rating, cost of financing, and availability of financing. The importance of a sound financial statement analysis is evidenced by Enron.

To obtain worthwhile conclusions from financial ratios, the financial manager has to make two comparisons:

1. *Industry Comparison.* The financial executive should compare the company's ratios with those of competing companies in the industry or with industry standards. Industry norms can be obtained from such services as Dun and Bradstreet, Robert Morris Associates, Standard and Poor's, and Value Line.

EXAMPLE 1: Dun and Bradstreet computes 14 ratios for each of 125 lines of business. They are published annually in Dun's Review and Key Business Ratios, Robert Morris Associates publishes Annual Statement Studies. Sixteen ratios are computed for more than 300 lines of business, as is a percentage distribution of items on the balance sheet and income statement (common size financial statements).

In analyzing a company, you should appraise the trends in its industry. What is the pattern of growth or decline in the industry? The profit dollar is worth more if earned in a healthy, expanding industry than in a declining one.

You have to make certain that the financial data of competitors are comparable to yours. For example, you cannot compare profitability when your company uses FIFO while a competitor uses LIFO for inventory valuation. In this case, you must restate the earnings of both companies on a comparative basis.

2. *Trend Analysis.* A company's ratio may be compared over several years to identify direction of financial health or operational performance. An attempt should be made to uncover the reasons for the change.

The optimum value for any given ratio usually varies across industry lines, through time, and within different companies in the same industry. In other words, a ratio deemed optimum for one company may be inadequate for another. A particular ratio is typically deemed optimum within a given range of values. An increase or decrease beyond this range points to weakness or inefficiency.

EXAMPLE 2: Whereas a low current ratio may indicate poor liquidity, a very high current ratio may reflect inefficient utilization of assets (e.g., excessive inventory) or inability to use short-term credit to the firm's advantage.

For a seasonal business, you may find that year-end financial data are not representative. Thus, averages based on quarterly or monthly information may be used to level out seasonality effects.

When computing ratios for analytical purposes, you may also want to use the realistic values for balance sheet accounts rather than reported amounts.

For example, in ratios, including the asset and its market value is more relevant than its historical cost.

A distorted trend signals a possible problem requiring management attention. However, a lack of change does not always mean normalcy. For example, labor growth may be up but production/sales may be static or down. Hence, labor costs may be disproportionate to operational activity.

AUDIT ATTENTION

Financial statement analysis indicates areas requiring audit attention. You should look at the percentage change in an account over the years or relative to some base year to identify inconsistencies.

EXAMPLE 3: If promotion and entertainment expense to sales was 3% last year and shot up to 15% this year, the internal auditor would want to know the reasons. This would be particularly disturbing if other competing companies still had a percentage relationship of 3%. The internal auditor might suspect that the promotion and entertainment expense account contained some personal rather than business charges. Supporting documentation for the charges would be requested and carefully reviewed by the internal auditor.

HORIZONTAL AND VERTICAL ANALYSIS

Horizontal analysis looks at the trend in accounts over the years and aids in identifying areas of wide divergence mandating further attention. Horizontal analysis may also be presented by showing trends relative to a base year.

EXAMPLE 4: X Company's revenue in 2X11 was \$200,000 and in 2X12 was \$250,000.

The percentage increase equals:

$$\frac{\text{Change}}{\text{Prior Year}} = \frac{\$ 50,000}{\$200,000} = 25\%$$

In vertical analysis, a significant item on a financial statement is used as a base value, and all other items on the financial statement are compared to it. In performing vertical analysis for the balance sheet, total assets is assigned 100%. Each asset is expressed as a percentage of total assets. Total liabilities and stockholders' equity is also assigned 100%. Each liability and stockholders' equity account is then expressed as a percentage of total liabilities and stockholders' equity. In the income statement, net sales are given the value of 100% and all other accounts are appraised in comparison to net sales. The resulting figures are then given in a common size statement.

Vertical analysis is helpful in disclosing the internal structure of the business and possible problem areas. It shows the relationship between each income statement account and revenue. It indicates the mix of assets that produces the income and the mix of the sources of capital, whether by current or long-term liabilities or by equity funding. Besides making internal evaluation possible, the results of vertical analysis are also employed to appraise the company's relative position in

the industry. Horizontal and vertical analysis point to possible problem areas to be evaluated by the financial manager.

EXAMPLE 5:

X Company Common-Size Income Statement for the Year Ended 12/31/2X12		
Sales	\$40,000	100%
Less: Cost of Sales	10,000	25%
Gross Profit	\$30,000	75%
Less: Expenses	4,000	10%
Net Income	\$26,000	65%

BALANCE SHEET ANALYSIS

As a financial manager, you have to be able to analyze asset and liability accounts, evaluate corporate liquidity, appraise business solvency, and look to signs of possible business failure. You are concerned with the realizability of assets, turnover, and earning potential. Besides analyzing your company's financial health, you will want to make recommendations for improvement so that financial problems are rectified. Also, you can identify corporate strength which may further be taken advantage of. The evaluation of liabilities considers their possible overstatement or understatement.

Appraising Asset Quality

Asset quality applies to the certainty associated with the amount and timing of the realization of the assets in cash. Therefore, assets should be categorized by risk category.

What to Do: Calculate the following ratios: (1) high-risk assets to total assets, and (2) high-risk assets to sales. If high risk exists in assets, future write-offs may occur. For instance, the realization of goodwill is more doubtful than machinery. Also evaluate the risk of each major asset category. For example, receivables from an economically unstable government (e.g., Mexico) have greater risk than a receivable from ITT.

Special Note: Single-purpose assets have greater risk than multipurpose ones.

What to Watch Out for: Assets with no separable value that cannot be sold easily, such as intangibles and work-in-process. On the contrary, marketable securities are readily salable.

In appraising realization risk in assets, the effect of changing government policies on the entity has to be taken into account. Risk may exist with chemicals and other products deemed hazardous to health. Huge inventory losses may have to be taken.

EXAMPLE 6: Company A presents total assets of \$6 million and sales of \$10 million. Included in total assets are the following high risk assets:

Deferred moving costs	\$300,000
Deferred plant rearrangement costs	100,000
Receivables for claims under a government contract	200,000
Goodwill	150,000

Applicable ratios are:

High-risk assets	\$750,000	
-----	=	----- = 12.5%
Total assets	\$6,000,000	
High-risk assets	\$750,000	
-----	=	----- = 7.5%
Sales	\$10,000,000	

Cash

How much of the cash balance is unavailable for use or restricted? Examples are a compensating balance and cash held in a foreign country where remission restrictions exist. Note that foreign currency holdings are generally stated at year-end exchange rates but may change rapidly.

You should determine the ratio of sales to cash. A high turnover rate may indicate a deficient cash position. This may lead to financial problems if additional financing is not available at reasonable interest rates. A low turnover ratio indicates excessive cash being held.

EXAMPLE 7:

	2X12	2X13
Cash	\$500,000	\$400,000
Sales	8,000,000	9,000,000
Industry norm for cash turnover rate	15.8 times	16.2 times

The turnover of cash is 16 (\$8,000,000/\$500,000) in 2X12 and 22.5 (\$9,000,000/\$400,000) in 2X13. It is clear that the company has a cash deficiency in 2X13, which implies a possible liquidity problem.

Distinguish between two types of cash: (1) cash needed for operating purposes and (2) cash required for capital expenditures. While the former must be paid, the latter is postponable.

Accounts Receivable

Realization risk in receivables can be appraised by studying the nature of the receivable balance. Examples of high risk receivables include amounts from economically unstable foreign countries, receivables subject to offset provisions, and receivables due from a company experiencing severe financial problems. Further,

companies dependent on a few customers have greater risk than those with a large number of important accounts. Receivables due from industry are typically safer than receivables arising from consumers. Fair trade laws are more protective of consumers.

Accounts receivable ratios include the accounts receivable turnover and the average collection period. The accounts receivable turnover ratio reveals the number of times accounts receivable is collected during the period. It equals net sales divided by average accounts receivable. Average accounts receivable for the period is the beginning accounts receivable balance plus the ending accounts receivable balance divided by 2. (However, in a seasonal business where sales vary greatly during the year, this ratio can become distorted unless proper averaging takes place. In such a case, monthly or quarterly sales figures should be used). A higher turnover rate is generally desirable because it indicates faster collections. However, an excessively high ratio may point to too tight a credit policy, with the company not tapping the potential for profit through sales to customers in higher risk classes. But in changing its credit policy, the company must weigh the profit potential against the risk inherent in selling to more marginal customers.

The average collection period (days sales in receivables) is the number of days it takes to collect receivables.

$$\text{Average collection period} = \frac{365}{\text{Account receivable turnover}}$$

Separate collection periods may be calculated by type of customer, major product line, and market territory.

A significant increase in collection days may indicate a danger that customer balances may become uncollectible. However, reference should be made to the collection period common in the industry. One reason for an increase may be that the company is now selling to highly marginal customers. The financial manager should compare the company's credit terms with the degree to which customer accounts are delinquent. An aging schedule is helpful.

The quality of receivables may also be appraised by referring to customer ratings given by credit agencies.

Also look for a buildup over time in the ratios of (1) accounts receivable to total assets, and (2) accounts receivable to sales as indicative of a receivable collection problem. Receivables outstanding in excess of the expected payment date and relative to industry norm implies a higher probability of uncollectibility.

The financial manager should appraise the trends in bad debts to accounts receivable and bad debts to sales. An unwarranted decrease in bad debts lowers the quality of earnings. This may happen when there is a decline in bad debts even though the company is selling to less creditworthy customers and/or actual bad debt losses are increasing.

CHAPTER 59

HOW TAXES AFFECT BUSINESS DECISIONS

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The objective of companies is to maximize profits while simultaneously minimizing income taxes. Tax planning strategies are essential in satisfying this basic objective. The controller must: (1) be familiar with certain basic federal income tax rules, and (2) be aware of the complex tax implications of business combinations.

The company and the shareholders must be considered when planning and implementing tax strategies. The determination of whether a business should operate as a C corporation or an S corporation involves consideration of tax rates at both the entity and owner's levels. Further consideration should be given to Internal Revenue Code restrictions, long-term considerations, including liquidation possibilities are crucial. The selection of the cash or accrual basis of accounting must be based on a variety of factors including regulatory agency requirements, federal income tax provisions, and basic timing factors in accounting recognition. Where alternatives exist, the controller is called upon for analysis and recommendations.

TAX ACCOUNTING METHODS

The cash method of accounting results in the recognition of income when collected and expenses when paid. Under this method, constructive receipt of income results in recognition. The apparent advantage to the cash method of accounting is that careful planning can result in the deferral of income from the current period to the next. Billing and collection should therefore be timed carefully. Under Internal Revenue Code (IRC) Sec. 448, however, the cash method of accounting may be elected only by: (1) C corporations with average annual gross receipts of \$5 million or less, (2) qualified personal service corporations, and (3) farming and timber businesses. Taxpayers failing to qualify for the cash method of accounting must use the accrual method of accounting, whereby income is recognized when earned and expenses are recognized when incurred.

INSTALLMENT SALES

Pursuant to IRC Sec. 453, the installment sale provisions prorate the gross profit on a sale over the years in which payments are to be received. Depending on current and potential tax rate changes, the installment sale provisions might be advantageous. The installment sale provisions are automatic; i.e., a taxpayer must elect not to be covered by the statutory provisions. The installment sale provisions are applicable to sales of real property and casual sales of personal property at a gain. Sales by dealers of personal or real property are generally not eligible for the installment sale provisions, nor are revolving credit sales and sales of publicly traded securities. The character of gain recognized will not be altered under the

installment sale provisions; accordingly, the disposition of a capital asset will result in capital gain. Caution must be exercised in case of depreciable property since any depreciation that must be recaptured under IRC Sec. 1245 and IRC Sec. 1250 must be recaptured in the year of sale, regardless of the installment sale provisions.

DIVIDENDS-RECEIVED DEDUCTION

Corporations that receive dividends from unaffiliated domestic taxable corporations are generally entitled to a 70% dividends-received deduction. The deduction, however, is limited to 70% of the corporation's tentative taxable income, which is the taxable income of the corporation before consideration of the dividend-received deduction and any applicable net operating loss deduction. The 70% of tentative taxable income limitation is not applicable when the corporation sustains a net operating loss before or after the dividends-received deduction. Additionally, the deduction is increased to 80% in cases where the dividends are received from a 20% or more owned corporation.

A corporation whose stock is included in a debt-financed portfolio will partially or totally lose the dividends-received deduction. The beneficial provisions will also not be applicable in cases involving the receipt of dividends from mutual savings banks, since such receipts in essence represent interest income.

It should be noted that dividends received from affiliated corporations are generally entitled to a 100% dividends-received deduction.

The application of the general rule may be illustrated as follows:

Sales	\$300,000
Dividend income received from a less than 20%-owned corporation	100,000
	<hr/>
Operating expenses	400,000
	310,000
	<hr/>
Tentative taxable income	90,000
Dividends-received deduction; limited to 70% of \$90,000	63,000
	<hr/>
Taxable income	<u>\$ 27,000</u>

On the other hand, had the corporation sustained an operating loss of \$90,000, the "70% of tentative taxable income limitation" would not be applicable; accordingly, the dividends-received deduction would be 70% of \$100,000, or \$70,000, effectively increasing the net operating loss to \$160,000.

Further, the following example illustrates that the "70% of tentative taxable income limitation: does not apply if the corporation sustains a net operating loss after the dividends-received deduction."

Sales	\$300,000
Dividend income received from a less than 20%-owned corporation	100,000
	<hr/>
Operating expenses	400,000
	390,000
	<hr/>

Tentative taxable income	10,000
Dividends-received deduction; 70% of \$100,000	70,000
Net operating loss	<u>\$ (60,000)</u>

Investment strategies should be carefully monitored in order to secure the benefits of the dividends-received deduction. The wrong investment vehicles could easily result in the loss of the desired tax benefit. For example, the following dividends are not eligible for the dividends-received deduction:

- Dividends from mutual savings banks, which in essence represent interest on bank accounts.
- Dividends derived from real estate investment trusts.
- Capital gains dividends passed through from mutual funds.
- Dividends from money market funds which invest solely in interest-paying securities.

It should also be noted that the dividends-received deduction is allowed only if the dividend-paying stock is held at least 46 days during the 90-day period that commences 45 days before the stock became ex-dividend with respect to the dividend.

CHARITABLE CONTRIBUTIONS

The deduction for charitable contributions is generally limited annually to 10% of taxable income, computed without regard to the deduction for charitable contributions, and with taking into account: (1) the dividends-received deduction, (2) any net operating loss carryback, and (3) any net capital loss carryback. Furthermore, the charitable contribution deduction may not increase an existing net operating loss. Any charitable contributions which may not be deducted in the current year by virtue of the 10% limitation may be carried forward up to five years. Corporations using the accrual method of accounting may deduct charitable contributions authorized by the board of directors but paid after year-end as long as payment is made within two months after year-end. Otherwise, cash basis accounting is applicable.

With respect to contributions of property, the deduction is generally measured by the corporation's basis in the property. In the case of contributions of inventory and other ordinary income producing property for the care of the ill, the needy, or infants, the deduction is equal to the corporation's basis in the property increased by 50% of the property's appreciation. In no event, however, may the deduction exceed twice the property's basis. A contribution of a vehicle is generally limited to the gross proceeds the charitable organization receives upon subsequent sale of the vehicle. In the event that the vehicle is not sold by the charitable organization (donee), the donee must provide written certification of the vehicle and the duration of its use.

NET OPERATING LOSS DEDUCTIONS

In general, net operating losses of corporations may be carried back up to two years and carried forward up to 20 years. **Note:** With respect to net operating losses arising in tax years beginning before August 6, 1997, the carryback period is three years and the carryforward period is 15 years.

An election may be made, however, to forego the carryback. This may be advisable when tax rates in future years render the loss deduction more valuable. IRS attention is drawn to the tax return for the year to which the carryback is claimed. Accordingly, it might be judicious to relinquish the right to a carryback claim since the prior year's tax return may be subject to IRS scrutiny. When calculating the net operating loss deduction, no deduction is allowed for net operating loss carrybacks or carryovers. The dividends-received deduction, however, is allowable.

ORGANIZATION COSTS

Organization costs are costs incurred in connection with creating a corporation. Organization costs include legal and accounting fees as well as filing fees and payments to temporary directors. Under current tax law, up to \$5,000 of start-up costs and \$5,000 of organization costs may be deducted in the year of commencement of business.

The available \$5,000 deduction for organization costs must be reduced by the amount by which the cumulative start-up or organization costs exceed \$50,000. Any remaining start-up costs and organization costs may be amortized over 15 years. An election may be made to capitalize and amortize all organization costs.

DEPRECIATION

With respect to tangible depreciable property placed into service after 1986, the modified accelerated cost recovery system (MACRS) of depreciation is applicable.

Under MACRS, assets are placed into recovery periods based on estimated economic lives specified in the Code.

The table below represents the recovery periods applicable to tangible personal property subject to depreciation recapture under IRC Sec. 1245.

Recovery Period	Qualifying Property
3 years	Assets with a life of 4 years or less
5 years	Assets with a life of at least 4 years and less than 10 years
7 years	Assets with a life of at least 10 years and less than 16 years
10 years	Assets with a life of at least 16 years and less than 20 years
15 years	Assets with a life of at least 20 years and less than 25 years
20 years	Assets with a life of at least 25 years

Examples of tangible personal property classified by recovery period are presented in the following table:

Recovery Period	Examples of Eligible Property
3 years	Special tools
5 years	Light duty trucks, automobiles, and computers
7 years	Office furniture and fixtures, and other equipment
10 years	Railroad tank cars
15 years	Industrial generation systems
20 years	Sewer pipes

Real property is classified into three recovery periods. Residential real property is 27.5-year recovery property while nonresidential real property is 31.5-year recovery property (if placed into service after 1986 and before May 13, 1993) or 39-year recovery property (if placed into service after May 12, 1993). Leasehold improvements made to nonresidential real property before 2006 may be depreciated over a 15-year recovery period.

Personal property in the 3-year, 5-year, 7-year, and 10-year recovery period categories is to be depreciated using the 200% declining balance method with a switch to the straight-line method at the point in time when deductions will be maximized (i.e., generally in the middle of the recovery period). The 150% declining balance method is applicable to 15-year and 20-year recovery property. The provision regarding the switch to straight line is also applicable. An election may be made to calculate the cost recovery deduction utilizing the straight line method. The election must be made for all assets placed into service in a particular class in each year.

In general, an additional first-year depreciation deduction is available. The additional deduction is equal to 50% of the property's basis if acquired and placed into service before January 1, 2014. The adjusted basis of qualified property must be reduced by the additional deduction before computing the depreciation deduction otherwise allowable. Further, if Section 179 deduction (discussed later) is claimed, it reduces the adjusted basis of the property eligible for the additional first-year deduction. The additional first-year depreciation deduction is automatic unless an election is made to forgo the additional amount. The election to forgo the additional deduction is required to be made for all assets acquired in a particular recovery class in each year.

Real property must be depreciated utilizing the straight-line method. Classification into residential and nonresidential categories is irrelevant.

Whether the accelerated method or the straight-line method is used for personal property, a half-year convention is applicable in the year the asset is placed into service and in the year the property is disposed of, if prior to the expiration of the recovery period.

The timing of asset purchases must be planned because the "mid-quarter convention" may be triggered. Under the "mid-quarter convention," if more than 40% of the aggregate value of personal property is placed into service during the last quarter of the year, the half-year convention must be replaced by the mid-quarter

convention. With respect to real property, a mid-month convention is to be applied when the asset is placed into service and when the asset is disposed of prior to the expiration of the recovery period.

The *Alternative Depreciation System (ADS)* must be used for certain types of property including personal property used outside of the United States and property leased to tax-exempt entities. ADS, however, may be elected for any class of property placed into service. The recovery deduction will be based on the straight-line method and longer recovery periods. Personal property with no class life will be recovered over 12 years, while real property will be recovered over 40 years. All other property will be recovered over the applicable class life.

Automobiles are included in a special category of property referred to as "listed property."

The annual depreciation deduction for automobiles is dependent upon the year in which the auto was placed into service, because the Internal Revenue Service issues applicable tables annually.

If a business leases an automobile that is used 100% for business purposes, the full lease cost will generally be deductible. However, in order to prevent the avoidance of the "listed property" limitations, the IRS requires that an "add-back" be included in income each year of the automobile's use. The inclusion, which is based on the initial fair market value of the vehicle and the year in which the lease was effected, is adjusted annually for inflation.

The deductible amounts are periodically adjusted for inflation. Listed property not used more than 50% of the time for business must use the alternative depreciation system.

The Sec. 179 election allows the expensing of certain depreciable assets (and off-the-shelf computer software). Under the statute, in lieu of capitalizing the asset and depreciating it, the assets may be expensed in the year they are placed into service. There is, however, an annual limitation as follows:

Tax Year	Annual Limit
2007	125,000
2008	250,000
2009	250,000
2010	500,000
2011	500,000
2012	500,000
2013	500,000
2014	25,000

The annual limitation must be reduced (phased out) dollar for dollar by the amount by which the cost of Sec. 179 property placed into service during the year exceeds \$500,000 in 2007, \$800,000 in 2008 and 2009, \$2,000,000 in 2010 through 2013, and \$200,000 in 2014. Additionally, the deduction cannot be used to create or increase a net operating loss. Furthermore, the deduction must be considered for