# unit 2: interim financial reporting

**2.1 introduction**

Stakeholders, like investors, creditors, suppliers, and others, need information about the financial performance of the enterprise. These users cannot wait for the end of the year to do so. They need financial information periodically, at the end of either a month, quarter, or semiannually. This chapter deals with important issues like accounting principles and practices used in the preparation of interim financial statements, and approaches to preparing interim financial statements.

**2.2 the need for interim reports**

Interim financial reports are defined as reports prepared for a period of less than a year. The purpose of preparing interim financial reports is to meet the needs of decision makers. Decision makers are interested in frequent and timely information about the firm’s financial position and results of operations. Among decision makers lenders are the common users. They need to closely monitor the progress of borrowers so that problems can be identified as early as possible. Another reason for the interest in interim financial reports is to use such reports as a basis for projecting annual results.

An interim financial report may include either a

* 1. Selected financial data
	2. Complete set of financial statements

Although there is greater need for interim financial reports, there are problems associated in their preparation. Some of them include the following:

1. It is difficult to make estimates and judgments as accurately as possible. When the accounting period gets shorter, estimates and judgments cannot be accurately made.
2. The treatment of seasonal expenses. i.e. expenses that relate to a full year’s activity but that occur randomly during the year.

**2.3 approaches to interim reporting**

This relates to the view accountants hold about interim period. Accountants hold two views about interim period. There are:

***1. Discrete period approach***

It is the approach in which each interim period is treated as a distinct accounting period. Alike annual financial results, the same principles and processes are used in determining interim net income. Under this approach, any outlay such as for advertising, repairs and maintenance would be expensed in the interim period in which the outlay occurs.

***2. Integral period approach***

It is an approach in which an interim period is considered as an integral part of the annual period. Under this approach, accruals, deferrals, estimates, and allocations depend on overall estimates of the relationship between estimated annual revenues and expenses. Expenses, such as advertising and research and development costs will be deferred so that a proper allocation between interim periods within one year can be achieved.

According to Accounting Principles Board [[1]](#footnote-1)\*(APB) opinion No. 28, interims financial statements are based on integral period approach. APB opinion No. 28 also stressed that interim financial statements should be based on the same accounting principles and practices that are used in the preparation of annual financial statements.

**2.4 standards for interim reporting of revenues, costs, and expenses**

**1. Revenues**

Revenues should be recognized as earned during the interim period on the same basis as followed for the full year. Seasonal variations in revenue should be disclosed by issuing data for the latest 12 months in addition to the interim data.

**2. Costs and expense**

1. ***Direct costs and expenses***

Costs and expenses may be classified into direct costs, and indirect costs. Direct costs and expenses are those that can be associated with revenues, or directly associated with the products or services provided. They are also called allocated product costs, and include all inventoriable direct costs (i.e. materials, labor, and manufacturing overhead).

For interim periods, direct/allocated costs are treated in the same way as full year. However, APB opinion No. 28 provided the following exceptions with respect to the determination of cost of goods sold for interim financial statements.

1. Enterprises that use the gross profit method at interim dates to estimate cost of goods sold should disclose their practice in the interim financial statements.
2. Enterprises using the LIFO method of inventory may dig into LIFO layers temporarily during an interim period because LIFO is an annual concept.
3. Inventory losses resulting from market declines should not be deferred beyond the interim period in which they occur. If losses are recovered in a subsequent interim period, gains should be recognized to the extent of losses previously recognized. To illustrate, assume that the costs and market value of inventory in the 1st quarter are Br. 10,000 and Br. 7000 respectively. Inventory loss to be reported in the 1st quarter would be Br. 3000 (i.e 10,000 – 7000 = 3000). If inventory value (market value) is Br. 14,000 in the 2nd quarter, gain is Br. 4000, but only Br. 3000 is recognized because loss was Br. 3000 in the 1st quarter.

Inventory losses due to temporary inventory market decline should not be recognized in interim period. (Temporary inventory market decline is a market value decline in one interim period with an expected market recovery in a subsequent interim period within the same fiscal year.

To illustrate, the application of the lower-of-cost or market rule to interim reporting, let’s consider the following data. Grace Company accounts for its single merchandise item on the FIFO basis by applying the lower-of-cost or market method. The company has 15000 units in stock with a cost of Br. 60,000 or Br. 4 per unit. For simplicity of illustration, we assume that no purchases were made during the year (2003). Quarterly sales and end-of-quarter replacement costs for inventory during the year were as follows:

Quarter Quarterly End of quarter

ended sales (units) Replacement cost/per unit

March 31 -----------------3000 --------------------------------.--Br. 5

June 30 -------------------2000 ---------------------------------------3

September 30 -----------3500 ---------------------------------------6

December 31 -----------2500 ----------------------------------------2

Assume that the replacement cost decline in the second was not considered to be temporarily.

Grace Company’s cost of goods sold for four quarters, including the second quarter is computed as follows:

 Cost of goods sold

Quarter ended Computation for quarter For quarter Cumulative

March 31 ------------------3000 x 4------------------------- 12,000 12,000

June 30 --------------------(2000 x 4) + (10,000 x 1)a -----18,000 30,000

September 30 -------------(3500 x 3) – (6500 x 1)b --------4,000 34,000

December 31 --------------(2500 x 4) + (4000 x 2)c ------18,000 52,000

1. 10,000 units remaining in inventory multiplied by Br. 1 write down to lower replacement cost
2. 6500 units in inventory multiplied by Br. 1 write-up to original FIFO cost.
3. 4000 units remaining in inventory multiplied by Br. 2 write-down to lower replacement cost.

The Br. 52,000 cumulative cost of goods sold for Grace Company for 2003 may be verified as follows:

**Alternative 1:**

11000 units sold during 2003, at Br. 4.00 FIFO cost

 per unit (4 x 11,000) -------------------------------------------------------------44,000

Add: write-down of 2003 ending inventory to

 replacement cost (4000 units x Br. 2.00) ------------------------------------------8,000

Cost of goods sold for 2003 ---------------------------------------------------------------52,000

## Alternative 2

Cost of goods available for sale (15000 units x Br. 4) --------------------------------60,000

Less: Ending inventory, at lower of FIFO cost, or market

 (4000 units x Br. 2) ------------------------------------------------------------------8,000

Cost of goods sold for 2003 --------------------------------------------------------------52,000

Therefore, if interim reports are prepared for the 2nd quarter, cost of goods sold is reported at Br. 18,000.

## Check your progress 2.1

1. What are the reasons for preparing interim financial statements?
2. What does interim financial statements include?
3. Mention the problems associated with the preparation of interim financial statements?
4. What are the two approaches to preparing interim financial statements? Which one is recommended by APB opinion No. 28. Differentiate between the two approaches?
5. What are the principles and practices of treating revenues in interim reports?
6. What principles and practices are followed in treating direct costs and expenses in interim financial statements? Indirect costs and expenses?
7. What are the exceptions provided by APB opinion No. 28 with respect to the determination of costs of goods sold for interim financial statements?
8. Pool Company uses FIFO basis by applying the lower-of-cost, or market method for its single merchandise item, M7. On January 1, year 3, the company had an inventory of 20,000 units in stock with a cost of Br. 100,000. Assume that there were no purchases during year 3. Quarterly unit sales as well as end of quarter market quotations for the merchandise items were as follows:

Sales for Quarter End of quarter

Quarter (units) market quote per unit

First ---------------------------------5000 Br. 7

Second -----------------------------7000 3

Third -------------------------------4000 6

Fourth -----------------------------3000 4

Assume that the replacement cost decline in the second was not considered to be temporary.

## Required

1. Compute the cost of goods sold for four quarters.
2. What is the cost of goods sold that should be reported in the third quarter interim financial statements?
3. What is the cumulative cost of goods sold for year 3?
4. Verify the cumulative cost of goods sold for the year.

Enterprise using standard cost accounting for the determination of inventory and cost of goods sold should follow the same procedures for interim periods as would apply to the entire fiscal year. The following guidelines may apply to variances.

* 1. Planned or normal variances at the end of the interim period should be deferred at the interim date because they are absorbed by the end of the fiscal year.
	2. Unplanned or abnormal variances should be shown in the interim period during which they occur.
1. **Indirect costs**

Indirect costs represent those costs and expenses other than product cost (direct, or allocated costs). APB opinion No. 28 has indicated the following standards with respect to costs and expenses other than product costs:

* 1. They should be charged to income in interim period as incurred or be allocated among interim period based on an estimate of time expired, benefit received, or activity associated with the periods. The same procedures should be used as annual reporting dates.
	2. Those costs and expenses that cannot be readily identified with the activities or benefits of other interim periods should be charged to the interim period in which incurred, and disclosures should be made.
	3. Arbitrary assignment of the amount of indirect costs and expenses to an interim period should not be made.
	4. Gains and losses that arise in any interim period similar to those that would not be deferred at year-end, should not be deferred to later interim periods within the same fiscal year.

## N.B

* + 1. The above standards apply to such items as major repairs, quantity discounts, property taxes, and advertising costs.
		2. The above standards encourage enterprises to avoid year-end adjustments as much as possible may making quarterly estimates of items, such as inventory shortages, bad debt expense, and contract adjustments.

**2.5 income taxes in interim financial statements**

The determination of interim operating results requires the estimation of income tax provision for the interim periods. According to APB opinion No. 28, the amount of income tax charged to an interim period should be related to the expected annual income tax provision. To estimate interim income tax, we need to determine the effective tax rate for the entire current fiscal period at the end of each interim period. This effective tax rate is applied into interim income. Interim income tax expense (or benefit) is computed as follows:

Year-to-date tax expense or benefit ----------------------------------------------------------- xxx

Less: cumulative amounts of tax reported in the

 previous interim period ----------------------------------------------------------------- xxx

Interim income tax expense or benefit ------------------------------------------------------- xxx

The effect of permanent tax differences should be estimated in determining the estimated effective annual tax rate. Permanent tax differences include:

* + Percentage of depletion
	+ Nontaxable income
	+ Non taxable expense

In determining the estimated effective annual tax rate, we need to exclude the tax effect of non-ordinary items of income or loss because they are sold net of income tax effect. Non ordinary item of income or expense include:

* + Extra ordinary items
	+ Discontinued operations
	+ Cumulative effect of changes in accounting principles

## Illustration

Suppose that Stars Company has pretax income of Br. 130,000 at the end of the first quarter. Assume further that at the end of the first quarter, Stars estimated that effective annual tax rate is 59%. What is income tax provision for the first quarter?

Tax provision for the 1st quarter is equal to pretax income times estimated effective income tax rate. i.e.

Income tax provision = Pretax income x Estimated effective tax rate

 = 130,000 x 59%

 = 76,700

To illustrate further, Stars Company had a pretax income of Br. 180,000 for second quarter. Its estimated combined effective tax rate is 55% at the end of the second year. Income tax provision for the second quarter is the difference between year to date tax expense (or benefit) and cumulative amounts of tax reported in the previous interim period. i.e

Cumulative pretax income year-to-date (130,000 + 180,000) -----------------310,000

Tax at estimated combined rate of 55% ------------------------------------------170,500

Less: Income tax accrued first-in the 1st quarter --------------------------------- 76,700

Income tax provision for the second quarter --------------------------------------93,800

The above process is repeated for the third and fourth quarters. The effect of a change in the estimated full year tax rate is included in the tax provision of the second quarter. As a result, retroactive revision is not undertaken.

## Journal Entries

1. To record Stars’ 1st quarter income tax provision

Income taxes expense ------------------------76,700

Income taxes payable -------------------------76,700

2. To record Stars’ 2nd quarter income tax provision

Income taxes expense -------------------------93,800

Income taxes payable --------------------------93,800

Tax benefit arises when operating result for the quarter turned to be a loss and the realization of tax benefit is assured reasonably. If income tax benefit resulting from operating loss is not reasonably assured, it is not realized.

To illustrate, consider the following data for Stars Company in year 3.

 Pretax income Estimated

Quarter Current Year to date tax rate for year

First -----------------Br. (40,000) Br. (40,000) 70%

Second -------------------30,000 (10,000) 70%

Third ---------------------70,000 60,000 70%

Fourth --------------------90,000 150,000 65%

Assume that tax benefits that arise from loss are not assured beyond a reasonable doubt.

Based on the above data, income tax provision for each quarter can be determined as follows:

Tax provision for quarter three:

Cumulative pretax income year to date ------------------------------------------------- 60,000

Tax at estimated combined rate (70% x 60,000) ---------------------------------------42,000

Less: Income tax accrued for the 1st and 2nd quarters -------------------------------------0

Income tax provision for the 3rd quarter ------------------------------------------------ 42,000

Tax provision for 4th quarter:

Cumulative pretax income ---------------------------------------------------------------150,000

Tax at estimated combined rate of 65% --------------------------------------------------97500

Less: Tax accrued for 1st, 2nd, & 3rd quarters -------------------------------------------42,000

Income tax provision ---------------------------------------------------------------------- 55,500

The manner in which tax provisions (tax benefits) are determined differs if tax benefits arising from loss are assured reasonably. To illustrate, consider the above data for Stars Company assuming that the realization of tax benefits from the 1st quarter was assured reasonably. Then tax benefits or expense for each quarter can be determined as follows:

## First Quarter

Cumulative pretax income ------------------------------------------------------ (40,000)

Tax at estimated effective rate of 70% (40,000 x 0.70)---------------------- (28,000)

## Quarter two

Cumulative pretax income ----------------------------------------------------- (10,000)

Tax at estimated combined rate of 70% (10,000 x 0.70)-------------------- (7000)

Less: Tax benefit accrued for 1st quarter ------------------------------------ (28,000)

Tax benefit in 2nd quarter ------------------------------------------------------- 21000

**3rd quarter**

Cumulative pretax income ------------------------------------------------------ 60,000

Tax at estimated combined rate of 70% (60,000 x 0.70)-------------------- 42,000

Less: Tax benefits accrued for 1st & 2nd quarters ----------------------------(7,000)

Tax provision for 3rd quarter --------------------------------------------------- 49,000

**4th quarter**

Cumulative pretax income -------------------------------------------------------150,000

Tax at estimated combined rate of 65% (150,000 x 0.65)- --------------------97500

Less: Tax accrued for three quarters -------------------------------------------- 42,000

Income tax provision for 4th quarter ---------------------------------------------55,500

## Check your progress 2.2

1. Assume that Moon Company prepares its interim financial statements quarterly. The following data were extracted from its records during year 2.

Quarterly pretax Estimated tax rate for

Quarter Income year

First Br. 180,000 60%

Second 160,000 70%

Third 220,000 50%

Fourth 290,000 40%

## Required

1. Determine income tax provision for each quarter
2. Prepare the entry to record income tax provision for each quarter.

2. Assume that Moon Company prepares its interim financial statements quarterly. The following data were extracted from its records during year 3.

Quarterly pretax Estimated tax

Quarter Income rate for year

First -------------------- Br. (95,000) 40%

Second ---------------------(40,000) 50%

Third -----------------------120,000 50%

Fourth ---------------------200,000 40%

## Required

1. Assuming that the realization of tax benefits is not reasonably assured, determine tax benefit or tax expense for each quarter.
2. Assuming that the realization of tax benefit is reasonably assured, determine tax benefit or tax expense for each quarter.

2.6 reporting of accounting changes and extra ordinary and other non operating items

**2.6.1 Reporting extra ordinary and other non operating items**

Extra ordinary items are events or transactions that are distinguished by their unusual nature and by the infrequency of their occurrence. Any loss arising from extra ordinary events are shown in the income statement, net of income taxes. Extraordinary and unusual items are reported in full as they occur so that their impact is immediately known i.e. they are shown in the income statement in the interim period in which they occur.

**2.6.2 Reporting gains or losses from disposal of business segment**

Business segment is a component of a business enterprise whose activities represent a separate major line of business or class of customer. Any gain or loss on the disposal of the segment is reported separately in the income statement, net of the related income tax effects. In interim reports, any gain or loss resulting from disposal of segment is reported in full in the interim period it arises.

**2.6.3 Reporting accounting changes in interim periods**

Business enterprises are required to use accounting principles consistently so that the financial performance of two periods can be compared. However, management of a business enterprise may justify a change in accounting principles on grounds that it is preferable. There are three types of accounting changes. These are changes in accounting principles, a change in accounting estimates, and a change in reporting entity.

A change in accounting principles generally requires the inclusion of the cumulative effect of change to a new principle in net income of the accounting period in which the change is made. Change in accounting estimates affect only the current and future periods’ financial statements. With regards to reporting accounting changes in interim period, there are two principal provisions.

***1. Accounting changes in the First interim period***

If a change of accounting principles is made during the first interim period of an enterprise’s fiscal year, the cumulative effect of the change on retained earnings at the beginning of that fiscal year shall be include in net income of the first interim period.

***2. Accounting changes in other than the first interim period of an enterprise.***

If a change of accounting principle is made in other than the first interim period no cumulative effect of the change shall be included in net income of the period of the change. Instead, financial information for the pre-change interim periods of the fiscal year in which the change is made shall be stated by applying the newly adopted accounting principle to those prechance interim periods. The cumulative effect of the change on retained earnings at the beginning of that fiscal year shall be included in restated net income of the first interim period of the fiscal year in which the change is made.

**2.7 disclosure of summarized interim financial data**

In order to be timely, interim financial reports may not be as detail as annual financial reports. However they should contain at minimum the following information: for the current quarter, the current year-to date, or the last 12 months to date.

* + 1. Sales (or gross revenue),
		2. Provision for income taxes
		3. Extra ordinary items
		4. Cumulative effect of change in accounting principles
		5. Net income
		6. Earning per share data
		7. Seasonal revenue, costs, or expenses
		8. Significant changes in estimates or provision for income taxes
		9. Disposal of a business segment
		10. Contingent items
		11. Significant changes in financial position

Note that interim reports may not be prepared for the 4th quarter of the fiscal year. In such case, annual financial reports should disclose the effects of the following for the fourth quarter:

* + Disposal of a segment
	+ Extraordinary items
	+ Changes in accounting principles
	+ The aggregate effect of year-end adjustments that are material to the 4th quarter results.

# 2.8 Summary

Annual financial statements normally do not provide decision makers with the timely data needed to make decisions. Thus, external decision makers need financial data for shorter intervals of time. Interim financial statements are provided to external users to meet their needs.

Interim financial statements may be prepared using the discrete period approach, and integral period approach. The integral period approach is presently used for interim reporting purposes.

Revenues in interim reports are recognized on the same basis used for annual reports. Costs and expenses that are associated with revenue are allocated to the products or service rendered. Another costs and expenses are charged to the interim period based on time expired, benefits received, or activities associated with the interim period.

The income tax provision for an interim period should use an effective annualized tax rate. Extraordinary and other non-operating items should be recognized in the interim period in which they occur.

# 2.9 Answers to check your progress exericses

## Check your progress 2.1

1. - To provide frequent and timely information to decision makers

 - To project the annual financial results.

1. - Selected financial data

 - Complete set of financial statements

1. - Difficulty to make estimates and judgments as accurately as possible.

 - The treatment of seasonal expenses

1. Discrete period approach and integral period approach. APB opinion No. 28 recommends the integral period approach. Discrete period approach treats each period as a distinct accounting period whereas integral period approach treats interim period as an integral part of the annual period.
2. Revenues are recognized on the same basis as followed for the full year.
3. Direct costs and expenses are recognized in the same way as full year. Indirect costs and expenses are charged against income as incurred in the interim period.
4. a. If gross profit method is used to estimate the cost of goods sold, it has to be disclosed.

 b. The interim cost of goods sold should include for replacement of inventory when LIFO method is used.

c. Inventory losses resulting from market declines should not be deferred beyond the interim period in which they occur.

1. a. Quarter 1 = Br. 25,000 Quarter 3 = Br. 4,000

 Quarter 2 = Br. 51,000 Quarter 4 = Br. 16000

 b. Br. 20,000

 c. Br. 96,000

d. 19,0000 units sold during year 3 at Br. 5.00 ------------------------ 95,000

 Add: write-down of year 3 ending inventory

 to replacement cost (1000 x Br. 1) ----------------------------1,000

 Cost of goods sold for year 3 ---------------------------------------- 96,000

#### Check your progress 2.2

1. (a) 1st quarter =Br. 108,000 3rd quarter = Br. 42,000

 2nd quarter = 130,000 4th quarter = Br. 60,000

 1st 2nd 3rd 4th

(b) Income taxes expense 108,000 130,000 42,000 60,000

 Income taxes payable 108,000 130,000 42,000 60,000

1. a) Quarter

 One = 0

 Two = 20,500

 Three = 60,000

 Four = 81,500

b) Quarter

 One = (38,000)

 Two = 29500

 Three = 60,000

 Four = 81,500

1. \* APB – Accounting Principles Board [↑](#footnote-ref-1)