In our series *Learning Outcomes Decoded* we break down a single Learning Outcome Statement (LOS) from the CFA level 1 curriculum. Cheryl Wu, CFA, CPA, author of this article, is the Content Developer of the CFA team at the Princeton Review. She also works as a corporate development manager in the Energy and Utilities industry.
Learning module 1 discusses the general principles of revenue and expense recognition used to prepare the income statement. This LOS introduces the treatment for non-recurring items, which is important to consider when analysts prepare for a company’s financial forecast.

From time to time, analysts may be required to prepare financial forecasts on a company’s future earnings. When preparing such a forecast, separating the continuing items from the one-offs is helpful. IFRS and US GAAP both require that items be disclosed separately, such as discontinued operations, unusual/infrequent items, and accounting changes.

**Discontinued Operations**

Discontinued operations are components or operations that were or will be disposed of or discontinued. To qualify as a discontinued operation, both IFRS and US GAAP require that the component be separable physically and operationally. Companies must disclose discontinued operations as a separate line item on the Income Statement. Since such operations will no longer provide earnings in the future, analysts should exclude them from forecasts of the company’s financial performance.

**Unusual or Infrequent Items**

Material items that are unusual or infrequent should be disclosed separately. Examples are:

- Restructuring charges that occur because of a business reorganization
- Gains or losses from selling a part of the business, or acquisition costs
- Litigation costs
FINANCIAL STATEMENT ANALYSIS:
UNDERSTANDING INCOME STATEMENTS

LOS: Describe the financial reporting treatment and analysis of non-recurring items (including discontinued operations, unusual or infrequent items) and changes in accounting policies

When preparing a company’s financial forecast, an analyst must consider whether such unusual or infrequent items are likely to occur. If the items are unlikely to recur, the analyst should normalize the forecast by eliminating the unusual items.

Changes in Accounting Policy
At times, companies may be required to change the way they report due to a change in accounting policy. Other times, the company can propose the change to provide information that reflects the business better.

Changes in accounting policy must be applied retrospectively, meaning that financial statements in the prior periods must be restated as if the new accounting principles were adopted in the entire period. An example of a change in accounting policy is the new IFRS 16, which requires a lessee to recognize lease-related assets and liabilities for a minimum of 12 months on the Balance Sheet. Previously, a lessee had the choice of recognizing the lease on or off the Balance Sheet depending on certain criteria.

Changes in accounting estimate
Changes in accounting estimates are applied prospectively, meaning the change only affects the financial statements for the period of the change and future periods. No adjustments are made to the prior periods. An example is a change in the estimated useful life of a manufacturing asset or a change in the method of calculating a company’s expense related to the defined benefit pension plan.

Correction of error
Correction of error must be applied retrospectively by restating the financials for prior periods. Note that disclosures are required regarding the error. One example is if an employee incorrectly recorded the transaction amount or incorrectly capitalized a repair expense where the cost should have been expensed.
PRACTICE QUESTION
An analyst is preparing the financial statements for the most recent year. After careful review, he finds two issues. First, an employee mistakenly recorded the purchase of a piece of manufacturing equipment as $5,000 when the amount should have been $50,000. Second, management has decided to shorten the useful life of its steam boilers from 20 years to 15 years. Which of the following statement is most likely correct?

A. The correction on recording the manufacturing equipment should be applied retrospectively, and the change in the useful life of steam boilers should be applied prospectively

B. The correction on recording the manufacturing equipment should be applied prospectively, and the change in the useful life of steam boilers should be applied retrospectively

C. Both the correction on recording the manufacturing equipment and the change in the useful life of steam boilers should be applied retrospectively

A is correct. The correction on recording the manufacturing equipment is an accounting error. Therefore, it needs to be corrected retrospectively. The change in the useful life of steam boilers is a change in accounting estimate that better reflects the economics of the asset, and it should be made prospectively.