

## **Model for efficient and effective footnote disclosure in pedagogical and practitioner application**

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### **ABSTRACT**

In the U.S. and in other countries, accounting graduates continue to enter diverse size work forces in industry, government, and in public accounting. Beyond income tax and consulting work, accounting professionals often require a specific association with financial statement services. These services involve not only detailed scheduled financial statements and schedules, but also notes or “footnotes” to assist in the overall transparency of the reporting entity. The structure and overall communication of these footnotes to the financial statement reader-user is extremely important in this era of economic financial clashes, where the need to communicate truthful, relevant information is paramount.

The accounting student, and more importantly, the accounting graduate, must have the skill sets, and be ready to use them in assisting management on reporting on the economic entity. Learning outcomes and assessment of learning for accounting and other business students need to include critical thinking and communications skills. This paper provides a template tool for analysis which illustrates how important it is that the information be presented in a logical way for users of overall financial information. The template involves a multiple paragraph approach describing the situation, outlining professional requirements and managerial constraints, and generating a conclusion for informative disclosure. This paper hopefully contributes to the goal that institutions of higher learning can still produce significant and substantial gains not only in the educational environment, but upon extension, into the private markets where graduates are placed.

**Keywords:** Accounting education, assessment, instructional innovations in business education, footnote disclosure, readability of footnotes, financial reporting disclosures,

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## INTRODUCTION

Educational institutions in the United States have taken severe brow-beatings since 2000 in terms of greatly increased tuitions and absence of progress in real economic gains for various constituents. The tuition charges and other fees are exacerbated for both public, state-supported institutions of higher learning and private institutions. This paper offers a glimmer of hope that these bastions of learning can still produce significant and substantial value-added gains for individuals studying business reporting needs. Upon extension, beyond the educational environment, the private markets where graduates are placed can also deem benefits.

Specifically, work has been conducted by a dedicated cadre of faculty interested in student learning outcomes (Brightman and Noble, 1979). Templates and rubrics are helpful learning guides for the contemporary student (Decker and Ebersole, 2007; Durkee, 2011; Kerby and Romine, 2010; Young and Warren, 2011; Bullen, Kordecki and Capener, 2013). Regional accreditation bodies in the United States, and international accreditation associations such as AACSB, have also provided support and encouragement in promoting activities for working on student success in knowledge retention devices, assurance of learning, and assessment controls (Martell and Calderon, 2005; AACSB, 2006). When there is further evidence of application of new learning outcomes into private markets, the overall economy benefits (Krause, 2007; Kordecki; 2008; Vandenberg, Stollak and McKeag, 2010).

Learning outcomes for accounting students need to include critical thinking and communications skills—and these skills should be included in the assessment of learning presented to assessment bodies such as the Association to Advance Collegiate Schools of Business (AACSB.) In addition to involvement with taxes and financial statement reporting in statements and schedules, accounting professionals also need to be able to have the skills to develop notes or “footnotes” to assist in the overall transparency of the reporting entity. The structure and overall communication of these footnotes to the financial statement reader-user is extremely important to decision-making. The accounting student, and more importantly, the accounting graduate, must have the skill sets, and be ready to use them in assisting management in reporting on the economic entity. This paper provides a template tool for analysis which illustrates how important it is that the information be presented in a logical way for users of overall financial information.

This paper also illustrates how the scholarship of teaching and learning in one aspect of the baccalaureate degree program in business with an accounting major, provides proof that underlying knowledge and education is not only useful, but critical, in the expansion of markets for small closely-held businesses and the external accountants that provide services for professional advice. Bachelor of Business Administration (BBA)-Accounting students have long taken the brunt of being “numbers only,” calculator-based, and perceived as greatly incapable of making rational decisions based upon qualitative and behavioral input (Kordecki, 2007). This paper attempts to dispel that myth and provide examples of the viable contributions that accounting departments in Colleges of Business make, and further demonstrate the successes these graduates enjoy as they invoke the classical language of business in neoclassical ways.

## RESEARCH ISSUES

Long run value attaches to developing and writing the note disclosures that accompany external financial statements. The AACSB's continuous emphasis on improved assurance of learning and knowledge retention methodologies clearly echoes the need for academic controls, especially as viewed by practitioners concerned with skills of accounting graduates. Graduates unable to demonstrate course and program outcomes to the satisfaction of employers are clearly academic failures in the economic sense (Mackay-Smith, 1985). Reasons for dissatisfaction may include the absence of relevant, practical case material, and the lack of incentives within the academy to address these needs. Critical thinking and formal communication success are strongly desirable outcomes sought in graduates. Proven techniques of drafting footnote disclosures can reward the students who are exposed to the process, generate wins for all involved in the teaching and learning process, diminish training time and turnover in practice, and build client base and growth.

Critical thinking and communication of technical accounting content is a skill too often underdeveloped by both students and practitioners (AAA, 1986; Arthur Andersen, et al., 1989). Employers seek graduates that can turnkey as much material as soon as possible (AECC, 1990; AACSB, 2006; AICPA, 2006). In both public accounting and private industry, the expectation continues that recruits should be able to converse and correspond with others both inside and outside of the organization, with clear delivery of financial information.

Analysis of the accompanying notes, or "footnotes" as they are commonly called, to the financial statements is an area of intriguing interest, both for constituents of public companies and the proliferation of small and medium size businesses in the United States of America. These entities need financial statements, frequently with full disclosures and an independent attestation by an outside public accountant.

Footnotes provide an important component of disclosure and continue to be an especially important part of financial reporting. In a recent exposure draft the Financial Accounting Standards Board (FASB) has specified that CFOs and other corporate executives will have to reveal more information in their financial-statement footnotes about their company's ability to exist as a going concern. As noted by Hoffelder (2013), "Where there is potential that a company will not meet obligations that will ensure its existence, FASB proposes that the company disclose in footnotes a description of the principal conditions and events that give rise to the inability to meet obligations, the possible effects those conditions and events could have on the company, management's evaluation, any mitigating conditions, and managements' plans to address the matter."

How the disclosures are written does make a difference. Former U.S. Securities and Exchange Commission Chairman Arthur Levitt strongly encouraged "plain English" in disclosure documents, and during his tenure the SEC (1998) published *A Plain English Handbook: How to Create Clear SEC Disclosure Documents*. In the Preface to this volume, Warren Buffett comments that for more than forty years he has studied the documents that public companies file. He states: "There are several possible explanations as to why I and others sometimes stumble over an accounting note or indenture description. Maybe we simply don't have the technical knowledge to grasp what the writer wishes to convey. Or perhaps the writer doesn't understand what he or she is talking about. In some cases, moreover, I suspect that a less-than scrupulous issuer doesn't want us to understand a subject it feels legally obligated to touch upon. Perhaps the most common problem, however, is that a well-intentioned and informed

writer simply fails to get the message across to an intelligent, interested reader. In that case, stilted jargon and complex constructions are usually the villains.”

In a recent empirical study, Rennekamp (2012) found that more readable disclosures lead to stronger reactions from small investors such that their valuation judgments are more positive when news is good, and more negative when news is bad. Rennekamp predicted and found that the reason for this result was that the disclosure acts as a subconscious heuristic queue and increases investors’ beliefs that they can rely on the disclosure. In another recent empirical study Lee (2012) investigated the association between the readability of quarterly reports and the information efficiency of stock prices. Using 60,000 mandatory quarterly 10Q reports filed with the SEC between 2001 and 2007, Lee found that consistent evidence that unexpectedly longer and more texturally complex quarterly reports impede the timely stock price adjustment to earnings news, resulting in an initial market under-reaction to earnings announcements.

Because of the unique circumstances surrounding each company, and at each reporting period, there is little danger in moving the footnote disclosure process “offshore” to others not intimately involved with a company’s operating, investing, and financing decisions. Accordingly, the art of footnote drafting, with high level analysis, synthesis, and evaluation, is less likely to be an exported commodity than is the preparation of income tax returns (Bloom, et al., 1954; AACSB, 2007). Is it possible to extend modern teaching methods beyond the academy into the world of practice? Will economic gains be realized by application of template-driven accounting information? Will overall entity transparency be achieved?

## SCENARIO

Consider the following example in Figure 1(Appendix) typical of situations encountered in both theory and practice. The fast track accountant lunges forward to respond. However, with critical thought, the accountant should consider the calculation only as a necessary first step, and only then take the subsequent step of booking the entry. The accountant should also address requirements for financial statement classifications, and finally, the footnote disclosures.

Accordingly, the improved full cycle requirements could be shown as follows:

Required:

- (1) Prepare calculations for the amount of the 2013 adjusting journal entry,
- (2) Record the adjusting journal entry,
- (3) Determine financial statement presentation implications,
- (4) Draft the footnote disclosures required as a result of the findings in Requirements (1), (2), and (3) for the Company’s financial statements as of, and for the year ended, December 31, 2013.

Figure 2 (Appendix) describes the solution to the first two requirements, the “necessary conditions”. While the results in Figure 2 serve as a good workable exercise, any good student or entry level practitioner can probably solve for the necessary conditions. But what are the sufficient conditions for the “real world”? Requirements (3) and (4) are needed for presentation and disclosure. This forces the accountant to think through the critical elements of the problem and to anticipate communicating the footnote information. Among questions the accountant would consider at this point are the following --

- What would have been the fourth year depreciation had the sum-of-the-years’ digits method been continued?
- What would have been the fourth year depreciation had the straight-line method been used since inception?

- What are the relevant amounts to include in the footnote? Approximately where should they be reported, and in which paragraph? What is the optimum presentation and classification of amounts on the financial statements?
- What other wording or language is needed in the footnote? Approximately where should all of this appear in paragraph structure?

Answers to these and related issues follow readily with the application of a template. In view of these issues, the accountant can calculate  $(7/55)(\$1.2 \text{ million} - \$200,000 \text{ residual value}) = \$127,273$  for the fourth year accelerated depreciation had it been continued, and  $(1/10)(\$1.2 \text{ million} - \$200,000 \text{ residual value}) = \$100,000$  per year had the straight-line method been used since inception. Then, determining what is relevant for presentation and disclosure, the next calculation could be  $\$127,273 \text{ sum-of-the-years' digits depreciation} - \$72,727 \text{ straight-line depreciation} = \$54,546$  to yield the difference between the old and new methods of depreciation in terms of effect on income for the fourth year, the year ended December 31, 2013.

If additional assumptions are made regarding the allocation of overhead between product cost and period cost as 90% and 10%, and the weighted average number of outstanding shares of common stock for the year ended December 31, 2012 are 100,000 shares, further disclosure information could be provided. The amounts of the depreciation in cost of goods sold and general and administrative expense are \$65,454 (90% of new depreciation of \$72,727) and \$7,273 (10% of new depreciation of \$72,727). The “accounting” savings in earnings per share is \$0.545 (\$54,546 difference between old and new depreciation calculated above divided by 100,000 outstanding shares).

## APPLYING THE MODEL

In trying to put all this together in a manner that makes sense, consider the footnote drafting template shown in Figure 3 (Appendix). Usually, the practical needs of the problem case are best handled with three separate paragraphs, breaking the 9 steps in Figure 3 down into three clusters: the effects of steps 1, 2, & 3 in the first paragraph, steps 4, 5, & 6 in the second paragraph, and steps 7, 8, & 9 in a third paragraph. See Figure 4 (Appendix) for a possible “solution” to the footnote disclosure needs of our sample Company on the “Accounting Change,” with appropriate narrative and numeric detail in the notes accompanying the financial statements.

Templates are effective and efficient when they provide general guidance. If they are viewed as the absolute required formula for success, the process of meeting disclosure requirements is hamstrung. Figure 4, the actual finished footnote, illustrates how the guidance of the template described in Figure 3 could be implemented. Figure 3, or any template for that matter, need not be followed to arrive at appropriate disclosures, but for many accountants, this guidance is extremely helpful.

Porter (2012) illustrates an expanded scenario where transaction effects carry through beyond the communication of disclosure into the realm of ethical reporting. However, the model presented in this paper is likely to provide a good first step for most situations regarding disclosures.

## ECONOMIC RETURNS

This example helps illustrate that accounting requires critical thinking, communication, and technical skills all bundled holistically. When one considers the limited (highlighted gray



areas for emphasis here) in the third paragraph of Figure 4, and realizes that the dollar amount scheduling consumes much less space than the other narrative components such as description and justification of change, it becomes clear that literacy competence is required. In fact, even more could have been said in the first two paragraphs, citing specifically the Codification location of the Financial Accounting Standards Board pronouncement as authoritative source, or other rationale in applying the straight-line depreciation method.

The example is primarily designed for small enterprises. Very likely, had this been a widely-held concern, there would be comparative financial statements, complex capital structures requiring separate disclosure requirements for both basic and diluted EPS, and other matters. The purpose of this example is to illustrate required language for drafting footnotes in general, by means of a specific case for the accounting change. The example does not address all the reporting requirements for EPS disclosures.

Others have provided learning examples of footnote disclosure applications for large entities and using language that is psychologically persuasive (DuPree, 1985; Schroeder and Gibson, 1990). Still others have also come forward with good tips on developing writing skills and grammatical corrections (John, 1976; Worthington, 1978). Whether the accountant is still a student or is a practitioner, the footnote drafting becomes enhanced with hands-on experience in writing actual footnotes. Shortcomings in undergraduate programs occur, as students believe they can "get by" in making statements that "footnote disclosures would be required," but the professors and downstream employers find students more often clueless in how to actually write the footnote (Franz, 1989; Bonner, 2012; Pathways, 2012). Template applications gives the accountant critical guidance in structuring the needed disclosures.

Recent studies on footnote disclosures have tended to focus on the financial statements of large publicly-held companies (Chander, 2007). Other research has delved into the particulars of technical writing, emphasizing grammatical skills and clear delivery (John, 1976; Worthington, 1978; Catanach and Rhoades, 1997). The purpose of this paper has been to illustrate methods of honing in on the market that places many of our baccalaureate graduates, and where this young staff has an opportunity to meet challenges and rise up the ladder through critical thinking and communication in small and medium-sized businesses. An individual's skill in providing the appropriate accompanying narrative detail to numeric schedules and statements develops in many ways, including communication of financial, managerial, and tax research. The increasingly important area of the notes accompanying financial statements of closely-held enterprises cannot be overlooked, nor can it be downplayed with arbitrary and capricious footnote management systems described by bookkeeping pundits (O'Bannon, 2007; Janvrin and Mascha, 2012; Needleman, 2010).

Once the sole domain of the outside CPA firm's managing partner, the scope and depth demanded for today's transparency requires that all individuals working on a piece of the financial statement output be prepared to contribute to the communication process (Catanach, Croll and Grinaker, 2000). The expansion of workpaper requirements to document the economic events supporting key transactions is something with which staff must increasingly deal. Drafting the disclosures accompanying the financial statements is a natural outgrowth of this expansion. On-going, continuous reviews are needed at multiple levels to assure that the end-product that goes out the door is truly user-oriented and relevant for decision making.

What remains is the mechanism to download some of this responsibility to the lower level staff, not just in saving billable time, but also for overall efficiency and effectiveness in the client engagement, as well as in staff development within the firm. The importance of on-the-job

training and learning is recognized. However the university environment can be the first training ground teaching necessary critical thinking and communication skills, and providing defined learning outcomes, constructive problem based learning scenarios, and assessment instruments with accompanying templates and grading rubrics that mirror the voice of experience witnessed in practice.

## **SUGGESTIONS FOR FUTURE RESEARCH**

This paper transcends the academic environment into the rich harvest land of the accounting practitioner with a methodology of enhancing learning and professional development in a very much needed skills area. Writing footnotes to financial statements is a good outgrowth of case material in an intermediate accounting course. Ripe for further research would be the identification of those areas in the accounting curriculum that can be tendered as workable for adjustment to meet the needs of today's business practice. Cost and managerial courses might be a site for student experience with creative methods of persuasive writing defending and proposing actions in capital budgeting analysis. Tax courses might be a site for student practice in delivering the elements of tax research to responsible persons, and examples could vary from drafting the response to an IRS notice, to proposing a tax avoidance strategy to a client.

Student work following the guidance of templates can be monitored with constructive feedback. Templates can be critical tools in the teaching and learning process, and be customized to meet special program needs of the university, or even in a course in a major. Additional attention in this area is given by some firms through CPE sessions with staff. Research showing specific ways public accounting firms train, assess, and evaluate critical thinking and communication of their staff will further enlighten the professors. In this way course materials can be developed to meet the appropriate learning outcomes and to assess student learning on issues that matter. A word of caution needs to be expressed—one size does not fit all. Ongoing tailoring will always be needed. Template driven accounting information for footnote disclosure is only one of many ways where gains are realized.

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## APPENDIX

Figure 1

The Company purchased a machine for \$1.2 million in 2010 with an expected residual value of \$200,000, and began depreciating it under the sum-of-the-years'-digits method over a 10-year useful life. However at the beginning of 2013, the Company decides to change the depreciation method for this machine to the straight-line depreciation method.

Figure 2

(1) Depreciation to date $[(10 + 9 + 8) / 55] \times (\$1.0 - .2) \text{ million} = \$490,909$	
This amount is the sum-of-the-years'-digits accumulated depreciation as of December 31, 2012.	
\$1,200,000	Cost
490,909	Depreciation to date, SYD (2010 - 2012)
709,091	Undepreciated cost as of 1/1/13
200,000	Less residual value
509,091	Depreciable base
÷ 7 yrs.	Remaining life (10 years - 3 years)
\$ 72,727	New annual depreciation
(2) Adjusting entry (dated December 31, 2013):	
Depreciation expense (calculated above).....	72,727
Accumulated depreciation .....	72,727

Figure 3

Footnote Disclosure Template—Drafting Footnotes to Financial Statements	
Paragraph 1: Steps 1, 2, and 3.	
<ol style="list-style-type: none"> <li>1. Reference time frame and Company name; use “management” as subject of sentence.</li> <li>2. Make sound statement about what is generally accepted accounting principles (GAAP).</li> <li>3. Describe conditions affecting the Company and/or current applications.</li> </ol>	
Paragraph 2: Steps 4, 5, and 6	
<ol style="list-style-type: none"> <li>4. Provide management’s rationale for the financial accounting treatment.</li> <li>5. Defend management’s conclusions in view of external authority.</li> <li>6. Describe the nature of the appropriate current, prospective, or retroactive effects.</li> </ol>	
Paragraph 3: Steps 7, 8 and 9	
<ol style="list-style-type: none"> <li>7. Illustrate or schedule any key material amounts subject to change.</li> <li>8. Describe the effect on income, if any, including per share amounts.</li> <li>9. Tie amounts in schedule to the body of the financial statements.</li> </ol>	

Figure 4

<p>Note XX Accounting Change</p>
<p>During the fiscal year ended December 31, 2013, management of the Sample Company considered alternative accounting policies for its depreciation on selected equipment. Accounting principles generally accepted in the United States of America usually include a method of allocation of the original cost of long-lived assets which is systematic and rational to benefit future accounting periods. Management had generally been applying the sum-of-the-years' digits method, a method which is not generally accepted. (Steps 1, 2, 3)</p>
<p>Management believes the utilization of the straight-line method of depreciation would more clearly match the expense allocation of current and future periods with the revenue generated in those periods. Furthermore, the straight-line method is consistent with practices within the industry in which the Company operates. Accordingly, effective for the year ended December 31, 2013, management has adopted the straight-line method. Usually, accounting changes in principle are treated retroactively with the cumulative effect of the change made evident in the retained earnings for the year of the change. However, in accordance with recent pronouncements of the Financial Accounting Standards Board, changes in depreciation method are to be treated as a change in accounting estimate that is achieved by a change in accounting principle. Accordingly, the Company's income statement for the year ended December 31, 2013 includes the allocated current amount, with the prospective amount going forward into future years, for the provision for depreciation on a straight-line basis, rather than reporting the cumulative effect of the accounting change retrospectively. (Steps 4, 5, 6)</p>
<p>The effect for the year 2013 is a charge against income in the amount of \$72,727, of which \$65,454 is included with cost of goods, and \$7,273 included in general and administrative expense. The effect on net income for 2013 is a reduction in expense and increase in income before the provision for income taxes of \$54,546 and a corresponding increase in earnings per share of \$0.545. These amounts are included with the presentation of the Company's statement of income. (Steps 7, 8, 9)</p>