

PART 1

An Overview of Financial Accounting

In early 2010, after the Christmas season, stock market analysts following Apple, Inc.—manufacturer of the popular iPhone, iPod, and Macintosh computer—were very optimistic about the company’s future revenues and earnings. Based largely on bullish expectations concerning the recently upgraded smart phones and a new tablet computer rumored to be released later in 2010, analysts elevated Apple’s earnings forecast from \$7.66 to \$7.81 per share, boosting the share price to \$213.35, a whopping 27 times earnings.

What are revenues and earnings? How do they relate to stock prices? What role do analysts and their expectations play? Would an investment in Apple be a wise move? Answering such questions begins with an understanding of the business environment, investment decisions and financial statements—topics addressed in Part 1 of this textbook.

CHAPTER 1

Financial Accounting and Its Economic Context

CHAPTER 2

The Financial Statements

CHAPTER 1

Financial Accounting and Its Economic Context

KEY POINTS

The following key points are emphasized in this chapter:

- The economic role of financial accounting statements.
- The four financial statements and the information each provides.
- The standard audit report, management letter, and footnotes to the financial statements.
- The two forms of investment—debt and equity—and how the information on the financial statements relates to them.
- The nature and importance of corporate governance and the role of financial statements.
- The current status of accounting standard setting—both in the U.S. and internationally.

Like schoolchildren who have practiced fire drills dozens of times, investors know exactly what to do when news leaks out that a company's financial records may not be in order. First, sell the stock; then, look around to see who else might get sucked up into the budding scandal, and drop them like a "hot potato." Investors followed their "fire drill" to the letter when they learned that the financial records of New Century, one of the nation's leading lenders of high-risk loans, were misstated. Its stock price plummeted; it was forced to declare bankruptcy; and one of the worst credit crises in U.S. history was underway.

The situation described above is all too common. Billions of dollars are lost each year by investors who base their investment decisions on misleading reported numbers. This text, beginning with this first chapter, explains how that could happen. It also describes how you can avoid the fate of those investors who, believing the profits reported by New Century, chose to invest their hard-earned money and lost much of it. The first step involves understanding the **financial accounting** process.

FINANCIAL REPORTING AND INVESTMENT DECISIONS

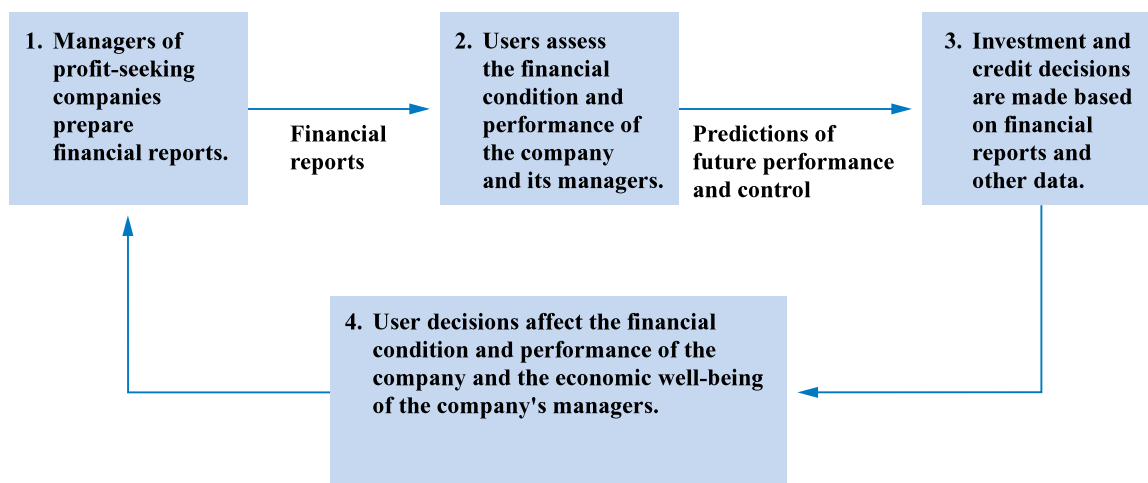
Financial reporting plays an important role in investment decisions.

1. *Profit-seeking companies*—Managers of profit-seeking companies prepare reports containing financial information for the owners of these companies. In addition to other information, these reports contain four financial statements: the balance sheet, the income statement, the statement of shareholders' equity, and the statement of cash flows.
2. *Owners and other interested parties (users)*—Although prepared primarily for the owners, these financial reports are available to the public and are read by other interested parties who use them to assess the financial condition and performance of the company as well as the performance of its managers. Such interested parties, called users in this text, include potential investors, bankers, government agencies, and the company's customers and suppliers.
3. *User decisions*—Users obtain information from the financial reports that helps assess the company's past performance, predict its future performance, and control the activities of its managers. Financial reports, therefore, help users to make better decisions. Investors, for example, use financial reports to choose companies in which to invest their funds; bankers use them to decide where to loan their funds and what interest rates to charge.
4. *Effects of user decisions*—User decisions affect the financial condition and performance of the company and the economic well-being of its managers. For example, a banker may use the information contained in a financial report to decide not to loan a certain company much-needed funds. Such a decision may cause the company to struggle and may cost managers their jobs and owners their investments.

Figure 1–1 illustrates how financial reporting relates to investment decisions. Note its dynamic nature: The financial information provided by managers of a profit-seeking company is used by interested parties to make decisions that, in turn, affect a company's financial condition and the economic well-being of its managers. Managers need to understand the process depicted in Figure 1–1 from two perspectives:

1. Economic consequences
2. User orientation

FIGURE 1-1 Financial reporting and investment decisions



Economic Consequences

To run a company effectively, management must be able to attract capital (funds) from outsiders who use financial statements to evaluate the company's performance and financial health. Managers apply for loans from bankers, for example, who use the financial statements to determine whether to grant the loan and, if so, what interest rate to charge. Since using financial statements by outsiders leads to economic consequences for managers and the companies they operate (e.g., higher interest rates), it is important that they know how economic events (e.g., business decisions) affect the financial statements. Consider a case where management is deciding to either purchase or rent equipment. When making such a decision, an astute manager would consider how the choice affects the financial statements because it could influence the way in which the company is viewed by outsiders. Considering and understanding how such events affect the financial statements are referred to in this text as an **economic consequence perspective**.

User Orientation

Managers are also users of financial statements, such as when they are called upon to assess the performance and financial health of other companies. Questions such as the following are often answered by analyzing financial statements provided by those companies.

- Should we purchase a company?
- Should we use a company as a supplier?
- Should we extend credit or loan funds to a company?

Accordingly, managers also need to know how to read, evaluate, and analyze financial statements. We call this perspective a **user orientation**.

The next section develops a scenario designed to highlight issues particularly important to users of financial statements. That same scenario serves as the basis for the next section, which covers the economic environment in which financial statements are prepared and used. Appendix 1A introduces managerial, tax, and not-for-profit accounting.



Some managers, particularly in certain high-tech companies, claim that required methods for computing manager pay overstate the company's costs and unfairly understate its performance. They argue that they are being penalized by these requirements. Others maintain that the financial performance of high-tech companies cannot be properly assessed unless manager pay is computed in line with the requirements. Which of the two arguments takes an economic consequence perspective, and which takes a user orientation? Discuss.

THE DEMAND FOR FINANCIAL INFORMATION: A USER'S ORIENTATION

Suppose that you recently learned that a long-lost relative died and left you a large sum of money. You know little about financial matters, so you consult Mary Jordan, a financial advisor, to help you decide what to do with the funds. She tells you that you have two choices: You can consume it or you can invest it.

Consumption and Investment

In consuming your new fortune, you would spend the money on goods and services, such as a trip around the world, expensive meals, a lavish wardrobe, or any other expenditures that bring about immediate gratification. Consumption expenditures, by definition, are enjoyed immediately and have no future value.

In investing the fortune, you would spend the money on items that provide little in the way of immediate gratification. Rather, they generate returns of additional money at later dates. In essence, investments trade current consumption for more consumption at a later date. Examples include investing in stocks and bonds, real estate, or rare art objects, or simply placing the money in the bank.

Where to Invest?

You decide to invest the money, and with a little direction from Mary, you begin to explore investment alternatives. You find that investments come in a number of different forms, however, and you quickly become overwhelmed, confused, and frustrated. Just as you are about to give up your search and put all your money in the bank, a man by the name of Martin Wagner knocks at your door. Through a mutual friend, Martin has heard of your recent windfall and states that he has an interesting offer for you.

Martin claims that he manages a very successful research company, called Microline, owned by a group of European investors. In its short history, the company has earned a reputation for innovation in software development. As Martin describes it, Microline's research staff is on the verge of designing a voice-activated word-processing system that will revolutionize word processing in the future.

Martin has come to you for capital—\$1 million, to be exact. The company's research and development efforts have run short of funds, and money is still needed to complete the design. With your money, Martin asserts that the software system can be completed and sold, producing millions of dollars of income, some of which will provide you with a handsome return on your investment. Without your capital, Martin believes that the project may have to be abandoned.

The Demand for Documentation

You have listened to Martin's story and now must decide what to do. Your first thought is that you simply cannot accept his word without some documented evidence. How do you really know that he has successfully managed this business for the past two years and that \$1 million will enable the company to turn this design into a fortune in the future?

After careful consideration, you decide that you need to see some proof before making a final decision. You ask for specific documents to show that Microline has been run successfully for the past two years, is currently in reasonably good financial condition, and has the potential to generate income of the magnitude Martin suggests. He agrees to provide you with such documentation because he knows that if he does not, you will invest your money elsewhere, and both he and Microline will suffer.

Several days later, Martin returns with a set of financial statements prepared by Microline's accountants. He explains the meanings of the numbers on the statements and further claims that the records at his office can be used to verify them. Taken at face value, the figures look promising, but somehow Martin's explanation is not convincing. It occurs to you that Martin might fabricate or at least influence the figures. After all, Microline needs money, and who would blame Martin for showing you only the figures that make Microline's situation look attractive to a potential investor?

The Demand for an Independent Audit

You require that Martin go one step further. He must return again with financial statements that have been checked and verified by an independent outsider who is an expert in such matters. You insist that the person not be employed by Microline or have any interest whatsoever in the company and have the appropriate credentials to perform such a task. In essence, you demand that Martin hire a **certified public accountant (CPA)** to verify Microline's financial statements. You require, in other words, that Microline subject itself to an **independent audit**. Martin agrees because, once again, if he does not, you will take your money and invest it elsewhere. At the same time, Martin is somewhat troubled. He knows that hiring and working with a CPA can be very costly and time-consuming.

Martin and the CPA: Different Incentives

Time passes and you become concerned that Martin has taken too long to return with the financial statements. You have thought of several questions since Martin's last visit and decide to call on him in person. You arrive at Microline's office and are seated by Martin's secretary. While you are waiting, you hear Martin's voice through the partly open door to his office. He seems to be discussing Microline's financial statements with the CPA. While you cannot understand exactly what is being said, it is clear that they are not in complete agreement and that they are both strong in their convictions.

You wonder why Martin and the CPA might view the financial statements from different perspectives and speculate that perhaps the CPA recommended presenting Microline's financial condition in a way that was unsatisfactory to Martin. You reason that Martin should probably follow the CPA's recommendation because, after all, the CPA is the expert in financial reporting. You realize, however, that Martin wants the statements to be as attractive as possible and that he may have some influence over the CPA. Indeed, Martin did hire the CPA and does pay the CPA's fee.

Before long, the CPA leaves and Martin invites you into his office. During your short discussion, you mention nothing of what you think you have heard. Martin answers your questions confidently and assures you that the statements will be ready within the week. Satisfied, you return home.

The Auditor's Report, the Management Letter, and the Financial Statements

Martin arrives at your home with seven official-looking documents: (1) an **auditor's report**, a short letter written by the auditor that describes the activities of the audit and comments on the financial position and operations of Microline; (2) a **management letter**, signed by Martin, which accepts responsibility for the figures on the statements; (3) a balance sheet; (4) an income statement; (5) a statement of shareholders' equity; (6) a statement of cash flows; and (7) a comprehensive set of footnotes, which more fully explains certain items on the four statements listed above. You briefly review the documents and tell Martin that you will have a decision for him soon.

THE AUDITOR'S REPORT

You begin your examination by reviewing the auditor's report, from which you hope to learn how credible the financial statements actually are (see Figure 1–2).

FIGURE 1–2
The standard
audit report

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF MICROLINE:

We have audited the accompanying balance sheet of Microline as of December 31, 2010 and 2009, and the related statements of income, shareholders' equity, and cash flows for the years then ended. We have also audited management's assessment of the effectiveness of its internal control over financial reporting. These financial statements and the effectiveness of the internal controls are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and management's assessment of the internal controls based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of the internal controls. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Microline as of December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles. Also, in our opinion management maintained effective internal control over financial reporting as of December 31, 2010.

Arthur Price

Arthur Price, Certified Public Accountant
March 12, 2011

Overall, you are reassured by the auditor's report. It indicates that the auditor reviewed Microline's records thoroughly and concluded that the statements (1) were prepared in conformity with generally accepted accounting principles, (2) present fairly Microline's financial condition and operations, and (3) resulted from an effective internal control system. You suspect that the auditor could have rendered a much less favorable report, such as that the statements were not prepared in conformance with generally accepted accounting principles, or that no opinion could be reached because Microline's accounting system and internal controls were so poorly designed, or that Microline was in danger of failure. You also realize, however, that you know very little about internal control systems, auditing standards, and generally accepted accounting principles, and that Microline's management made a number of significant estimates when preparing the statements. This discovery is somewhat troubling because, even with the audit, it seems that Microline's management may have had some subjective influence on the financial statements.

THE MANAGEMENT LETTER

You next read the management letter, hoping to learn more about how the financial statements were prepared and audited (see Figure 1–3).

FIGURE 1–3
Management's
letter

MANAGEMENT'S RESPONSIBILITIES:

Management is responsible for the preparation and integrity of the financial statements and the financial comments appearing in this financial report. The financial statements were prepared in accordance with generally accepted accounting principles and include certain amounts based on management's best estimates and judgments. Other financial information presented in this financial report is consistent with the financial statements.

The Company maintains a system of internal controls designed to provide reasonable assurance that the assets are safeguarded and that transactions are executed as authorized and are recorded and reported properly. The system of controls is based upon written policies and procedures, appropriate division of responsibility and authority, careful selection and training of personnel, and a comprehensive internal audit program. The Company's policies and procedures prescribe that the Company and all employees are to maintain the highest ethical standards and that its business practices are to be conducted in a manner which is above reproach.

Arthur Price, an independent certified public accountant, has examined the Company's financial statements, and the audit report is presented herein. The Board of Directors has an Audit Committee composed entirely of outside directors. Arthur Price has direct access to the Audit Committee and meets with the committee to discuss accounting, auditing, and financial reporting matters.

Martin Wagner

**Martin Wagner, Chief Executive Officer
March 12, 2011**

Once again, you are both reassured and troubled. It is comforting to know that Microline's management is accepting responsibility for the integrity of the statements, which have been prepared in conformance with generally accepted accounting principles, and that the company has an **internal control system** that safeguards the assets and reasonably ensures that transactions are properly recorded and reported. It is also nice to know that Microline's policies prescribe that its employees maintain high ethical standards. However, you still do not understand generally accepted accounting principles, are still

concerned that the statements reflect management's estimates and judgments, and have very little idea about the function of Microline's Board of Directors and Audit Committee.

THE FINANCIAL STATEMENTS

You briefly review the four financial statements (see Figure 1–4) and note first that dollar amounts are listed for both 2010 and 2009. This discovery is somewhat discouraging because only information about the past is included on the statements and is subject to the auditor's report and management letter. Nothing about Microline's future prospects is included in the financial statements—but the future is what interests you most. Whether Microline is able to provide an acceptable return on your \$1 million

FIGURE 1–4
Financial
statements for
Microline

Microline Financial Statements As of December 31, 2010 and 2009

	2010	2009
BALANCE SHEET		
ASSETS		
Cash	\$ 100,000	\$ 60,000
Accounts receivable	80,000	90,000
Equipment	330,000	300,000
Land	500,000	500,000
Total assets	\$1,010,000	\$ 950,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Short-term payables	\$ 50,000	\$ 30,000
Long-term payables	420,000	450,000
Common stock	400,000	400,000
Retained earnings	140,000	70,000
Total liabilities and shareholders' equity	\$1,010,000	\$ 950,000
INCOME STATEMENT		
Revenues	\$1,650,000	\$1,500,000
Expenses	1,450,000	1,350,000
Net income	\$ 200,000	\$ 150,000
STATEMENT OF SHAREHOLDERS' EQUITY		
Beginning balance in common stock and retained earnings	\$ 470,000	\$ 400,000
Plus: Net income	200,000	150,000
Less: Dividends	130,000	80,000
Ending balance in common stock and retained earnings	\$ 540,000	\$ 470,000
STATEMENT OF CASH FLOWS		
Net cash flow from operating activities	\$ 250,000	\$ 120,000
Net cash flow from investing activities	(50,000)	(340,000)
Net cash flow from financing activities	(160,000)	280,000
Net increase (decrease) in cash	\$ 40,000	\$ 60,000
Beginning cash balance	60,000	0
Ending cash balance	\$ 100,000	\$ 60,000

investment depends primarily on what happens in the future. The past is often a poor indicator of the future.

You also observe that each statement emphasizes a different aspect of Microline's financial condition and performance. The balance sheet, for example, lists the company's assets, liabilities, and shareholders' equity. On the income statement, expenses are subtracted from revenues to produce a number called net income. The statement of shareholders' equity includes (1) the beginning and ending common stock and retained earnings balance, which can be found on the 2009 and 2010 balance sheets; (2) net income, which is the bottom line on the income statement; and (3) dividends. The statement of cash flows includes the beginning and ending balance of cash, which can be found on the 2009 and 2010 balance sheets, and net cash flows from operating, investing, and financing activities. It becomes clear quite quickly that you do not understand these terms and that you know very little about the information conveyed by these statements and, therefore, cannot begin to assess whether Microline would be a good company in which to invest.

THE FOOTNOTES

At this point you decide to examine the **footnotes**, hoping that they will clear up some of your uncertainty about the financial statements (Figure 1–5). They state that many of the numbers on the statements are the result of assumptions and estimates made by Microline's management, which does not surprise you because both the audit report and the management letter made similar statements. It is also clear from the footnotes that Microline was able to choose from a number of different acceptable accounting methods. While you know little about generally accepted accounting principles, you confidently conclude that they do not ensure exact and unbiased statements. Alternative accounting methods, as well as assumptions and estimates by Microline's management, are very evident.

FIGURE 1–5

Notes to the
financial
statements

Cash. Cash consists of cash on hand and cash in a bank checking account.

Accounts Receivable. The balance in accounts receivable has been adjusted for an estimate of future uncollectibles.

Equipment. Equipment is carried at a cost and includes expenditures for new additions and those that substantially increase its useful life. The cost of the equipment is depreciated using the straight-line method over an estimated useful life of ten years.

Land. Land is carried at cost.

Short-Term Payables. Short-term payables consist of wages payable, short-term borrowings, interest payable, taxes payable, and an estimate of future warranty costs.

Long-Term Payables. Long-term payables consist primarily of notes that must be paid back after one year.

Common Stock. Common stock represents the contributions of the company's shareholders.

Revenue Recognition. Revenues from sales are reflected in the income statement when products are shipped. Revenues from services are estimated in proportion to the completion of the service.

Expenses. Expenses include selling and administrative expenses and estimates of uncollectible receivables and depreciation on the equipment.

Descriptions of Financial Statements

After your initial examination, you decide that Microline may be a reasonable investment, but your lack of knowledge renders you incapable of making a confident choice. You decide to return to Mary Jordan, your financial advisor, for help. Perhaps she can explain the nature of the financial statements and improve your understanding of the decision that faces you. Mary begins by defining some of the fundamental terms used on the financial statements.¹

The **balance sheet**, which lists Microline's assets, liabilities, and shareholders' equity, is a statement of the company's financial position as of a certain date. **Assets**, representing items that will bring future economic benefit to Microline, include the cash balance, the dollar amounts due from Microline's customers (accounts receivable), and the original cost of the equipment and land purchased by the company. **Liabilities**, which represent current obligations, consist of the amounts currently owed by Microline to its **creditors**. Satisfying these liabilities will generally require cash payments in the future. Common stock and retained earnings comprise the **shareholders' equity** section. **Common stock** represents the initial investments by Microline's owners, and **retained earnings** is a measure of Microline's past profits that have been retained (reinvested) in the business. Without the balance sheet, investors would have difficulty assessing the current financial condition of the company.

The **income statement** is divided into two parts: **revenues**, a measure of the assets generated from the products and services sold, and **expenses**, a measure of the asset outflows (costs) associated with selling these products and services. The difference between these two amounts is a number called **net income (profit or earnings)**, which measures the success of Microline's operations over a particular period of time. Without the income statement, investors would be unable to determine the company's performance during the period.

The **statement of shareholders' equity** describes the changes in the shareholders' equity items (common stock and retained earnings) from one year to the next: There was no change in common stock for Microline, so in this case the statement only includes the increases and decreases to retained earnings, which is a measure of Microline's past profits. The net income, profit, or earnings amount from the income statement is first added to the beginning balance of retained earnings. **Dividends**, the assets paid to Microline's owners as a return for their initial investment, are then subtracted from this amount to compute ending retained earnings. The ending retained earnings amount appears on the balance sheet and becomes the beginning balance of the following period. The change in retained earnings indicates in any given year how dividends compare to profit.

The **statement of cash flows** summarizes the increases and decreases in cash over a period of time. The beginning cash balance is adjusted for the *net cash flows* (cash inflows less cash outflows) associated with Microline's operating, investing, and financing activities. **Operating activities** are associated with the actual products and services provided by Microline for its customers. **Investing activities** include the purchase and sale of assets, such as equipment and land. **Financing activities** refers to the cash collections and payments related to Microline's capital sources. Examples include cash borrowings and loan payments as well as collections from owners' contributions and the payment of dividends. Without the statement of cash flows, investors would have difficulty assessing the company's cash management strategies.

1. This section of the text provides basic definitions for important terms. These definitions are expanded upon in later chapters, and a complete glossary is provided at the end of the text.

Analysis of Financial Statements

After defining the terms on the financial statements, Mary notes that Microline appears to be in reasonably strong financial shape. She focuses first on the statement of cash flows, pointing out that the company's cash position has been increasing and that operating activities have contributed \$120,000 and \$250,000 in cash in the last two years. She also notes that Microline has invested heavily in new assets since its inception and that \$160,000 was paid during 2010 for dividends and to reduce outstanding debts. In short, Microline has demonstrated the ability to generate cash. Mary believes this is very important, because in order to remain solvent, the company must be able to generate enough cash to meet its debts as they come due. She comments that **solvency** is a requirement for financial health.

Mary then moves to the income statement and statement of shareholders' equity, noting that Microline has shown profits of \$150,000 and \$200,000 over the past two years and, at the same time, has paid significant dividends to its owners, specifically \$80,000 in 2009 and \$130,000 in 2010. These numbers show that Microline has demonstrated **earning power**, the ability to grow and provide a substantial return to its owners. Mary also notes that the balance sheets indicate Microline's assets have increased during the past year from \$950,000 to \$1,010,000, while its liabilities (payables) have decreased from \$480,000 to \$470,000. She indicates that such a trend is promising.

To further support Microline's financial strength, Mary computes a few ratios by using the dollar values on the income statement and balance sheet. She points out that net income as a percentage of revenues increased from 10 percent ($\$150,000/\$1,500,000$) in 2009 to over 12 percent ($\$200,000/\$1,650,000$) in 2010. Total payables as a percent of total assets decreased from over 50 percent ($\$480,000/\$950,000$) in 2009 to less than 47 percent ($\$470,000/\$1,010,000$) in 2010. Dividends as a percent of net income increased substantially over the two-year period—to 65 percent. After consulting some statistics covering the industry in which Microline is a member, Mary reports that Microline's financial ratios, in general, are stronger than those of many other similar firms.



In its 2008 annual report, Bed Bath & Beyond, a leading housewares retailer, reported sales of \$7.2 billion; net income of \$425 million; total assets and total liabilities of \$4.3 billion and 1.1 billion, respectively; and net cash flows from operating activities of \$584 million. On which of the financial statements were each of these values reported, and what values were reported for each of the following items: total expenses, shareholders' equity, and the net income to sales ratio?

What Form of Investment: Debt or Equity?

The definitions and analysis provided by Mary are encouraging, and you decide that Microline is a good investment. However, Mary states that now you must decide what form your investment should take. Should it be in the form of a loan, or should you purchase ownership (equity) in Microline? She explains that the risks you face and the potential returns associated with these two forms of investment are really quite different. Moreover, the relative importance to you of the different kinds of information disclosed on the financial statements depends on the kind of investment you make.

A DEBT INVESTMENT

You would make a **debt investment** if you loaned the \$1 million to Microline. You would then become one of the company's creditors and would require that Microline's management sign a **loan contract**, specifying (1) the *maturity date*, the date when the loan is to be paid back; (2) the **annual interest** payment, the amount of interest to be paid each year; (3) *collateral*, assets to be passed to you in case the principal or the interest on the loan is in *default* (not paid back); and (4) any other **debt restrictions** you feel you should impose on Microline to protect your investment. The contract might specify, for example, that Microline maintain a certain cash balance throughout the period of the loan or that dividends during that period be limited.

As one of Microline's creditors, your first concern would be Microline's ability to meet the loan's interest and principal payments as they come due. Since such payments are made in cash, you would be especially interested in Microline's cash management record and its ability to generate cash over the period of the loan. Thus, the information in the statement of cash flows would be very relevant. You would also be interested in the selling prices of assets that could be used as collateral and in the amounts of the loans and other liabilities owed by Microline to other creditors. The balance sheet, therefore, which lists Microline's assets and liabilities, would also contain some useful information.

Mary reminds you that many of Microline's assets are valued on the balance sheet at **historical cost**, the dollar amount paid when the assets were acquired, which, in many cases, was several years ago. This discovery is worrisome because the historical cost of an asset is rarely the same as its current selling price, the relevant amount if an asset is to be considered as collateral for the loan.

AN EQUITY INVESTMENT

Rather than loaning Microline the \$1 million, you may wish to purchase **equity** in the company. As an equity investor, you would become one of the owners, or **shareholders**, of Microline.

Equity investments give rise to considerations that are somewhat different from those of debt investments. As a shareholder, for example, your return would be primarily in the form of stock appreciation and dividends, which would tend to be large if Microline performed well and small, or nonexistent, if the company performed poorly. Unlike a loan investment, for which interest and principal payments are specified by contract, dividend payments are at the discretion of Microline's **board of directors**, which is elected annually by the shareholders to represent their interests. Such representation involves (at least) quarterly meetings where company policies are set, dividends are declared, and the performance and compensation of the company's upper management are reviewed. The board of directors has the power to hire and fire upper management as well as determine the form and amount of their compensation.

As a shareholder who could vote in the election of the board of directors, your primary concern would be the performance of Microline's management—specifically, its ability to generate and maintain earnings in the future. To achieve such an objective, management must both ensure that cash is available to meet debts as they come due and invest in assets that produce a satisfactory return in the long run. Consequently, shareholders are interested in the information contained in all four of the financial statements: the balance sheet because it indicates Microline's assets and liabilities, the income statement and statement of shareholders' equity because they indicate Microline's earning power and dividend payments, and the statement of cash flows because it provides a report of Microline's past cash management policies. As a shareholder, however, you

would be especially interested in the income statement, since the board of directors often sets dividends as a percentage of income, which is generally considered to be the overall measure of management's performance and the company's earning power.

You would also be interested in the methods used to compensate Microline's upper management. You may wish, for example, to encourage the board of directors to institute a system of compensation that paid upper management on the basis of its performance. One way to implement such a system would be to set compensation levels at amounts expressed as percentages of net income. This would motivate Microline's management to increase net income and, accordingly, their compensation. Such a result should also mean increased earning power and greater dividend payments in the future. At the same time, however, you realize that management can influence the manner in which net income is measured.

A Decision Is Made, but Important Questions Still Remain

After a lengthy discussion with Mary, you decide to invest in the equity of Microline. From the information contained in the audit report, the management letter, the financial statements, and the footnotes, you have concluded that Microline is a legitimate operation that is solvent, has shown significant earning power, and has provided a reasonable return to its shareholders. You reason further that if Martin is correct in his prediction that their new voice-activated word-processing system will revolutionize the industry, there is a distinct possibility of large returns in the future. Shareholders would receive such returns in the form of an increase in the value of their investment and/or larger dividends, while payments to creditors would be limited to the contractual interest and principal payments.

You thank Mary for her advice and feel satisfied with your decision. You realize, however, that the future is uncertain and that your investment involves risks.



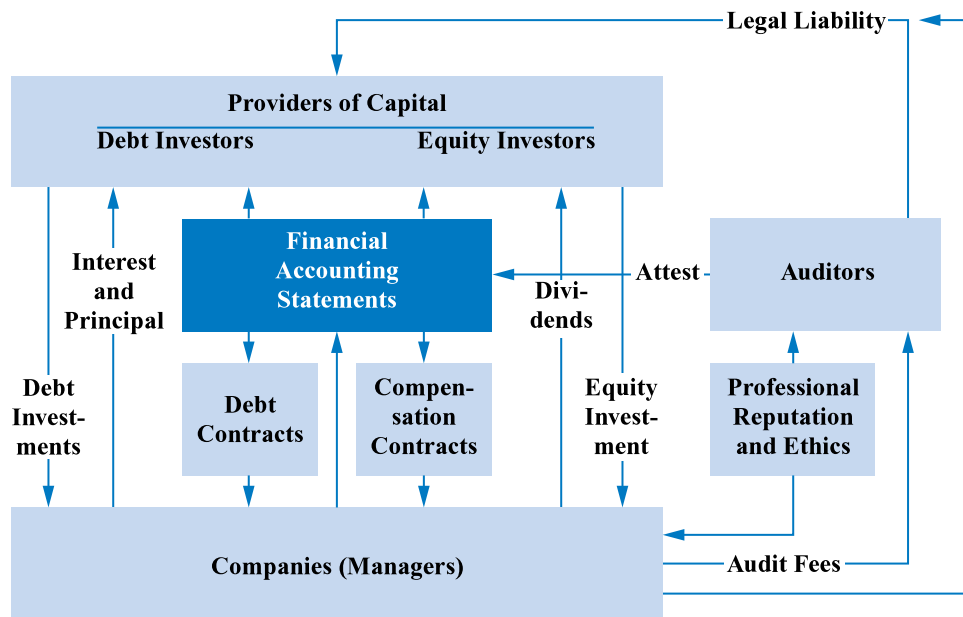
The asset side of the balance sheet for the Bank of New York Mellon, as well as many other financial institutions, is composed primarily of loans, while the Coca-Cola Company's assets include a large percentage of equity investments in other companies. What is the difference between these two kinds of assets, and why would these two companies rely more heavily on one than the other?

THE ECONOMIC ENVIRONMENT IN WHICH FINANCIAL REPORTS ARE PREPARED AND USED

Recent and significant financial disasters perpetrated by poor risk assessment and sometimes even fraudulent financial statements underscore the importance of accurate and credible financial reporting for the United States and the world economy. Financial statements provide measures of firm performance that support decisions by a wide variety of individuals and entities leading to billions of dollars in resource transfers each year. Indeed, the world economy depends to an important extent on the reliability and validity of financial statements.

Figure 1-6 illustrates the key elements of the financial accounting environment introduced earlier in the Microline scenario. In that scenario, as a potential investor

FIGURE 1-6
Basic relationships
in the financial
reporting process



you acted as a provider of capital, Martin Wagner and Microline represented the company (manager), and Arthur Price was the auditor. The figure shows that providers of capital (debt investors and equity investors) invest in (send funds to) companies operated by managers. In return, creditors (debt investors) expect to receive interest and principal payments, and equity investors expect to receive returns in the form of dividends and/or stock price appreciation. Company managers (1) hire auditors to attest to the financial information and (2) enter into debt and/or **compensation contracts**. Auditors add credibility to the financial statements by attesting to whether they were prepared in conformance with financial reporting standards and fairly present the company's financial performance and position, and contracts either protect the interests of creditors or are structured to encourage management to act in the interest of the company's owners—the shareholders.

In this environment, financial reporting information plays two fundamental roles. First, it helps debt and equity investors evaluate management's past business decisions and predict future performance. Second, it contains numbers (e.g., net income) used in debt and compensation contracts that influence management behavior.



On its 2008 income statement General Electric reported over \$17 billion of net income. Explain how this number could be used to evaluate GE management's past business decisions, predict GE's future performance, and influence GE management to make decisions in the interests of GE's shareholders.

An important feature of this environment is the level of **corporate governance**, which refers to mechanisms encouraging management to act in the interest of—and report in good faith to—the shareholders. Strong corporate governance is necessary because management has incentives to act and report in its own interest at the expense of the shareholders, and auditors face conflicting goals—they are responsible to capital

providers to perform independent and objective audits, but their fees are paid by management, who can choose to replace them. As illustrated in Figure 1–6, three factors encourage managers and auditors to act professionally: (1) **professional reputation**, (2) **legal liability**, and (3) **ethics**. The first two are driven by economics—professional behavior enhances the auditor’s reputation, which both leads to future business and reduces the likelihood of litigation. The third encourages professional behavior simply because it is the right thing to do. In the following sections we describe the reporting process in more detail and discuss the essential elements of effective corporate governance.

Reporting Entities and Industries

Financial statements are prepared by reporting entities called companies, businesses, or firms—referred to as Company (Managers) in Figure 1–6. These **profit-seeking entities** are often further divided into segments and subsidiaries, each of which provides its own financial statements. For example, in the annual report of The Limited, Inc., the financial statements are referred to as **consolidated financial statements**, which means that the total dollar amounts in the accounts on the financial statements include those of other companies, such as Victoria’s Secret, Express, and Bed & Body Works, which The Limited owns. These companies, called **subsidiaries**, prepare their own separate financial statements. Furthermore, The Limited is divided into retail divisions, and financial reports on each of these are compiled.

Financial statements are also prepared by entities not established to make profits, including counties, cities, school districts, other municipalities, charitable organizations, and foundations. In this text we limit our coverage to financial reports prepared by profit-seeking entities.

Companies are often grouped into **industries** based on the nature of their operations. While there are many industry classifications, they can be summarized into three basic categories: manufacturing, retailing, and services (general and financial). Manufacturing firms like General Motors, IBM, and PepsiCo acquire raw materials and convert them into goods sold either to consumers, usually through retailers, or to other manufacturers who use them as raw materials. Retail firms like Wal-Mart, Home Depot, Lowe’s Home Improvement, Kohl’s, Toys “Я” Us, and JCPenney purchase goods from manufacturers and sell them to consumers. The service industry includes firms like AT&T, Federal Express, and H&R Block, which provide general services, as well as firms like Citicorp, American Express, and Prudential Insurance, which provide financial services. Internet firms, such as Google, Yahoo!, and Amazon.com, are also part of the service industry. Specific industry classifications are provided by the well-known Standard Industrial Classification (SIC) Index, which assigns a 1- to 4-digit code to industries—the more digits in the code, the more specific the industry classification.

Knowledge of industries is important when analyzing financial statements because the relative importance of different aspects of financial performance and condition varies across firms in different industries. Managing outstanding loans, for example, is very important for lending institutions (banks) but less important for retailers like Wal-Mart that extend limited credit to customers. Furthermore, it is difficult to assess management’s performance without knowledge of the overall performance of the company’s industry, and without benchmarking management’s performance against the performance of companies facing similar economic environments normally in the same industry.



Into what industry category (manufacturing, retail, service) would each of the following firms be placed? Boeing, Tommy Hilfiger, DuPont, American Express, General Electric, Microsoft, eBay, Southwest Airlines, and Sprint Nextel.

CORPORATE GOVERNANCE

As indicated earlier, corporate governance refers to mechanisms that encourage management to act in the interest of—and report in good faith to—the shareholders. Components of corporate governance include financial information users and capital markets, contracts between management and debt and equity investors, financial reporting regulations and standards, independent auditors, boards of directors and audit committees, internal controls ensuring that the company is in compliance with financial reporting regulations, legal liability, professional reputation, and ethics. As discussed below, each of these components somehow involves the financial statements, and an effective financial reporting system is critical for effective corporate governance.

Financial Information Users and Capital Markets

Financial statements are used by a variety of groups and can be divided into three categories: equity investors, debt investors, and others (including management).

EQUITY INVESTORS

Equity investors (often referred to simply as investors) purchase shares of stock, which represent ownership interests in a company. Ownership of an equity security entitles the holder to two basic rights: (1) to vote for company directors at the annual shareholders' meeting and (2) to receive dividends if paid. Equity investors can be classified into two groups. The first owns a substantial amount of the company's stock and uses the voting rights associated with that ownership to exert influence on, or control over, the activities of the company. The majority of equity investors, however, fall into a second group, where the ownership interest is too small to exert significant influence on the company through voting power. These investors have little direct influence over management, so their main concern is the returns (dividends and price appreciation) associated with holding the equity security.

Equity investors, and their representatives, such as financial and security analysts and stockbrokers, are interested in financial information because it helps them ascertain whether management is making wise business decisions. If the financial statements indicate that management has failed, investors holding large equity interests often use voting power to replace management while investors with relatively small equity interests normally sell their ownership interests. Indeed, management's performance as depicted by the financial statements plays an important role in monitoring and enforcing management's accountability to the shareholders. Simply stated, the financial statements tell shareholders how well their capital is being managed.

DEBT INVESTORS (CREDITORS)

Creditors provide capital (funds) to companies through loans. These investments involve loan contracts that normally specify: (1) a maturity date, the date when the loan is to be repaid; (2) an annual interest payment, the amount of interest to be paid each year;

(3) collateral, assets to be transferred to the creditor in case the loan payments are not met (default); and (4) additional debt restrictions generally designed to reduce default risk.

Creditors have limited influence over the company other than through the terms of the debt contract. They use financial information because it helps them assess the likelihood of default (the company is unable to make the loan payments), which in turn helps to establish terms of the debt contract. Normally, if the financial statements indicate that the risk of default is increasing, the terms of the debt contract become harsher—the interest rate and need for collateral increase, and the creditor may impose additional restrictions to further limit management’s behavior. Consequently, a company’s financial condition and performance, as indicated by the financial statements, are directly linked to how much it costs to borrow funds from creditors.

MANAGEMENT AND OTHER FINANCIAL STATEMENT USERS

Management often uses the financial statements of other firms to assess the financial strength and strategies of competitors, and to decide whether to enter into business relationships with other firms (e.g., suppliers, customers). It also uses its own financial statements to determine dividend payments, set company policies, and, in general, to help guide business decisions.

Other users include government bodies, such as the Federal Trade Commission, which often base regulatory decisions on information disclosed in the financial statements, and public utilities, which normally base their rates (the prices they charge their customers) on financial accounting numbers such as net income. Labor unions have also been known to use accounting numbers to argue for more wages or other benefits.

CAPITAL MARKETS

Equity and debt securities (investments) are held by both individuals and entities. Billions of shares of stock are held in large U.S. corporations, which, in turn, hold shares in each other. Debt securities in the form of loans are held primarily by banks, while debt securities in the form of bonds issued by large corporations are held by individuals and institutions.

Equity and debt securities are traded on public exchanges in the United States and in other countries. The *New York Stock Exchange (NYSE)* is by far the largest, but active exchanges exist in most of the major cities throughout the world. Large U.S. companies normally have their stocks listed on several exchanges, and many non-U.S. firms are listed in New York. More information about the NYSE, and the firms listed on it, can be found on the Internet at www.NYSE.com.



Publicly traded firms are so named because their shares of stock are owned by the public and traded on the public stock exchanges. As of December 18, 2009, for example, one share of Microsoft, a publicly traded firm, could be purchased by anyone for \$30.36. So that investors can be adequately informed, the U.S. government requires publicly traded firms to meet extensive reporting requirements, and the financial statements of these companies can easily be accessed by anyone at any time. Recently, large investing firms, such as KKR and Blackstone, have purchased via the public exchanges all the outstanding shares of many publicly traded firms, “taking them private.” Briefly discuss why Blackstone might want to take such an action, and describe some of the implications to the managers of the purchased firm and the investing public.

The prices at which equity and debt securities trade on the financial markets vary from day to day based largely on changes in investor expectations about the issuing company's future performance. Good news about the company tends to lead to increases in the *market prices* of its outstanding equity and debt securities, whereas bad news normally is associated with price declines. Price changes are widely considered to be a measure of management's performance, although they are determined by a variety of factors, only some of which are under management's control. Financial statements are an important source of the information used by those who invest in capital markets in setting expectations about a company's future prospects and in determining whether the company met those expectations. Consequently, financial statements are directly linked to the market prices of the company's equity and debt securities.



In the introduction to Part 1 of this text we noted that stock market analysts were optimistic about Apple's future revenues and earnings. In response, the market price of Apple stock rose. Explain why the price increased, and how capital markets through the financial statements can incent or discipline management behavior.

Contracts: Debt Covenants and Management Compensation

Capital providers (debt and equity investors) normally require management to enter contracts designed to reduce risk and encourage business decision making consistent with capital-provider interests. Such contracts take two general forms: debt covenants and management compensation.

Debt covenants are included in debt contracts, often requiring management to maintain certain levels of financial performance or position to help ensure that management will be able to make the debt payments when they come due. Violating these requirements (technical default) normally gives the debtholder the right to demand that the entire debt be paid immediately, often leading to more costly debt terms. *Management compensation contracts* typically base management pay on certain net income or stock price goals, which can encourage desirable management decision making. Debt covenants and management compensation contracts provide examples where numbers taken from the financial statements are used in contracts written by capital providers to shape management behavior.



Motorola has an employee incentive plan that makes annual payments to eligible employees based on whether they achieve specified business goals, many of which are expressed in terms of financial statement numbers. Recently the company paid over \$250 million for these awards. Explain why Motorola has such a plan and how it works.

Financial Reporting Regulations and Standards

In 1934 the U.S. Congress created the **Securities and Exchange Commission (SEC)** to implement and enforce the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities Act of 1933 requires companies that raise capital (collect

funds) through public equity and debt exchanges (e.g., the New York Stock Exchange) to file a registration statement (Form S-1) with the SEC. The Securities Exchange Act of 1934 states that, among other requirements, companies with equity and/or debt securities listed on the public security markets (called *listed companies*) must (1) annually file a **Form 10-K** (audited financial reports), (2) quarterly file a **Form 10-Q** (unaudited quarterly financial statements), and (3) annually provide audited financial reports to the shareholders. Non-U.S. listed companies are required to file the SEC **Form 20-F**. The Forms 10-K, 10-Q, and 20-F contain a wealth of publicly available information and can be obtained by accessing the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system at the Web site www.sec.gov. Annual reports for individual companies are sent directly to shareholders, but can be obtained by anyone through the company's Web site (e.g., homedepot.com).

Annual reports published by major U.S. and non-U.S. companies typically include audited balance sheets for the two most recent years and audited statements of income, shareholders' equity, and cash flows for the three most recent years. They also include:

- A letter to the shareholders from a high-ranking officer
- A description of the business
- Management's discussion and analysis of the company's financial condition and performance
- Footnotes that describe the estimates, assumptions, and methods used to produce the numbers on the financial statements
- Selected quarterly data
- Summaries of selected financial information for at least the last five years
- Information about each of the company's major segments
- A letter from management stating its reporting responsibilities
- A letter from the company's outside (external) auditors stating whether the financial statements were prepared according to acceptable standards
- A listing of the members of the board of directors and executive officers

A large portion of the Form 10-K (including financial statements and footnotes) of NIKE, Inc. is provided in Appendix C at the end of this text. Take a few minutes to review it because we refer to this report frequently throughout the remainder of the text.

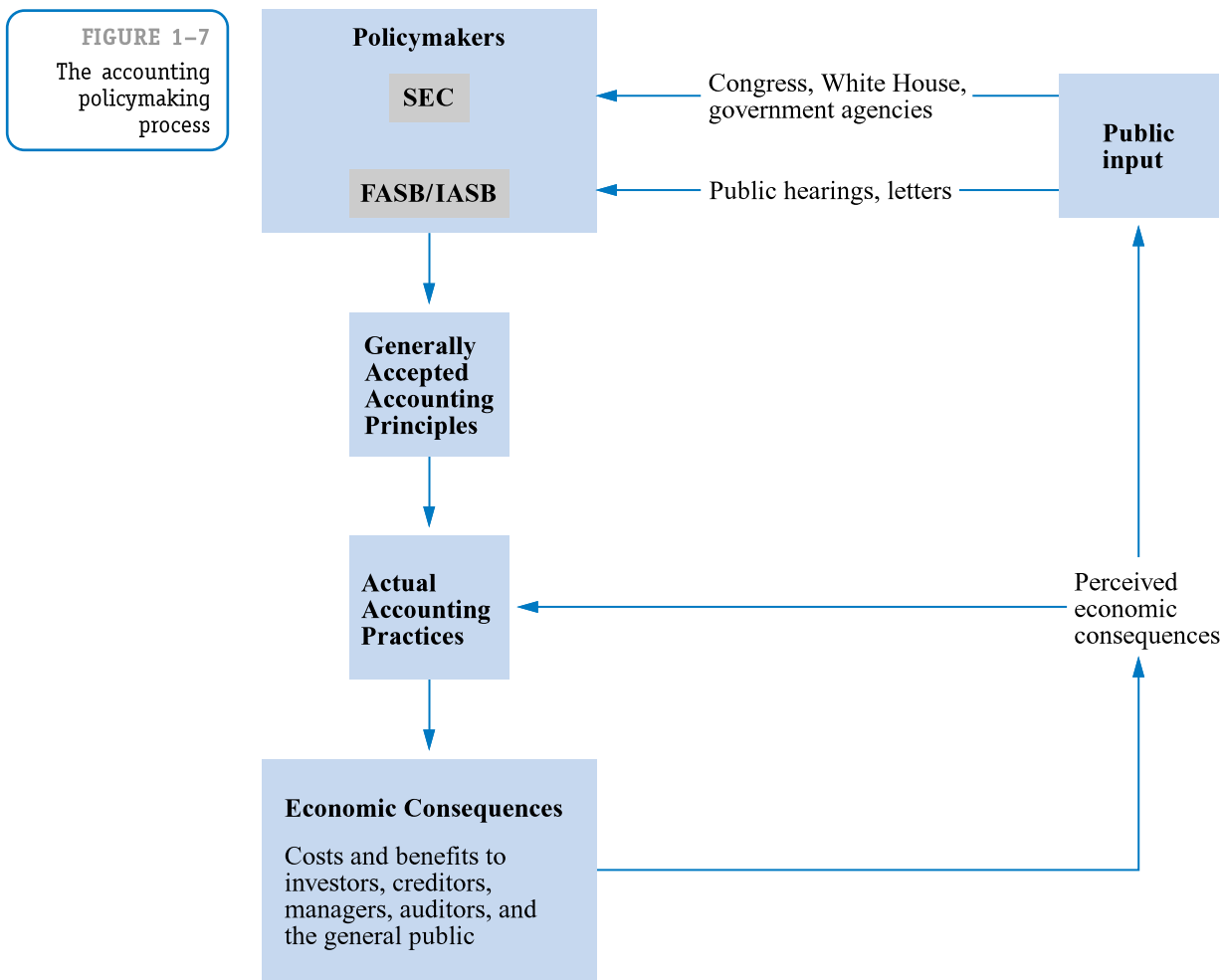
Generally Accepted Accounting Principles

Under current SEC regulations, U.S. companies whose securities are publicly traded on the U.S. exchanges must prepare their financial statements in accordance with **U.S. Generally Accepted Accounting Principles (U.S. GAAP)**, and non-U.S. companies can use either U.S. GAAP or **International Financial Reporting Standards (IFRS)**. External auditors must attest that these standards have been followed in the preparation of the financial statements. U.S. GAAP is established by a privately financed body called the **Financial Accounting Standards Board (FASB)**, and IFRS is established by the **International Accounting Standards Board (IASB)**. In the remainder of this text we use the phrase **Generally Accepted Accounting Principles (GAAP)** to describe either U.S. GAAP or IFRS.

These standards are useful because they lend credibility to the financial statements and help facilitate meaningful comparisons across different companies. However, the standards are often controversial because reporting requirements impose costs on companies required to follow them, many of which argue enthusiastically that these costs exceed the benefits created by the standards. Consequently, the accounting standard-setting process can be very political, involving controversial input from companies,

government regulators (e.g., SEC), Congress, financial statement users (financial and security analysts), and sometimes even the general public.

Figure 1–7 illustrates the political nature of the accounting standard-setting process. Policymakers, represented by the SEC, FASB, and IASB, are influenced in their deliberations by public input from Congress, the White House, government agencies, public hearings, and letters from interested parties. The result is GAAP, which sets the standard for actual accounting practices. These practices, in turn, create costs and benefits to investors, creditors, managers, auditors, and others (economic consequences) that underlie the public input targeted at the policymakers.



Source: Jamie Pratt, "The Economics of External Reporting: Three Frameworks for the Classroom," *Journal of Accounting Education* (1987), p. 182.



Many executives contend that financial accounting standards requiring that management compensation be measured in a way that reduces net income will negatively affect their firms. Accounting standard setters claim that the only objective is to improve financial reporting without regard for the consequences of its decisions. What do you think?

Independent Auditors

Major U.S. companies incur considerable costs to have their financial statements audited by independent public accounting firms. Four public accounting firms, known as the “**Big 4**,” audit most of the large companies. These firms and a selection of their major clients are listed in Figure 1–8. Many regional and local public accounting firms are located throughout the United States. Their audit clients comprise the thousands of mid-sized and small companies that, for various reasons, have their financial statements audited.

FIGURE 1–8
“Big 4” accounting firms and major clients

Accounting Firm	Major Clients
PricewaterhouseCoopers	eBay, Cisco Systems, DuPont
Deloitte & Touche	Microsoft, Boeing, Merrill Lynch
Ernst & Young	Wal-Mart, Intel, Hewlett Packard
KPMG Peat Marwick	JCPenney, PepsiCo, Xerox

The result of the audit is the audit report or audit opinion. The standard audit report, which is normally divided into three paragraphs, is illustrated in Figure 1–2. The first paragraph states that the financial statements and the internal controls were audited but that the responsibility for preparing the reports and the effectiveness of the controls rests with management; the second describes that the auditor conducted the audit in accordance with auditing standards established by the **Public Company Accounting Oversight Board (PCAOB)** and briefly describes what that means; the final paragraph states the conclusion, normally indicating that the financial statements present the company’s financial position and performance fairly and in accordance with GAAP, and the internal controls are reasonably effective. However, a standard audit opinion is not always rendered to all companies. Sometimes auditors find that they are unable to reach a conclusion, the financial statements are not in conformance with GAAP, the internal control system is not effective, or some concern exists about the company’s viability as a going concern in the foreseeable future. Departures from the standard audit opinion can signal problems that can cause great concern to management and capital providers.



Dell, Inc., one of the world’s leading computer manufacturers, postponed the release of its audited 2006 financial statements while the company discussed possible accounting irregularities with its auditor, PricewaterhouseCoopers. Briefly comment on what might have occurred in these discussions.

Board of Directors and Audit Committee

The *board of directors*, elected annually by the shareholders, oversees management to ensure that it acts in the interest of the shareholders. Such oversight involves periodic (at least quarterly) meetings where company policies are set, dividends are declared, and the performance and compensation of the company’s officers are reviewed. The board, normally composed of both company officers and nonmanagement representatives, has the power to hire and fire the officers as well as determine the form and amount of their compensation.

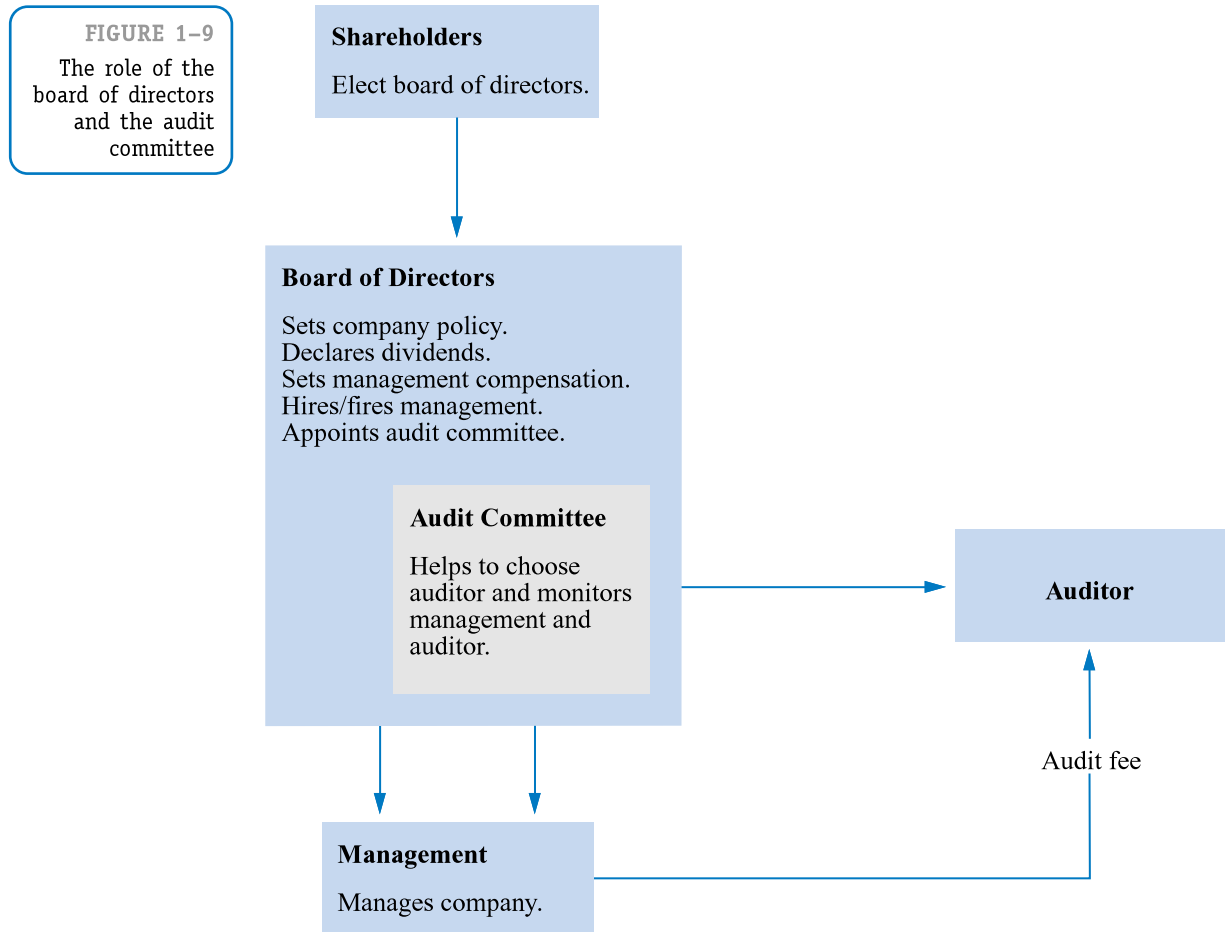


Figure 1-9 illustrates that the shareholders elect the board of directors, which appoints a subcommittee of outside (non-management) directors called the **audit committee**. This committee works with management to choose an auditor, and it monitors the audit to ensure that it is thorough, objective, and independent. Despite these controls, management still pays the audit fee and has considerable influence over whether the auditing firm is hired again. Such influence can threaten the auditor's independence. *Accountancy* magazine reports that "auditors may be loath to report faults in their clients' operations for fear of losing their audit contract." Some managers have been known to shop around for favorable audit opinions. For example, when Broadview Financial Corporation, a large Ohio company, switched auditors, it was revealed later that the switch was due to disagreements about proper methods of accounting. "Opinion shopping" is expressly prohibited by the SEC, and significant disagreements with the auditor are supposed to be reported and described by publicly traded companies in the Form 8K, which is filed with the SEC.



Much criticism has been directed at audit committees for their lack of financial expertise, and the SEC recently enacted rules to help ensure that audit committee members are financially literate. Explain why it is important that audit committee members understand financial statements.

Sarbanes–Oxley Act

The **Sarbanes–Oxley Act**, passed by Congress in 2002 in response to a series of corporate financial statement frauds leading to billions of dollars in investor losses, is an attempt to bolster corporate governance and restore confidence in the U.S. financial reporting system. It enacted sweeping changes in the responsibilities of management, financial disclosures, independence and effectiveness of auditors and audit committees, and oversight of public companies and auditors. The Act requires the principal executive and financial officers to certify that the financial reports have been reviewed, do not contain untrue statements or omit important information, and fairly present the company's financial condition and performance. It also places additional responsibilities on management and the auditor to ensure that adequate *internal controls* are in place to provide reasonable assurance that the financial records are complete and accurate. Management must also file an annual report on internal controls over financial reporting, and the external auditor must attest to and report on management's assessment of internal controls. In summary, this Act places heavy emphasis on the quality of a company's internal control system and significantly increases the auditor's role in ensuring that the control system meets high standards.



When a company discovers an accounting error, the company must restate all previous financial statements affected by the error. Such restatements have risen consistently and dramatically in recent years. Some believe that the Sarbanes–Oxley Act accounts for this shift. Explain why.

Legal Liability

Management is legally responsible to the shareholders to act in their interests and to report in good faith. Auditors are legally responsible to the shareholders to conduct a thorough and independent audit. These responsibilities create a legal liability to those who rely on the financial statements. If management or auditors fail in these responsibilities and as a result investors and others suffer financial losses, management and the auditors can be sued to recover those losses. Litigation brought against management and auditors by shareholders is common and very costly and seems to increase each year in the United States. Some of the greatest financial frauds in the history of the United States recently have led to billions of dollars in losses borne by innocent investors, creditors, employees, and others. Enron, WorldCom (now MCI), HealthSouth, Xerox Corp., Rite Aid, and Qwest Communications International provide vivid examples of how internal control breakdowns and flawed and dishonest management and auditing can result in misstated financial statements that ultimately cost the U.S. economy billions of dollars; in each case huge litigation settlements were brought against corporate management and the auditor. Indeed, in the last 20 years, two huge auditing firms—Laventhol & Horwath and Arthur Andersen—have met their demise, in large part due to the costs of litigation. Legal liability definitely plays a critical role in corporate governance, creating a powerful economic incentive for managers and auditors to act professionally and ethically.

Professional Reputation and Ethics

The many aspects of corporate governance (e.g., capital markets, contracts, reporting regulations, independent auditors, boards of directors and audit committees, and legal liability) suggest that a large amount of mistrust exists among shareholders, managers,

and auditors. This observation is difficult to question given that cases of management fraud and embezzlement have risen significantly in recent years, and that audit firms have increasingly been found guilty of misconduct. Some even suggest that U.S. business is suffering from an ethics crisis. Indeed, businesspeople in general are often viewed as greedy, driven, and unscrupulous.

Notwithstanding these developments, little doubt exists that ethics is a major business asset and that ethical behavior is in the long-run best interest of managers, shareholders, and auditors. Clifford Smith, a professor of finance at the University of Rochester, stated in the *Journal of Applied Corporate Finance* that “ethical behavior is profitable.” In recognition of the value of ethics, major U.S. companies, such as Boeing, General Mills, and Johnson & Johnson, have instituted special programs designed specifically to instill ethical behavior in their employees. Most of the top business schools offer courses in ethics. The **American Institute of Certified Public Accountants (AICPA)**, the professional organization of CPAs, has a strong professional code of ethics designed to instill higher ethical standards in the members of the accounting profession.

Such efforts are not only moral, but they are driven by sound economic logic. Companies with reputations for quality, service, and ethical business practices are highly valued by investors and creditors partially because their financial statements can be trusted. Such companies and their managers are sued less frequently. As the employee manual of Wetherill Associates states, “We do not try to make profits or avoid losses. Instead, we try to take the ‘right action’ in the best way we know; the profits are a natural by-product.”

Auditors also benefit from ethical behavior and strong reputations. Independent and respectable auditors face fewer liability suits and can generally charge client companies higher fees, primarily because their audit reports are trusted by the public. Consequently, it is important to realize that while the financial accounting process is a system of control, and manager and auditor fraud will continue to occur, it is best to be ethical, from both a moral and an economic standpoint. Not surprisingly, the most successful companies and audit firms enjoy the best reputations for high ethical standards.



In its annual report General Electric devotes an entire section to governance, stating that “GE’s directors have adopted corporate governance principles aimed at ensuring that the Board is independent, and fully informed of the key risks and strategic issues facing GE.” The section includes a Web site containing these principles (www.ge.com/governance). Explain why GE has established such principles.

INTERNATIONAL PERSPECTIVE: MOVEMENT TOWARD A SINGLE GLOBAL FINANCIAL REPORTING SYSTEM

For many years the different histories, economies, political systems, and cultures of countries throughout the world gave rise to vastly different financial reporting systems. In North America, the United Kingdom, and Australia, for example, the financial reporting systems were oriented toward the decision needs of equity investors and designed to measure management performance in a true and fair manner. In European countries and Japan, the financial reports were heavily influenced by government requirements (e.g., tax law), and the statements were targeted more toward the needs of creditors, giving management much more discretion in the preparation of the

reports. In these settings financial reporting also tended to be intentionally conservative instead of designed to report management's true performance. In today's fast-moving, global marketplace this situation is quickly changing.

As described earlier, two sets of financial reporting standards are currently accepted by the SEC: U.S. GAAP and IFRS. Non-U.S. companies that follow IFRS are accepted by the SEC, and while U.S. companies still must follow U.S. GAAP, it is likely that soon they will be allowed (perhaps required) to report under IFRS. The advent of international accounting standards dates back to 1973, but recently their acceptance has grown remarkably fast. Since 2005, for example, all public companies in the European Union have been required to report under IFRS, and virtually all of the major non-U.S. stock exchanges (e.g., London, Tokyo, Frankfurt, Paris) now accept IFRS. Indeed, in 2007 for the first time the SEC accepted IFRS-based financial statements from non-U.S. companies filing the SEC Form 20-F.

While the fundamental principles underlying U.S. GAAP and IFRS are the same and there is huge overlap in the content, significant differences do exist. In 2002 the FASB and IASB addressed these differences by entering into the Norwalk Agreement, reaffirmed in 2006, agreeing that the two boards will work to converge existing financial reporting standards and coordinate future efforts in an attempt to create a single set of global standards. Further, in 2008 the SEC established a roadmap that anticipates mandatory reporting for U.S. publicly traded companies under IFRS beginning in 2014, 2015, or 2016, depending on their size.

The future remains uncertain, but momentum continues to build for a single set of high-quality global standards. In this text most of the discussion is based on U.S. GAAP, but throughout we describe and illustrate important differences between the two systems as they arise. In the future you are very likely to be exposed to IFRS-based financial reporting in one form or another.



Discuss some of the problems associated with two different sets of financial reporting standards, and why a single set of global standards might be desirable. Would there be any drawbacks to a single set of standards?

APPENDIX 1A

THREE OTHER KINDS OF ACCOUNTING

This text is devoted almost exclusively to financial accounting. However, you should be aware of the three other kinds of accounting usually covered in other accounting courses: not-for-profit accounting, managerial accounting, and tax accounting.

Many economic entities do not have profit as an objective. Municipalities, such as cities, simply receive money from taxes, service fees, and debt investors and allocate it to address public needs. For example, a city allocates funds to a police department to ensure public safety. The process of recording these fund inflows and outflows and reporting them to the public is quite logically called **not-for-profit accounting**.

Managers need *internal information systems* to generate timely and accurate information that helps them plan and operate efficiently on a day-to-day basis. To guide their decisions, managers rely to some extent on the information produced by the financial accounting system. However, more important to such decisions is information that is not available to the public and is produced strictly for management's own use. Such information is referred to as **managerial accounting** information, and managerial accounting is usually covered in a separate course.

The area of accounting devoted to understanding and applying the tax law is known as **tax accounting**. Our complicated and constantly changing tax structure requires that thousands of accountants specialize in this area. Furthermore, tax law is extremely detailed and complicated; even a moderate coverage of tax accounting requires a number of separate accounting or law courses.

An important distinction should be made between the income number resulting from applying income tax laws (called *taxable income*) and the income number that results from financial accounting (called *net income*). The *Internal Revenue Code* specifies the rules to be followed to calculate taxable income. An entity's tax obligation is then computed as a percentage of this taxable income. Financial accounting income, or net income, is determined by applying financial accounting principles and procedures, which differ in many ways from the tax laws stated in the Internal Revenue Code. As a result, net income is not necessarily equal to taxable income. Tax laws are enacted for purposes quite different from those that drive the development of financial accounting principles. Accounting students often confuse these two sets of rules.

Figure 1A–1 compares not-for-profit, managerial, and tax accounting to financial accounting. The top of the chart depicts a sequential process in which the managers of an economic entity follow certain accounting processes that convert financial facts

FIGURE 1A–1 Four kinds of accounting

Economic Entity	Managers	System	Financial Information	Recipients	Decisions
FINANCIAL ACCOUNTING					
Profit-making companies	Finance or accounting department	U.S. Generally Accepted Accounting Principles or IFRS	Income statement Balance sheet Statement of shareholder's equity Statement of cash flows Other disclosures Auditor report	<i>External</i> Investors Creditors Suppliers Employees Managers Government General public	Equity and debt investments Contract negotiations Regulation Dividend payments
NOT-FOR-PROFIT ACCOUNTING					
Nonprofit entities	Finance or accounting department	Fund accounting principles	Balance sheet Funds flow statements	<i>External</i> Creditors Government General public	Debt investments Budget allocations
MANAGERIAL ACCOUNTING					
All entities	Internal accounting department	Company information system	Manager reports Production costs Performance evaluation, etc.	<i>Internal</i> Managers	Operating decisions
TAX ACCOUNTING					
All entities	Finance or accounting department	Internal Revenue Code	Official tax forms: 1040 for individuals 1120 for corporations	<i>External</i> Internal Revenue Service	Collection of government revenues

about the entity into a set of financial statements. Interested parties then use this information for a variety of business decisions.

SUMMARY OF KEY POINTS

The key points of this chapter are summarized as follows.

● *The economic role of financial accounting statements.*

Investors and creditors demand that management provide financial accounting information for two fundamental economic reasons. First, they need financial numbers to monitor and enforce the debt and compensation contracts written with management. Second, they need financial information to decide where to invest their funds. Companies incur the costs of providing the statements and having them audited because they need to attract capital from investors and creditors, and managers want to maintain their levels of compensation. Management hires auditors who must act independently because they face high levels of legal liability and must follow professional ethical standards.

● *The four financial statements and the information each provides.*

The four financial statements are (1) the balance sheet, (2) the income statement, (3) the statement of shareholders' equity, and (4) the statement of cash flows. The balance sheet lists the assets, liabilities, and shareholders' equity of a company at a given point in time. The income statement contains the revenues earned and expenses incurred by a company over a period of time. Revenues less expenses equals net income. The statement of shareholders' equity describes the changes in the shareholders' equity accounts from one period to the next. The statement of cash flows reconciles the cash amount from one period to the next. It lists net cash flows from operating activities, investing activities, and financing activities.

● *The standard audit report, management letter, and footnotes to the financial statements.*

The auditor's report is divided into three paragraphs. The first states that the financial statements and internal controls are the responsibility of management, they have been audited, and the auditor's responsibility is to express an opinion on them. The second indicates that the examination of the company's records and internal controls was made in accordance with standards established by the PCAOB and that the auditor has obtained reasonable assurance that the financial statements are free of material misstatement. The final paragraph states that the financial statements present fairly the financial position of the company, the results of operations, and its cash flows in conformity with generally accepted accounting principles, and that the internal controls are reasonably effective.

The management letter normally states that the company's management is responsible for the preparation and integrity of the statements, that the statements were prepared in accordance with generally accepted accounting principles, and that certain amounts were based on management's best estimates and judgments. It further indicates that the company maintains a system of internal controls designed to safeguard its assets and ensure that all transactions are recorded and reported properly. The footnotes provide additional information about the dollar amounts on the financial statements. They indicate which accounting methods were used and where the numbers on the statements are the result of assumptions and estimates made by management.

● *The two forms of investment—debt and equity—and how the information on the financial statements relates to them.*

There are two forms of investment: debt and equity. A debt investment is a loan, and debt investors are called *creditors*. When debt investments are made, management is normally required to sign a loan contract. Creditors are primarily concerned that the interest and principal payments are met on a timely basis. Since such payments are made in cash, creditors are interested in financial information that helps them predict future cash flows over the period of the loan.

Equity investments involve purchasing ownership interests in a company. Equity owners of corporations are called shareholders. Their returns come in the form of dividends (or *stock price appreciation*), which tend to be large if the company performs well and small, or nonexistent, if it performs poorly. The primary concern of shareholders is the performance of the company's management—specifically, its ability to generate and maintain earning power in the future. To achieve this objective, management must ensure that cash is available to meet debts as they come due and also invest in assets that produce satisfactory returns in the long run. Consequently, shareholders are interested in the information contained in all four of the financial statements.

● *The nature and importance of corporate governance and the role of financial statements.*

Corporate governance refers to mechanisms that encourage management to act in the interest of, and report in good faith to, the shareholders. Components of corporate governance include financial information users and capital markets, contracts between management and debt and equity investors, financial reporting regulations and standards, independent auditors, boards of directors and audit committees, internal controls ensuring that the company is in compliance with financial reporting regulations, legal liability, professional reputation, and ethics. The credibility of the financial reporting process depends on the effectiveness of these components, and recent financial frauds, imposing huge costs on the global economy, highlight what can happen when corporate governance fails.

● *The current status of accounting standard setting, both in the U.S. and internationally.*

For many years financial accounting practices and standards used in countries throughout the world were quite diverse due to different histories, cultures, economies, and political systems. Efforts by the International Accounting Standards Board (IASB) have attempted to bring greater uniformity to worldwide accounting practice by creating International Financial Reporting Standards (IFRS), and virtually all non-U.S. stock exchanges have accepted these standards. The SEC currently allows non-U.S. companies to file their financial statements using IFRS. The FASB and IASB have pledged to work together to create a single set of global accounting standards, and the SEC has established a road map leading to U.S. firms adopting IFRS in 2014, 2015, or 2016, depending on their size.

KEY TERMS

Note: Definitions for these terms are provided in the glossary at the end of the text.

American Institute of Certified Public Accountants (AICPA) (p. 25)	Debt restrictions (p. 13)
Annual interest (p. 13)	Dividends (p. 11)
Annual reports (p. 20)	Earning power (p. 12)
Assets (p. 11)	Economic consequence perspective (p. 4)
Audit committee (p. 23)	Equity (p. 13)
Auditor's report (p. 7)	Ethics (p. 16)
Balance sheet (p. 11)	Expenses (p. 11)
"Big 4" (p. 22)	Financial accounting (p. 3)
Board of directors (p. 13)	Financial Accounting Standards Board (FASB) (p. 20)
Certified public accountant (CPA) (p. 6)	Financing activities (p. 11)
Common stock (p. 11)	Footnotes (p. 10)
Compensation contracts (p. 15)	Form 10-K (p. 20)
Consolidated financial statements (p. 16)	Form 10-Q (p. 20)
Corporate governance (p. 15)	Form 20-F (p. 20)
Creditors (p. 11)	Generally Accepted Accounting Principles (GAAP) (p. 20)
Debt covenants (p. 19)	Historical cost (p. 13)
Debt investment (p. 13)	

Income statement (p. 11)	Profit-seeking entities (p. 16)
Independent audit (p. 6)	Public Company Accounting Oversight Board (PCAOB) (p. 22)
Industries (p. 16)	Retained earnings (p. 11)
Internal control system (p. 8)	Revenues (p. 11)
International Accounting Standards Board (IASB) (p. 20)	Sarbanes–Oxley Act (p. 24)
International Financial Reporting Standards (IFRS) (p. 20)	Securities and Exchange Commission (SEC) (p. 19)
Investing activities (p. 11)	Shareholders (p. 13)
Legal liability (p. 16)	Shareholders' equity (p. 11)
Liabilities (p. 11)	Solvency (p. 12)
Loan contract (p. 13)	Statement of cash flows (p. 11)
Management letter (p. 7)	Statement of shareholders' equity (p. 11)
Managerial accounting (p. 26)	Subsidiaries (p. 16)
Net income (profit or earnings) (p. 11)	Tax accounting (p. 27)
Not-for-profit accounting (p. 26)	User orientation (p. 4)
Operating activities (p. 11)	U.S. Generally Accepted Accounting Principles (p. 20)
Professional reputation (p. 16)	

ETHICS in the Real World

While granting clean audit opinions on the financial statements by Vienna software maker MicroStrategy, Inc., auditor PricewaterhouseCoopers was also serving as middleman in the sale of MicroStrategy products. Wearing those two hats can compromise

the independence required of audit firms, which highlights a federal requirement that auditors severely limit additional services provided for audit clients and under no circumstances own stock in their clients.

ETHICAL ISSUE Is it ethical for the same firm to provide an independent audit service for a client while also providing business advisory services, and can an auditor maintain an independent perspective while owning equity securities in an audit client?

INTERNET RESEARCH EXERCISE

Recall the reference to Apple, Inc., at the beginning of the chapter. Start with the Apple Web site (www.apple.com/investor/) and find the most recent SEC Form 10-K. Find the income statement and the revenues and net income numbers for the last three years.

ISSUES FOR DISCUSSION

ID1-1

Financial statement users

Financial accounting statements are used by many parties. Describe how each of the following parties might use them: security analysts and shareholders, bank loan officers, a company's customers and suppliers, public utilities, labor unions, and a company's managers.

ID1-2

Auditors and management fraud

The AICPA's list of red flags, alerting auditors to the possibility of management fraud, includes a "domineering management with a weak board of directors." Briefly explain the role of the board of directors and how such a situation could indicate management fraud. Why are auditors concerned with management fraud?

ID1-3

Audit committees

Explain the function of the audit committee, and describe why it is important that it consist of outside (nonmanagement) directors.

ID1-4

Banks, the credit crunch, and the financial statements

One of the factors contributing to the 2008–2009 recession was the unwillingness of commercial banks to extend loans to customers, some of whom were quite creditworthy. This unwillingness led to what was called a “credit crunch.” Discuss reasons why banks would become reluctant to extend credit to customers, and how the financial reporting system represents these loans on the banks’ financial statements.

REAL DATA**ID1-5**

Financial statement relationships

In its 2008 annual report, Home Depot reported that fiscal 2008 sales decreased to \$71.3 billion (from \$77.3 billion the previous fiscal year), while profits decreased to \$2.26 billion (from \$4.395 billion). Total assets decreased from \$44.3 billion to \$41.2 billion, while shareholders’ equity during the same time period remained flat at \$17.7 billion. The company’s cash balance increased \$74 million with cash flows from operating activities (+\$5.5 billion), investing activities (–\$1.7 billion), and financing activities (–\$3.7 billion). Discuss possible explanations for these financial results.

REAL DATA**ID1-6**

Debt covenants

Continental Airlines signed contracts with its major creditors (mostly banks) that require the company to maintain a minimum cash balance of \$600 million, a minimum shareholders’ equity balance of \$972 million, and dividend payments restricted to no more than \$576 million. Discuss why the creditors impose such restrictions on Continental.

REAL DATA**ID1-7**

Managing reported profits

Fortune magazine ran an article titled “New Ethics or No Ethics? Questionable Behavior Is Silicon Valley’s Next Big Thing,” which recounts stories of Internet companies that aggressively inflate their revenues, delay the recognition of expenses, and report sales that are not exactly sales. In many cases the actions of these companies, while aggressive, are not in direct violation of generally accepted accounting principles. Discuss why companies might engage in such behavior, and comment on the ethical implications.

REAL DATA**ID1-8**

Audit report

The following quote was taken directly from the audit report written by Pricewaterhouse Coopers on the 2009 financial statements of Kroger.

In our opinion, the accompanying consolidated balance sheets and related consolidated statements of operations, cash flows and changes in shareholders’ equity present fairly, in all material respects, the financial position of Kroger Co. and its subsidiaries at January 31, 2009 and February 2, 2008, and the results of their operations and their cash flows for each of the three years in the period ended January 31, 2009 in conformity with accounting principles generally accepted in the United States of America.

Explain the meaning of the quote and the terms used in it.

REAL DATA**ID1-9**

Corporate governance

In a report to its clients on the implications of the Sarbanes–Oxley Act of 2002, KPMG states that the Act is intended to expand corporate governance, increase public confidence in financial reporting information, and strengthen our capital market systems.

Describe the meaning of corporate governance and how it relates to financial accounting statements. Also, comment on how Sarbanes–Oxley can achieve the intentions stated in the KPMG report.

REAL DATA**ID1-10**

Ethics and accounting

In a survey conducted by two accounting professors, the *Wall Street Journal* reported that a number of high-level corporate managers indicated that they would choose investments that would boost current net income to meet the expectations of analysts following their companies in favor of better investments that produced much larger returns in the future. “To the professors’ surprise, the financial officers were eager to talk about how companies would forgo projects that would give them economic gain in order to put a finer gloss on earnings.”

Comment on the ethical implications of management’s behavior.

ID1-11

Global reporting standards

The FASB and IASB are working on converging U.S. GAAP and IFRS into a single reporting system. Currently, the SEC accepts IFRS financial statements from non-U.S. companies, while requiring U.S. GAAP from U.S. companies. Comment on the difficulties faced by

financial analysts who analyze financial statements to assess the financial condition and performance of companies. Consider, for example, the plight of an analyst in the pharmaceutical industry who must assess and compare the financial performance of giants Novartis (a Swiss firm using IFRS) and Johnson & Johnson (a U.S. firm using U.S. GAAP).

ID-12

International
accounting standards

The Securities and Exchange Commission has established a road map that will ultimately require U.S. companies to use International Financial Reporting Standards (IFRS). Already, the SEC allows foreign companies to list their securities in the United States and file IFRS financial statements. In general, IFRS policies are considered to be based on general accounting *principles*, while the U.S. Generally Accepted Accounting Principles are very detailed and are based on numerous *rules*. Accounting experts are debating the effectiveness of the two standards: the international guidelines that employ general concepts and principles versus the U.S. approach of anticipating all situations with a detailed set of rules. Discuss the advantages and disadvantages of a system based on concepts versus a system based on rules.

ID1-13

Appendix 1A

Distinguish managerial accounting from financial accounting, and describe how the information provided by the two systems is used differently.

Excerpts taken from the SEC Form 10-K of NIKE, Inc. are reproduced in Appendix C.

REAL DATA**ID1-14**

The SEC Form
10-K of NIKE

REQUIRED:

Review the 10-K of NIKE, and answer the following questions.

- a. Briefly describe the operations of NIKE, and indicate whether it is a manufacturing, retail, or service company.
- b. Which accounting firm audits NIKE? Briefly explain the contents of the audit report.
- c. What dollar amounts for net income were reported in 2009, 2008, and 2007?
- d. Compute NIKE's liabilities as a percent of total assets in 2009 and 2008. Did the percentage increase or decrease?
- e. How much cash was provided by operating activities during 2009, 2008, and 2007?
- f. Comment on NIKE's financial performance and condition.