10th Edition

FINANCIAL ACCOUNTING

JAMIE PRATT • MICHAEL PETERS

WILEY

Financial Accounting

In an Economic Context

Tenth Edition

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Brief Contents

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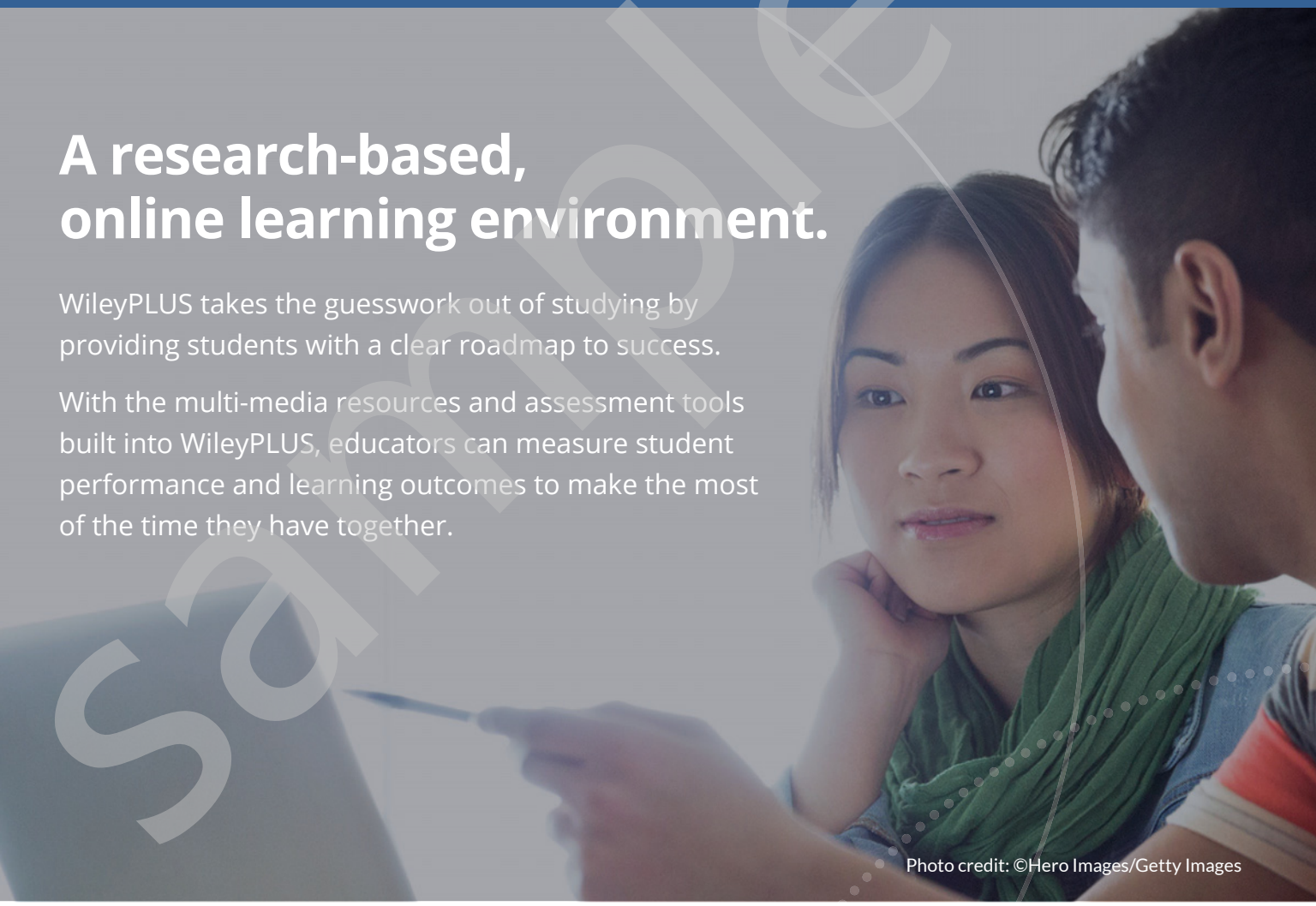

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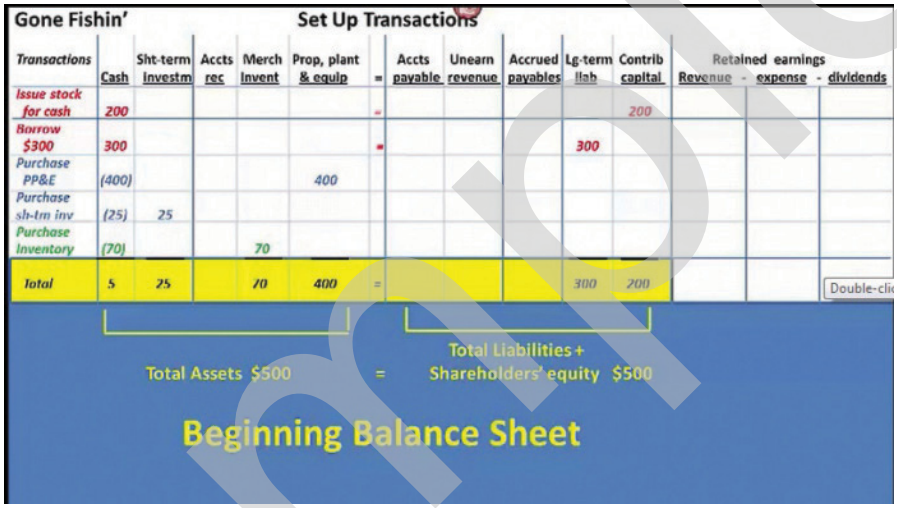

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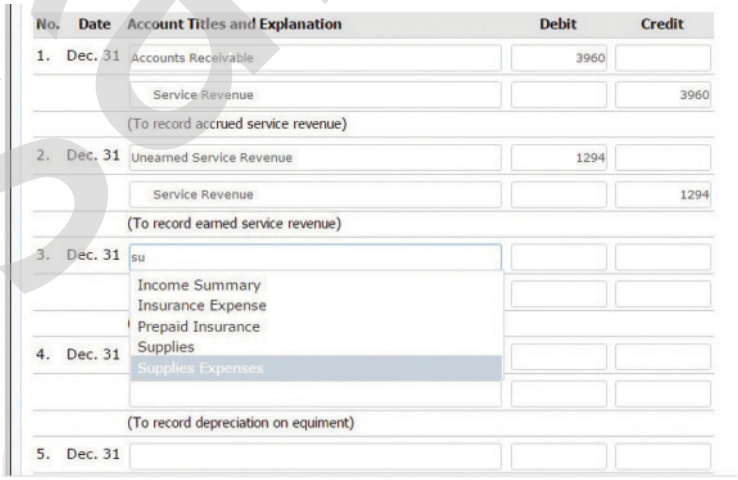

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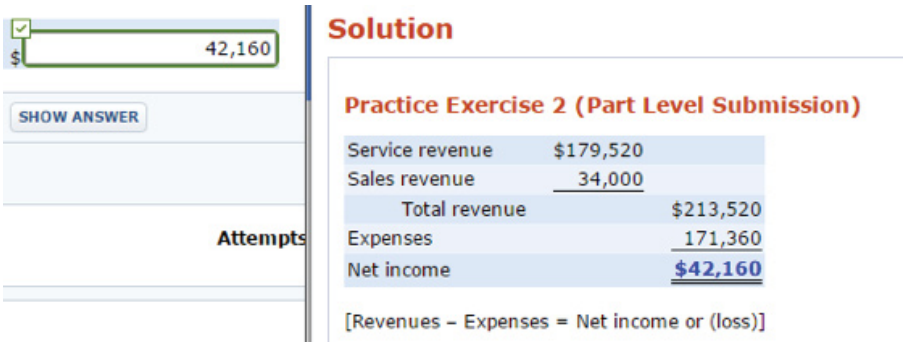

Students can practice their understanding of accounting topics with questions that are similar to select homework questions. Solutions for the select "similar" questions are provided.

New Features and Updates

Financial Accounting in an Economic Context continues to be an innovative resource in the area of introductory financial reporting and analysis. The tenth edition continues to build on the strengths of previous editions, while it introduces new ideas and refinements that better communicate the book's economic decision-making theme.

Concept Practice Exercises and Solutions

Concept Practice exercises and solutions in the body of the text prompt students to stop and review key concepts.

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 3

O'Malley and Richie purchased a computer for $8,000 on January 1. It was estimated to have a useful life of four years and it was depreciated evenly over that time period. Each of the four years it was serviced at a cost of $300. At the beginning of Year 2 due to a power surge the hard drive had to be reimaged and the software had to be reinstalled at a cost of $500. At the end of Year 2 the computer was upgraded with additional memory at a cost of $1,000. The computer was retired at the end of the fourth year. Compute the expenses (depreciation and maintenance) recognized by O'Malley and Richie over the four-year period.

SOLUTION

	Year 1	Year 2	Year 3	Year 4
Depreciation expense*	$2,000	$2,000	$2,500	$2,500
Maintenance and repairs expense**	300	800	300	300

*$8,000/4 = $2,000 for Years 1 and 2; for Years 3 and 4 the $1,000 upgrade was capitalized and depreciated over the remaining two-year life.

**The annual maintenance of $300 was expensed each year, and the $500 repair due to the power surge simply returned the computer to its original state prior to the damage, not upgrading it in any way.

Chapter 2

Chapter 2 was redesigned around a scenario that derives the nature of financial statements from the perspective of an entrepreneur trying to raise capital to start a new business. While the content of Chapter 2, which introduces the financial statements in more detail, is much the same as in prior editions, the new scenario adds a perspective that builds a complete set of financial statements in a uniquely effective and intuitive manner. The chapter concludes by identifying five key questions addressed by the financial statements, each of which considers a dimension of performance necessary for successful businesses. These questions then serve as a foundation throughout the text for how the financial statements should be analyzed.

Chapter 5

This tenth edition was written to further develop the idea that the financial statements should be viewed, not as individual statements, but instead as a package. They comprise an interrelated story about the historical performance of the firm and the key dimensions that in the past have driven that performance. This theme is very evident in Chapters 1–5 which introduce the economic role of the financial statements, how they should be interpreted, how they are prepared,

and how they should be analyzed. In this part of the text especially they are rarely discussed as independent statements; they are viewed as an integrated whole. Chapter 5 has been revised to emphasize this perspective and better package the financial ratio analysis.

Up-to-date Real World Examples and Exercises

Many of real-world examples were updated in the textbook. Real-world company end-of-chapter questions were updated to include current, real-world data and values. All chapters were updated to address current financial accounting practices.

New Accounting Standards

Effective December 2017 investments in equity securities will no longer be classified as available-for-sale on trading securities. These investments will be carried on the balance sheet at fair market value and price changes will be reflected in earnings. In addition, the cost method will be eliminated. Chapter 8 (Investments in Equity Securities) especially and other sections of the text have been revised to reflect these important changes. Also, effective January 1, 2019 capital lease accounting will effectively be eliminated. Chapter 11 (Long-terms Liabilities: Notes, Bonds and Leases) still covers capital lease accounting but also discusses this upcoming major change.

Learning Objectives and Design

Each chapter now opens with an outline that lists new learning objectives for the chapter and concept practice exercises associated with each learning objective. A new, four-color design highlights pedagogical tools and will help students navigate through each chapter more easily.

LEARNING OBJECTIVE		PRACTICE
1. Describe the balance sheet in terms of equity and debt capital and producing and operating assets.	• Equity capital • Debt capital • Producing assets • Operating assets	**1a.** Distinguish equity capital from debt capital and producing assets from operating assets. **1b.** Describe how equity and debt capital and producing and operating assets can be organized into a balance sheet.
2. Explain the concept of net income, who owns it and what they can do with it.	• Net income • Dividends • Retained earnings	**2.** Explain the generation and distribution of net income.
3. Define the three major activities of a business.	• Attracting capital • Converting capital into assets • Managing assets	**3.** Classify transactions into three categories.
4. Describe the four financial statements in greater detail.	• Balance sheet • Income statement • Statement of shareholders' equity • Statement of cash flows	**4.** Match financial statements with descriptions.
5. Discuss how the financial statements can be viewed as a package and use the package to assess five fundamental metrics of a company's performance.	• Relationships among the statements • Operating performance • Asset investment • Asset financing • Cash management • Return on shareholder investment	**5a.** Identify how transactions can affect more than one financial statement. **5b.** Assess five fundamental financial metrics.

Hallmark Approach and Features

Continuing the Approach

The tenth edition continues to develop fundamental pedagogical elements, such as ethics cases, Internet exercises, brief end-of-chapter real-world exercises and issues for discussion, and a set of interesting and challenging "quality of earnings" cases. This edition also includes an updated glossary. But perhaps most important, this edition has maintained and improved upon its most distinctive feature—the economic decision-making approach and the balanced coverage of three important themes: economic factors. measurement issues, and mechanics.

Economic Factors

Financial accounting is meaningless without an understanding of the economic environment in which it exists. Each chapter in the tenth edition, therefore, includes frequent references to actual events and companies; quotes from well-known business publications and corporate annual reports—information about industry practices, debt covenants, compensation arrangements, and debt and equity markets; and in-depth discussions of legal liability, ethical issues, and management's incentives and influence on financial reports. At the end of each chapter students are directed to The Walt Disney Company SEC Form 10-K to answer questions relevant to that chapter. Furthermore, ratio analysis and international issues are introduced early and integrated throughout the text, and the coverage still reflects a strong user orientation with a distinct "quality and persistence of earnings" flavor. The important role of the economic environment in this text makes it more than simply a study of financial accounting. It is a study of modern business management as seen through the financial accounting process.

Measurement Issues

As future managers and users, students must understand the measurement issues underlying the financial statements before they can interpret and meaningfully use them. The tenth edition devotes considerable attention to the conceptual and theoretical foundation of financial accounting measurement, with special emphasis on how the financial statements provide useful measures of the key areas of business performance. Cash and accrual statements are treated as equally important, with the statement of cash flows being covered from the very beginning. Chapter 3 provides a framework for accounting measurement that is used throughout the remainder of the text.

Mechanics

Using financial statements without understanding the underlying mechanics is like trying to interpret a foreign language without knowing the vocabulary. Consequently, the tenth edition provides a strong mechanical foundation and stresses mechanics early and throughout the text. Journal entries and T-accounts play an important role, but they are never treated as a goal. Rather, they are characterized as an efficient way to communicate how economic events are reflected on the financial statements. A special coding is used throughout the text to link the form of each entry to the basic accounting equation and financial statements. Thorough mechanical coverage is especially important in a text that takes a user orientation because effective users must be able to infer transactions from the financial statements. This mechanical skill, referred to as *reverse T-account analysis*, is covered several times in the text, and many exercises and problems are designed to test it.

Decision-Making Perspective

This text presents financial accounting in a way that helps managers make decisions—a decision-making perspective. At a fundamental level, managers make two kinds of decisions: attracting capital and investing capital. Simply put, managers must attract capital from debt and equity investors and then invest it in operations, producing assets, and investment securities. Successful management is defined by generating a return from these investments that exceeds the cost of capital. As depicted in Figure P–l, these two kinds of decisions can be matched with the three themes discussed above (mechanics, measurement issues, and economic factors) to produce six basic questions that must be answered by managers who use financial accounting information when making decisions.

	Management Decisions	
	Attract Capital	**Invest Capital**
Mechanics	1 How do the transactions affect the financial statements?	4 How are financial ratios computed, and how can transactions be inferred from the financial statements?
Measurement Theory	2 How do these financial statement effects influence outside perceptions of the company's performance?	5 How do the financial statements and ratios indicate a company's performance?
Economics	3 How do these financial statement effects influence decisions of outsiders as well as debt and compensation contracts?	6 What action should be taken (e.g., invest, extend credit, adjust loan terms)?

FIGURE P–1

In their effort to attract capital, managers must address three questions when considering whether to enter into certain transactions: How do the transactions affect the financial statements? (cell 1); how do these financial statement effects influence outside perceptions of the company's performance? (cell 2); and how do these financial statement effects influence the decisions of outsiders as well as debt and compensation contracts? (cell 3). These questions must be answered if management is to understand the economic consequences of the transactions under consideration.

In their effort to invest capital, managers must address three different questions: How are financial ratios computed, and how can transactions be inferred from the financial statements? (cell 4); how do the financial statements and ratios indicate a company's performance? (cell 5); and what action should be taken (e.g., invest, extend credit, adjust loan terms)? (cell 6). These questions must be answered if management is to understand how to use financial accounting information properly.

The decision-making perspective simply means that all six questions are addressed in this text. These are the areas where management decision making intersects with financial accounting information, or, in other words, this is what managers need to know about financial reporting and analysis. It is this perspective that makes *Financial Accounting in an Economic Context* different from all other texts.

Successful Features Retained from Previous Editions

With few exceptions, the text retains the main features of previous editions. Below is a brief description of the most important ones.

Globalization of Business and Financial Reporting Standards While the tenth edition is still based on U.S. GAAP, IFRS standards and concepts are woven throughout the entire text. It may be unlikely that the United States will require IFRS standards, but IFRS standards are now accepted on U.S. exchanges when submitted by non-U.S. firms. Also highlighted in the tenth edition are important differences in business practices and cultures across national borders. Indeed, we live in a global business world, and the tenth edition reflects what future business leaders need to know about accounting to operate effectively within it.

Statement of Cash Flows The tenth edition discusses the statement of cash flows from the very first chapter and in Chapter 4 demonstrates how to prepare a statement of cash flows from the activity in the cash T-account. Mechanical differences between accruals and cash flows are introduced and illustrated in Appendix 4A, which also includes coverage of reverse T-account analysis as well as the preparation of a relatively simple statement of cash flows from two balance sheets and an income statement. Chapters 6 through 12 contain frequent boxed-in items that highlight the accrual to cash adjustments in the operating section of the statement of cash flows of well-known companies, which serves as a periodic reminder to students—regardless of the account being studied—of the reconciliation between net income and net cash provided by operating activities. Chapter 14 contains an illustration of how to prepare a more complicated statement of cash flows from two balance sheets and an income statement.

Fair Market Value Accounting Fair market value accounting is woven throughout the tenth edition. While one might still describe the current accounting model as based on historical cost, heavy reliance on the lower-of-cost-or-market concept in the valuation of assets, accounting for trading and available-for-sale securities, the reliance on present value concepts in asset and liability valuation, and relatively recently, the U.S. adoption of the fair value option all point toward a measurement system that is gradually moving toward fair valuation—both for U.S. GAAP and IFRS. Savvy business students should know something about how fair market values are reflected in the financial statements.

Complete Financial Statement Analysis Package A strength of this text is its financial statement analysis perspective and the tenth edition continues in this tradition. The perspective is introduced in Chapter 1, fundamentally developed in Chapter 2 in which five key questions for analysis are derived, and thoroughly covered in Chapter 5, which is devoted specifically to financial statement analysis. Appendix 5A covers shareholder value creation and the ROE model as well as analyses of cash flow patterns, business segments, and projected financial statements. This theme is continued in Chapters 6–13, all of which end with a special section that discusses ROE analyses in terms of the chapter topic and directs students to a website where they can analyze real company data used as input in a prepopulated ROE spreadsheet model.

Flexible Modules Chapter 3 (The Measurement Fundamentals of Financial Accounting), Chapter 4 (The Mechanics of Financial Accounting), and Chapter 5 (Using Financial Statement Information) have been written so that they can be covered in any order. This modular structure adds an important dimension of flexibility to the text.

Real-World Review Throughout each chapter, real-world applications of chapter topics are highlighted and boxed. In the tenth edition, these boxed items also include real-world insights on general international issues, IFRS, and the reconciliation of net income with net cash from operations on the statement of cash flows.

Ethics Vignettes Each chapter closes with a short business scenario that introduces an ethical issue related to the material covered in the chapter. Several questions that follow each scenario are designed to encourage meaningful class discussion.

Industry Data Many of the chapters contain tables that compare accounting practices and show students the importance of accounting numbers and ratios across different industries and well-known companies. Updated in the tenth edition, these tables illustrate that the financial accounting issues faced by retailers, manufacturers, service enterprises, and financial institutions are quite different. A brief explanation of the operations of companies in different industries and how these operations give rise to different financial accounting concerns follows each table.

The Walt Disney Company SEC Form 10-K Disney is referenced periodically throughout the text and each chapter contains an end-of-chapter case that requires students to access the Disney report via the Internet and relate the financial statements to accounting issues covered in the chapter.

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Jamie Pratt is Alva L. Prickett Chair of Accounting at the Kelley School of Business in Indiana University. He received his doctoral degree from Indiana in 1977 and has held faculty positions at the University of Washington (Seattle), University of Zurich, Northwestern University, and INSEAD–returning to Indiana in 1991. He served as chair of the Accounting Department from 1998–2004, and chair of Graduate Accounting Programs from 2006–2007. He teaches financial accounting and financial statement analysis at both the undergraduate and graduate levels, and he has received teaching awards at each of the institutions listed above. In addition, he has taught in executive education programs all over the world. His research interests primarily include financial reporting and auditing issues, and he publishes frequently in the top academic accounting journals, including *The Accounting Review*, *Journal of Accounting Research*, *Contemporary Accounting Research*, *Accounting, Organizations & Society*, *Auditing: a Journal of Practice and Theory* as well as journals devoted to educational issues such as *Issues in Accounting Education* and *Journal of Accounting Education*. He has served as Associate Editor of *The Accounting Review*, program chair for the American Accounting Association (AAA) annual meeting, and he has received a number of AAA awards and recognitions. Professor Pratt was sole author of a popular textbook through 9 editions (*Financial Accounting in an Economic Context*), and co-authored another textbook (*Financial Reporting for Managers: a Value Creation Perspective*). He has also been involved in the creation of a number of other educational materials, including mini-lecture videos, casebooks, spreadsheet exercises, and state-of-the-art interactive cd-rom products. Parents of three grown boys, he and his wife (Kathy) live in Bloomington, Indiana where he enjoys sports, landscaping, and playing the piano.

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Jamie Pratt

An Overview of Financial Accounting

PART 1

Chipotle Mexican Grill, the fast-growing, casual restaurant chain, has been a popular stock investment ever since its 2006 initial public stock offering. In October 2015, however, the company released a report, indicating earnings of $4.59 per share of outstanding stock, which was below the $4.63 amount expected by the analysts. The response of the stock market was swift, with Chipotle share prices dropping by over 7 percent. The company reported new store openings and strong 12.2 percent revenue growth, but higher labor and marketing expenses cut into profit growth.

What are revenues and earnings? How do they relate to stock prices? What role do analysts and their expectations play? Would an investment in Chipotle 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

LEARNING OBJECTIVE		PRACTICE
1. Discuss the role of financial reports in investment decisions and the difference between the economic consequence and user perspectives.	• Profit-seeking entities • Users of financial statements • User decisions • Consequences of user decisions	**1.** User perspective vs. economic consequence perspective
2. Explain the difference between consumption and investment and why investors demand documentation and independent audits.	• Spending decisions • Documentation of past financial performance and current condition • Differing incentives	**2a.** Consumption vs. investment choices **2b.** Information necessary for investing
3. Describe the standard audit report, management letter, four financial statements, and related footnotes.	• Audit report • Management letter • Financial statements • Footnotes	**3.** Financial decision-making information package
4. Differentiate debt from equity and the concepts of solvency and earning power.	• Debt investment • Equity investment • Solvency • Earning power	**4a.** Debt vs. equity investments **4b.** Solvency vs. earning power
5. List the major elements of the environment in which financial reports are prepared and used and describe how these elements encourage effective corporate governance.	• Providers of capital • Companies • Debt and compensation contracts • Auditors • Board of directors • Legal liability • Professional reputation and ethics	**5.** Effective corporate governance
6. Summarize the current status of accounting standard setting—both in the United States and internationally.	• Securities and Exchange Commission (SEC) • U.S. Generally Accepted Accounting Principles (U.S. GAAP) • International Financial Reporting Standards (IFRS)	**6.** U.S. GAAP vs. IFRS

LEARNING OBJECTIVE 1

Discuss the role of financial reports in investment decisions and the difference between the economic consequence and user perspectives.

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 often 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 employees, 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. Thus financial reports 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

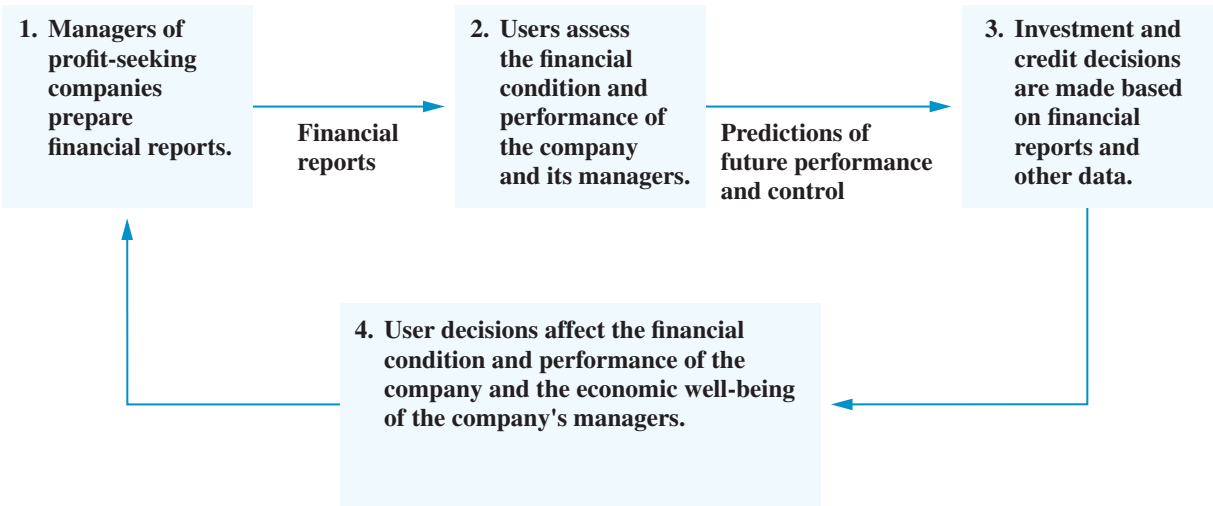

FIGURE 1–1 Financial reporting and investment decisions

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

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. Because 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.

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 1

Choose the best response to the following questions.

1. Which of the following groups are not likely to be users of financial statements prepared by a company?

a. Company owners
b. Potential investors in the company
c. Banks
d. Company suppliers and customers
e. Company managers
f. All of the above are users of financial statements.

2. A bank requires Blake Company to provide financial statements for the past five years as it considers loaning money to Blake. Blake's managers prepare the financial statements and want them to look as good as possible so that the bank will grant the loan and charge a low interest rate.

a. The bank is viewing the financial statements from an economic consequence perspective, while Blake's managers are viewing the financial statements from a user perspective.
b. The bank is viewing the financial statements from a user perspective, while Blake's managers are viewing the financial statements from an economic consequence perspective.
c. Both parties are viewing the financial statements from a user perspective.
d. Both parties are viewing the financial statements from an economic consequence perspective.

SOLUTION

1. f. Any party interested in the past financial performance and condition of a company would be considered a potential user of financial statements, which includes a company's owners, potential investors, managers, creditors, customers, suppliers, employees, government agencies, and other groups.

2. b. The bank wants to use the financial statements to assess the past financial performance and current condition of Blake to guide its credit-granting decision. Blake's managers are using the financial statements to attract funds and they know that if the financial statements reflect poorly on the company the bank may not grant the loan.

The Demand for Financial Information: A User's Orientation

LEARNING OBJECTIVE 2

Explain the difference between consumption and investment and why investors demand documentation and independent audits.

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, 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 virtual reality gaming system that will revolutionize the industry 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 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 have fabricated or at least influenced 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.

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 2

Choose the best response to the following questions.

2a. Which of the following purchases would be considered consumption instead of investment?

a. Purchasing a savings bond issued by the U.S. government.
b. Purchasing a ticket for a Mediterranean cruise.
c. Purchasing an ownership interest in a new start-up company.
d. Purchasing a rare coin in hopes that its value would increase.

2b. Suppose you are considering investing in a company (Solar Inc.) that manufactures an important part used in solar power systems. Which of the following information items should influence you the most in deciding whether or not to invest?

a. A statement by Solar's management that it believes that the company has performed well.
b. A set of financial statements prepared by Solar's management and reviewed closely by Solar's chief financial officer.
c. A set of financial statements prepared by Solar's management audited by an independent outside financial expert.
d. Statements by Solar's suppliers that Solar has paid its bills on time.

SOLUTION

2a. b. Investments are made anticipating a financial return. A Mediterranean cruise may be very enjoyable and well worth the cost, but the money spent on it will be gone forever. In all three of the other cases a financial return is expected.

2b. c. Financial statements provide a package that would allow you to reasonably assess Solar Inc.'s past financial performance and current financial condition. Because Solar's management, who prepares its financial statements, is biased, it is normally best to have the statements reviewed by an independent outside expert. The other alternatives either address only part of financial performance or are not independent.

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

LEARNING OBJECTIVE 3

Describe the standard audit report, management letter, four financial statements, and related footnotes.

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).

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF MICROLINE:

We have audited the accompanying balance sheet of Microline as of December 31, 2016 and 2015, 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, 2016, and 2015, 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, 2016.

Arthur Price

Arthur Price, Certified Public Accountant
March 12, 2017

FIGURE 1–2 The standard audit report

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).

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 that 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, 2017

FIGURE 1–3
Management letter

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 2016 and 2015. 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 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

Microline
Financial Statements
As of December 31, 2016 and 2015

	2016	2015
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 debt	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		
Sales and service revenue	$1,650,000	$1,500,000
Operating 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

FIGURE 1–4 Financial statements for Microline

2015 and 2016 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 2015 and 2016 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.

***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 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 Debt*. Long-term debt consists 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.**

FIGURE 1–5 Notes to the financial statements

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

[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.

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: sales and service **revenues**, a measure of the assets generated from the products and services sold, and operating **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.

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 3

Match the following information items with the appropriate description.

Information Item	Description
• Audit report	• Provides additional useful detail about the dollar values on the balance sheet, income statement, statement of cash flows, and the statement of shareholders' equity
• Management letter	• Provides information in a set of reports about the past performance and current financial condition of a company
• Financial statements	• Renders an opinion on a company's reporting practices by a financial expert with no economic ties to the company
• Footnotes	• States that the financial statements were prepared by the company's managers who are responsible for their content

SOLUTION

Information Item	Description
• Audit report	• Renders an opinion on a company's reporting practices by a financial expert with no economic ties to the company
• Management letter	• States that the financial statements were prepared by the company's managers who are responsible for their content.
• Financial statements	• Provides information in a set of reports about the past performance and current financial condition of a company
• Footnotes	• Provides additional useful detail about the dollar values on the balance sheet, income statement, statement of cash flows, and the statement of shareholders' equity

Analysis of Financial Statements

LEARNING OBJECTIVE 4

Differentiate debt from equity and the concepts of solvency and earning power.

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 2016 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 2015 and $130,000 in 2016. 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 2015 to over 12 percent ($200,000/$1,650,000) in 2016. Total payables as a percent of total assets decreased from over 50 percent ($480,000/$950,000) in 2015 to less than 47 percent ($470,000/$1,010,000) in 2016. 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 2014 annual report, Bed Bath & Beyond, a leading housewares retailer, reported sales of $11.9 billion; net income of $957 million; total assets and total liabilities of $6.8 billion and $4.0 billion, respectively; and net cash flows from operating activities of $1.2 billion. 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?

Which 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 which 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. Because 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, and especially net 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 Microline's new virtual reality gaming 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.

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 4

4a. Indicate whether the following items are characteristics of debt or equity.

1. Periodic interest payments
2. Covenant restrictions
3. Right to share proportionately in the profits of a company
4. Priority to the company's assets in case of bankruptcy
5. Right to oversee management
6. Maturity date

SOLUTION

1. Debt
2. Debt
3. Equity
4. Debt
5. Equity
6. Debt

4b. Match the concepts of solvency and earning power with the appropriate definitions below.

1. A company's ability to generate enough cash to meet its debt obligations as they come due
2. A company's ability to generate profits and increase net assets

SOLUTION

1. Solvency
2. Earning power

LEARNING OBJECTIVE 5

List the major elements of the environment in which financial reports are prepared and used and describe how these elements encourage effective corporate governance.

The Economic Environment in Which Financial Reports Are Prepared and Used

Huge and unfortunate 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 on the reliability and validity of financial reporting.

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 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 have a right to profits, which they can choose to receive in the form of dividends or allow to remain in the company. Company managers (1) hire auditors to attest to the financial information and

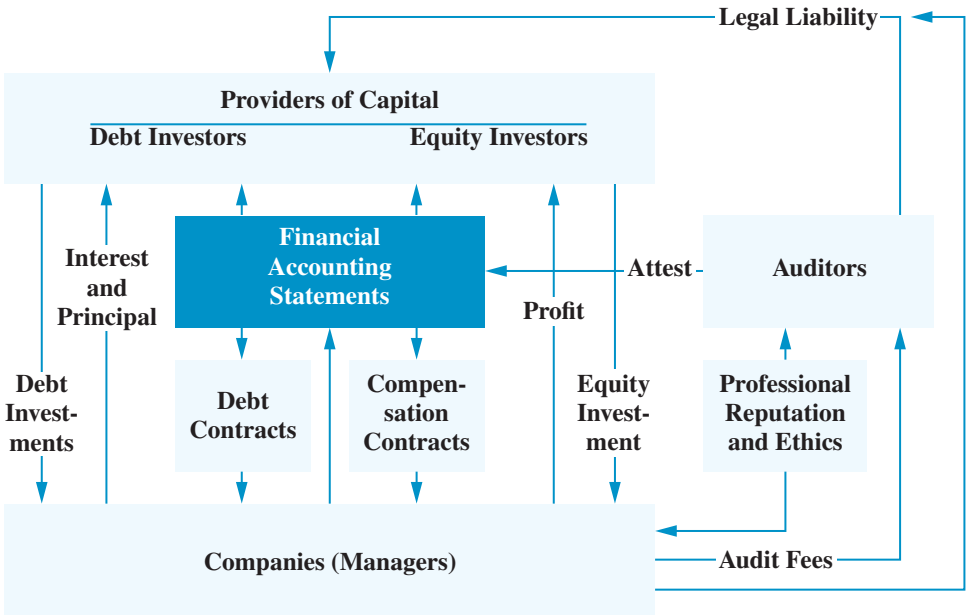

FIGURE 1–6 Basic relationships in the financial reporting process

(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 2014 income statement General Electric (GE) reported over $15.3 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 Darden Restaurants, 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 Red Lobster and Olive Garden, that Darden owns. These companies, called **subsidiaries**, prepare their own separate financial statements. Similarly, Alphabet, Inc., is a holding company that owns Google, in its consolidated financial statements. Google is now divided into web search and hardware divisions, and financial reports on each 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 that use them as raw materials. Retail firms like Walmart, 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 one- to four-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 Walmart 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.

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) the right to oversee management and (2) the right to profits earned by the entity. Equity investors can be classified into two groups. The first owns a substantial amount of the company's stock and uses the right to oversee management 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. 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 October 23, 2015, for example, one share of Microsoft, a publicly traded firm, could be purchased by anyone for $52.87. 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 surprised by Chipotle's revenues and earnings. In response, the market price of Chipotle stock dropped. Explain why the price decreased, 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 Solutions 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 Solutions has such a plan and how it works.

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 1–7. Many regional and local public accounting firms are located throughout the United States. Their audit clients comprise the thousands of midsized and small companies that, for various reasons, have their financial statements audited.

FIGURE 1–7
"Big 4" accounting firms and major clients

Accounting Firm	Major Clients
PricewaterhouseCoopers	eBay, Cisco Systems, DuPont
Deloitte & Touche	Microsoft, Boeing, Merrill Lynch
Ernst & Young	Walmart, 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.

?

When Dell, Inc., was a publicly traded firm, the leading computer manufacturer once postponed the release of its audited 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 1–8 illustrates that the shareholders elect the board of directors, which appoints a subcommittee of outside (nonmanagement) 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, after Broadview Financial Corporation, a large Ohio company, switched auditors, it was revealed 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.

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, was 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

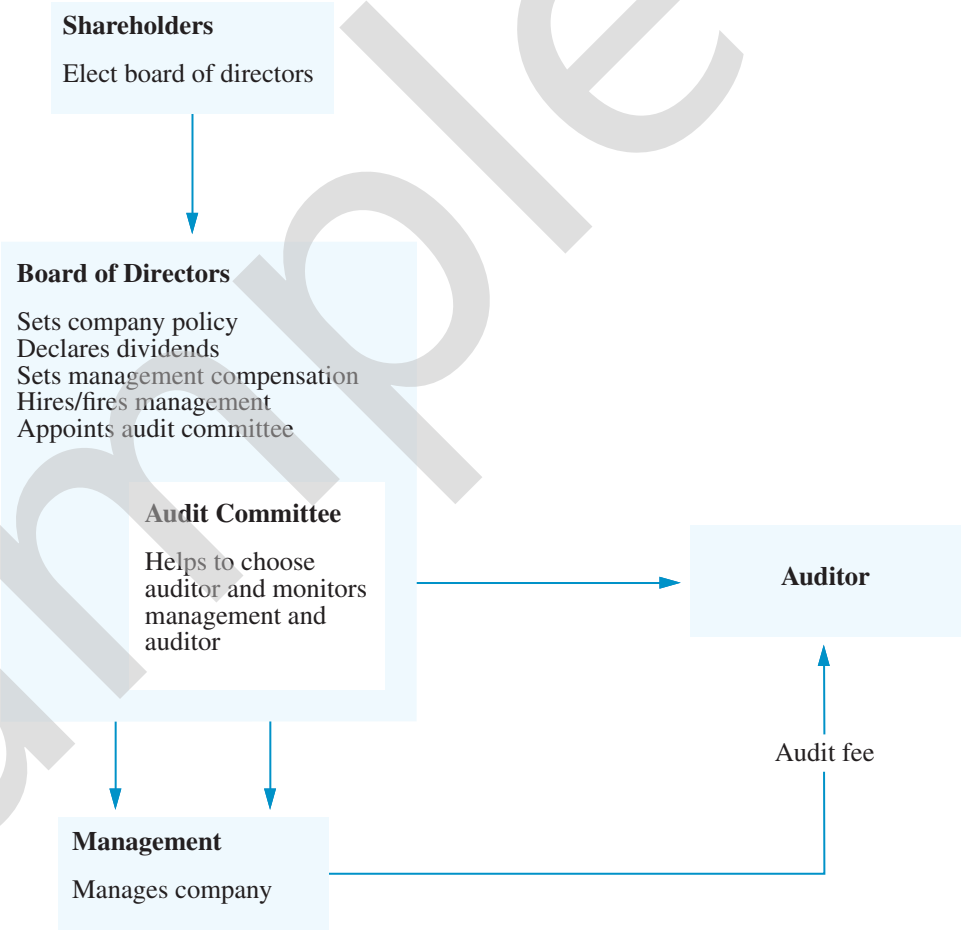

FIGURE 1–8
The role of the board of directors and the audit committee

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.

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 as well. 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.

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 5

Match the elements of the environment in which financial reports are prepared and used with the description of how they encourage effective corporate governance.

Elements of financial reporting environment	Description of how they encourage effective corporate governance
Providers of capital	Agreements required by creditors and owners to encourage management to act in a manner consistent with their interests
Companies	Group elected by the owners to oversee management and ensure that decisions are made in line with owner interests
Debt and compensation contracts	Standards that when violated may cause outsiders to lose faith in companies and consider them less valuable

Auditors	Risk of being sued for large sums of money if management and/or the auditors are negligent or fraudulent
Board of directors	Entities operated by managers in a manner that should be consistent with owner interests
Legal liability	Persons whose reports render an opinion to outsiders on the quality of a company's internal controls and financial statements
Professional reputation and ethics	Group whose investments in companies depend on management's ability to show that it acts appropriately and provides timely financial reports in good faith

SOLUTION

Elements of financial reporting environment	Description of how they encourage effective corporate governance
Providers of capital	Group whose investments in companies depend on management's ability to show that it acts appropriately and provides timely financial reports in good faith
Companies	Entities operated by managers in a manner that should be consistent with owner interests
Debt and compensation contracts	Agreements required by creditors and owners to encourage management to act in a manner consistent with their interests
Auditors	Persons whose reports render an opinion to outsiders on the quality of a company's internal controls and financial statements
Board of directors	Group elected by the owners to oversee management and ensure that decisions are made in line with owner interests
Legal liability	Risk of being sued for large sums of money if management and/or the auditors are negligent or fraudulent
Professional reputation and ethics	Standards that when violated may cause outsiders to lose faith in companies and consider them less valuable

LEARNING OBJECTIVE 6

Summarize the current status of accounting standard setting—both in the United States and internationally.

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 website www.sec.gov. Annual reports for individual companies are sent directly to shareholders but can be obtained by anyone through the company's website (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 the following:

- 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 The Walt Disney Company is provided online at www.wiley.com/college/pratt. 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.

> ? 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?

International Perspective: Financial Statement Users Need to Be Bilingual

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 U.S. companies must follow U.S. GAAP. Since 2005 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.

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, which means that in today's environment savvy investors must be bilingual; that is, they need to be familiar with both U.S. GAAP and IFRS.

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?

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 6

Indicate whether each of the following items describes U.S. Generally Accepted Accounting Principles (U.S. GAAP) or International Financial Reporting Standards (IFRS).

1. The authority of the Financial Accounting Standards Board to develop these financial reporting standards was delegated to it by the Securities and Exchange Commission.
2. To have their securities traded on the U.S. public exchanges, U.S. companies must follow these standards.
3. Unlike U.S. companies, non-U.S. companies that follow these standards can have their securities traded on the U.S. public exchanges.
4. When reading SEC Form 20-F, an investor often finds these standards used by non-U.S. companies.
5. When reading SEC Form 10-K, an investor is likely to find these standards used by U.S. companies.
6. These standards are being developed by the International Accounting Standards Board.

SOLUTION

1. U.S. GAAP
2. U.S. GAAP
3. IFRS
4. IFRS
5. U.S. GAAP
6. IFRS

APPENDIX 1A

Three Other Kinds of Accounting

LEARNING OBJECTIVE 7

Discuss 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.

REVIEW OF LEARNING OBJECTIVES

LO1. Discuss the role of financial reports in investment decisions and the difference between the economic consequence and user perspectives. Financial reports provide financial information used by investors to assess a company's past financial performance and its current financial condition. These reports help them to decide where to invest their money, and the dollar values in these reports are used in debt and compensation contracts to encourage management to act in the interests of the company's creditors and owners. A user perspective views financial reports as useful in guiding decisions that depend upon the financial performance and condition of a company, whereas an economic consequence perspective views financial reports in terms of how those decisions affect the parties (e.g., investors, creditors, management, employees, suppliers, customers, government) involved in the financial reporting process.

LO2. Explain the difference between consumption and investment and why investors demand documentation and independent audits. Consumption spending is enjoyed immediately without considering future financial returns, while investment spending considers future financial returns in an attempt to consume more in the future. Investors demand that financial reports be documented and audited by independent experts because management, who prepares the financial reports, has an economic incentive to cast

the financial performance and condition of the company in a positive light, which may not accurately reflect the truth.

LO3. Describe the standard audit report, management letter, four financial statements, and related footnotes. The standard audit report states that (1) the financial statements and the company's internal controls are the responsibility of management, (2) the auditor's examination of the financial statements and internal controls was made in accordance with standards established by the Public Company Accounting Oversight Board (PCAOB), and (3) the financial statements were prepared in conformance with generally accepted accounting principles and the internal controls are reasonably effective.

The management letter also states that management prepared the financial statements and maintains the company's internal controls in a manner consistent with professional standards and that the preparation of the statements required management's best estimates and judgments.

The balance sheet lists the company's assets, liabilities, and shareholders' equity at a given point in time, whereas the income statement, statement of shareholders' equity, and statement of cash flows all describe the company's activities during a period of time. The income statement describes the revenues less the expenses, highlighting net income or net profit; the statement of shareholders' equity describes the change in the investment made by the owners; and the statement of cash flows describes the change in the company's cash balance. The footnotes provide additional detail about the dollar values disclosed on the financial statements.

LO4. Differentiate debt from equity and the concepts of solvency and earning power. A debt investment is a loan and debt investors are called creditors. When debt investments are made in a company (loans are made), the loan contract normally states when the principal amount of the loan is to be paid back, the periodic interest payment, collateral, and other restrictions on management (covenants) designed to increase the likelihood that the loan service payments will be made on a timely basis. An equity investment in a company is a purchase of ownership, which gives the investor the right to influence management decisions and profits in proportion to the percent of ownership acquired. The return to the equity investor depends on the success of the company. If the company does well, profits are high and the return is high; if the company does poorly, profits are low and the return is low.

The concept of solvency refers to the ability of a company to meet its debt service payments (interest and principal) on a timely basis. Stated another way, can the company generate enough cash to meet the debt payments as they come due? The concept of earning power refers to the ability of a company to generate profits. Because cash and profits are not the same, solvency and earning power are not the same concept. A company can be solvent but not profitable or insolvent and profitable.

LO5. List the major elements of the environment in which financial reports are prepared and used and describe how these elements encourage effective corporate governance. The major elements of the environment in which financial statements are prepared and used include capital providers (debt and equity investors), companies, debt covenants and compensation contracts, independent auditors, boards of directors, legal liability, and professional reputation and ethics. Each of these elements contributes to effective corporate governance by encouraging management to act in the interest of the company's owners and prepare periodic financial reports in a timely manner and in good faith.

LO6. Summarize the current status of accounting standard setting—both in the United States and internationally. Currently two sets of financial reporting standards exist—U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS). When audits are performed, the auditor states whether the company's financial statements have been prepared in accordance with one or the other of these sets of standards. The Securities and Exchange Commission (SEC) requires that U.S. companies listed on the U.S. public exchanges prepare their financial statements in accordance with U.S. GAAP. The securities of non-U.S. companies can be traded on the U.S. exchanges if they use either U.S. GAAP or IFRS. The security exchanges operating in the European Union (EU) countries (e.g., France, Germany, Italy) require either IFRS or U.S. GAAP. While the rules of U.S. GAAP and IFRS are in the majority of cases very similar, some key differences exist, so debt and equity investors need to be reasonably familiar with both sets of standards.

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. 23
Annual interest, p. 14
Annual reports, p. 24
Assets, p. 11
Audit committee, p. 21
Auditor's report, p. 7
Balance sheet, p. 11
"Big 4," p. 20
Board of directors, p. 14
Certified public accountant (CPA), p. 6
Common stock, p. 12
Compensation contracts, p. 17
Consolidated financial statements, p. 17
Corporate governance, p. 17
Creditors, p. 12
Debt covenants, p. 20
Debt investment, p. 14
Debt restrictions, p. 14
Dividends, p. 12
Earning power, p. 13
Economic consequence perspective, p. 4
Equity, p. 14
Ethics, p. 17
Expenses, p. 12
Financial accounting, p. 3
Financial Accounting Standards Board (FASB), p. 25
Financing activities, p. 12
Footnotes, p. 11
Form 10-K, p. 24
Form 10-Q, p. 24
Form 20-F, p. 24
Generally Accepted Accounting Principles (GAAP), p. 25
Historical cost, p. 14
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Industries, p. 17
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International Accounting Standards Board (IASB), p. 25
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Net income (profit or earnings), p. 12
Not-for-profit accounting, p. 27
Operating activities, p. 12
Professional reputation, p. 17
Profit-seeking entities, p. 17
Public Company Accounting Oversight Board (PCAOB), p. 21
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Sarbanes–Oxley Act, p. 21
Securities and Exchange Commission (SEC), p. 24
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Statement of cash flows, p. 12
Statement of shareholders' equity, p. 12
Subsidiaries, p. 17
Tax accounting, p. 27
User orientation, p. 4
U.S. Generally Accepted Accounting Principles (U.S. GAAP), p. 25

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 intermediary 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?

ONLINE RESEARCH EXERCISE

Recall the reference to Chipotle at the beginning of the chapter. Start with the Chipotle website (www.chipotle.com, Investors) and find the most recent SEC Form 10-K. Find the income statement, revenues, and net income numbers for the last three years.

WileyPLUS Brief Exercises, Exercises, and Problems are assignable in WileyPLUS. Student resources for study and practice are also available in WileyPLUS.

ISSUES FOR DISCUSSION

ID1-1
Financial statement users
(LO 1)

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
(LO 5)

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
(LO 5)

Explain the function of the audit committee and describe why it is important that it consist of outside (non-management) directors.

ID1-4
Banks, the credit crunch, and financial statements
(LO 4)

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
(LO 4)

In its 2014 annual report, Home Depot reported that fiscal 2014 sales increased to $83.2 billion (from $78.8 billion the previous fiscal year), while profits increased to $6.3 billion (from $5.4 billion). Total assets decreased from $40.5 billion to $39.9 billion, while shareholders' equity during the same time period decreased from $12.5 billion to $9.3 billion. The company's cash balance decreased $206 million with cash flows from operating activities (+$8.2 billion), investing activities (−$1.3 billion), and financing activities (−$7.1 billion). Discuss possible explanations for these financial results.

REAL DATA ID1-6
Debt covenants
(LO 4)

United Continental Holdings, the parent of United Airlines and Continental Airlines, signed contracts with its major creditors (mostly banks) that require the company to maintain a minimum cash balance of $3.0 billion and a minimum ratio of cash flow to required payments of 1.50. Discuss why the creditors impose such restrictions on the airline company.

REAL DATA ID1-7
Managing reported profits
(LO 4)

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
(LO 3)

The following quote was taken directly from the audit report written by PricewaterhouseCoopers on the 2014 financial statements of Kroger.

"In our opinion, the accompanying consolidated balance sheets and related consolidated statements of operations, comprehensive income, cash flows and changes in shareholders' equity present fairly, in all material respects, the financial position of The Kroger Co. and its subsidiaries at January 31, 2015, and February 1, 2014, and the results of their operations and their cash flows for each of the three years in the period ended January 31, 2015, 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
(LO 5)

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
(LO 5)

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.

REAL DATA ID1-11
Global reporting standards
(LO 6)

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).

REAL DATA ID1-12
Appendix 1A
(LO 1, 7)

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

REAL DATA ID1-13
The SEC Form 10-K of Disney
(LO 3)

You can review the Disney SEC Form 10-K by searching for "Disney Annual Report" online.

REQUIRED:
Review the 2015 SEC Form 10-K of Disney and answer the following questions:

a. Briefly describe the operations of Disney and indicate whether it is a manufacturing, retail, or service company.
b. Which accounting firm audits Disney? Briefly explain the contents of the audit report.
c. What dollar amounts for net income were reported in 2015, 2014, and 2013?
d. Compute Disney's liabilities as a percent of total assets in 2015 and 2014. Did the percentage increase or decrease?
e. How much cash was provided by operating activities during 2015, 2014, and 2013?
f. Comment on Disney's financial performance and condition.

CHAPTER 2 A Closer Look at the Financial Statements

LEARNING OBJECTIVE		PRACTICE
1. Describe the balance sheet in terms of equity and debt capital and producing and operating assets.	• Equity capital • Debt capital • Producing assets • Operating assets	**1a.** Distinguish equity capital from debt capital and producing assets from operating assets. **1b.** Describe how equity and debt capital and producing and operating assets can be organized into a balance sheet.
2. Explain the concept of net income, who owns it and what they can do with it.	• Net income • Dividends • Retained earnings	**2.** Explain the generation and distribution of net income.
3. Define the three major activities of a business.	• Attracting capital (financing) • Investing capital (investing) • Managing working capital (operating)	**3.** Classify transactions into three categories.
4. Describe the four financial statements in greater detail.	• Balance sheet • Income statement • Statement of cash flows • Statement of shareholders' equity	**4.** Match financial statements with descriptions.
5. Discuss how the financial statements can be viewed as a package and use the package to assess five fundamental metrics of a company's performance.	• Relationships among the statements • Operating performance • Asset investment • Asset financing • Cash management • Return on shareholder investment	**5a.** Identify how transactions can affect more than one financial statement. **5b.** Assess five fundamental financial metrics.

LEARNING OBJECTIVE 1

Describe the balance sheet in terms of equity and debt capital and producing and operating assets.

Barnes & Noble, a well-known U.S. bookstore, has suffered through a difficult period—no doubt a vivid and scary example of how traditional bookstores have struggled in the online world of today. In reaction to the decision to close many stores, recent Barnes & Noble income statements have shown net losses, balance sheets have shown increases in the percent of total debt to total assets, and the statements of cash flows have shown drop-offs in investing activities. Interestingly, despite these difficulties, both the statements of cash flow and shareholders' equity indicate that dividends have been paid. Financial statements sometimes tell a happy story, sometimes not so happy. It looks like the equity investors in the stock market noticed. During this period, the company's stock price has plummeted. Indeed, the information in the financial statements seems to matter to somebody!

In this chapter we take a closer look at the financial statements. Recall that early in Chapter 1 we told a story, starting out with you coming across a large sum of money knowing little about what to do with it. That led to a description of many different kinds of investments, offering different combinations of risk and potential return; in the end, after having reviewed a set of financial statements, you decided to invest in a company called Microline, managed by Martin Wagner. In this story you were a potential investor—you had money but didn't know what to do with it

so, based on information in the financial statements, you chose to invest in somebody who did know what to do.

In this chapter we take a different perspective. We tell another story, but in this story you have no money. Instead, you have an idea about what to do with money, if you had it. We will assume that you are able to sell your idea to investors, and we will then build a set of financial statements as you make your idea a reality. In this story you are no longer a potential investor. You are a manager with a firsthand look at building a set of financial statements that shows investors how well you are doing.

A Story That Builds a Set of Financial Statements

Fishing and boating are fun, and your passion has always been to run a small fishing and boating operation on a picturesque lake somewhere near the mountains. So, what could this place look like?

You need a small piece of land on a lake, and on that land you will have to build a pier, a small building with some storage capacity, and a parking lot. You plan to rent and sell small fishing boats and fishing equipment to your customers as well as provide some fishing guide services. You will need to sell bait (worms, minnows, crickets), and your fishing shop will have to stock and sell picnic and snack food and drinks as well as other incidentals that support fishing and boating (e.g., life jackets, coolers, apparel). You happen to know just the place for your budding enterprise, and it's available for sale! After some painstaking research, you prepare the following list that lays out what you need, including an estimate of what each item would cost, and a little extra cash just in case.

Land	$200,000
Structures and fixtures (building, pier, parking lot)	150,000
Boats and fishing equipment for rental	40,000
Boats and fishing equipment for sale	80,000
Food, drinks, and incidentals for sale	20,000
Extra cash	10,000
Total	$500,000

You review the list—buy the land, build the structures and fixtures, stock it with equipment for rental and goods for sale. Now where will the $500,000 come from?

You conclude pretty quickly that you need to find an investor or group of investors—the same predicament that Martin Wagner and Microline faced in Chapter 1. Who out there has $500,000 that they are willing to invest in you and your vision of a boating and fishing operation on a scenic lake? You will have to convince any potential investors that an investment in your plan will offer a return that compensates them for the risk they will have to face. So, you start working on a **business plan**, a document designed to show investors that your idea can create a profit—that is, you can sell goods (boats and fishing equipment) and provide services (rentals and guiding) for prices that exceed the expenses required to run the business. The revenues will have to exceed the expenses by enough to create a return for the investors that compensates them for the risk they have to bear.

?

After a number of years of reporting losses, in 2015 Barnes & Noble finally turned a profit of a little over $36 million. While this profit was certainly a step in the right direction, it provided a return to the investment made by the company's shareholders of less than 3 percent. Yes, Barnes & Noble was profitable, but was it profitable enough to provide a reasonable return to the shareholders? Discuss.

Time passes and after many meetings, business plan revisions, and additional study, you finally find two investors, each willing to invest $100,000 for one-third of the ownership, leaving one-third of the ownership to you. You will manage the operation and be paid a salary. To complete the arrangement, you issue 100 shares of stock to each owner, including yourself, which means that there is a total of 300 shares of stock, each representing a 1/300th ownership (equity) interest in the business. At the same time, you open a checking account at your local bank, deposit the $200,000, and record the $200,000 receipt, labeling it as **contributed capital** because it is money contributed directly to your business by equity investors (see Figure 2–1).

FIGURE 2–1 Receipt of contributed capital

You also make a mental note that the other two owners each own one-third of the company, and they have some rights that accompany their ownership—a right to have some influence over what you do as the manager, a right to receive periodic reports (financial statements) from you about how the business is doing, and a right to one-third of any of the profits the business makes. In addition, while you are very pleased that you found investors to put up $200,000, you realize that you need another $300,000 to get started. Now is the time to return to your local bank to see if it is willing to lend your business, now owned by three people, $300,000.

The visit to the bank goes well. The loan officer likes your business plan and is especially attracted to the fact that there are two other investors, each of whom invested $100,000. The loan officer is willing to loan $300,000 to the business if all three owners sign a loan contract stating that (1) the business will pay an annual interest rate of 8 percent of the $300,000 ($24,000); (2) the loan will be paid back at the end of five years; and (3) if the payments are not made, the bank has a right to take over the land and structures. All this sounds acceptable to you and your partners, so you each sign the loan contract, add $300,000 to the company's checking account, and name your newly established enterprise "Gone Fishin'."

You can now record the receipt of the $300,000 as debt capital. It is now a liability of Gone Fishin'. The interest payment will come due on a regular basis, and at the end of the contract, the $300,000 will have to be paid back unless both you and the bank agree to an extension. As Figure 2–2 illustrates, the business now has $500,000 in cash: $200,000 contributed by the owners (contributed capital) and $300,000 from a bank loan (debt capital).

FIGURE 2–2 Receipt of contributed capital and debt capital

The other owners now leave you to manage the business. First on the agenda is to put the $500,000 of capital to good use—purchase the land, build the structures and fixtures, and buy the boats, fishing equipment, and other incidentals. You get right to work, and after a couple of months, Gone Fishin' is ready for business.

To keep the other two owners up-to-date you send them a chart that describes what you have done with the money (see Figure 2–3). You have not yet opened the business, so you have not yet sold anything or provided any services. You have no customers or clients at this point. But you have created a foundation on which to run the business.

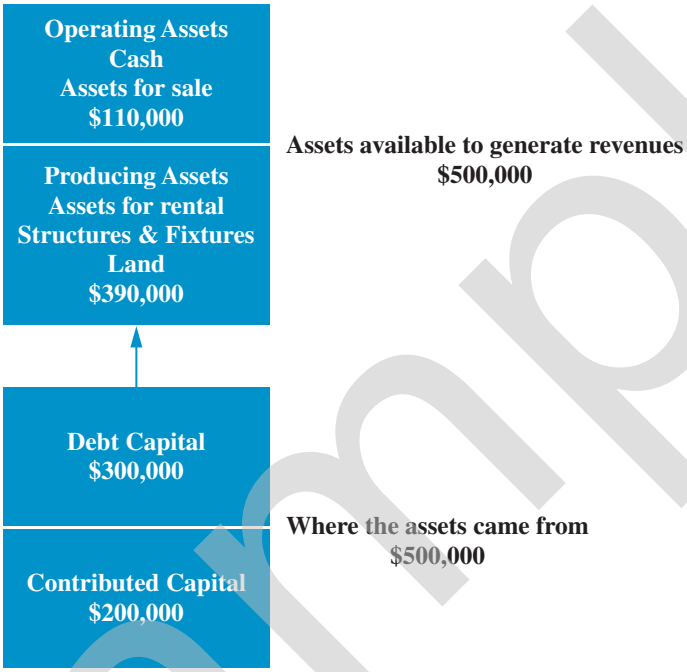

FIGURE 2–3
A balance sheet

In your report to the other owners, you describe that you invested the $200,000 of equity capital and the $300,000 of debt capital in two kinds of assets—producing assets and operating assets. The producing assets include the land ($200,000), the structures and fixtures ($150,000), and the boats and fishing equipment for rental ($40,000)—a total investment of $390,000. These you have labeled as **producing assets** because you will use them in the business to support the generation of revenues. You should be able to use them for a while—at least a few years before they will have to be replaced.

The remaining assets you have labeled as **operating assets** because they too will help to generate revenues but, unlike producing assets, you expect that they will be used up quickly and will have to be replaced often. The boats and fishing equipment for sale ($80,000) as well as the food, drinks, and incidentals ($20,000) are all for sale, and as they are sold, they will have to be replaced. Hopefully, that will happen often. You also expect to need a ready cash balance ($10,000) to cover periodic and sometimes unexpected cash needs.

Interestingly, you see that the total investment in the assets ($500,000) is exactly the same as the total amount of debt and equity capital ($500,000). You note that the assets represent what you have to work with to make this business successful, and the capital explains where those assets came from (60 percent from borrowing and 40 percent from equity investments). You have sent Gone Fishin's balance sheet to the other owners.

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 1

A. Identify the following descriptions as equity capital, debt capital, producing asset, or operating asset.

1. Items acquired by the manager which are expected to support the production of revenues over a period of time beyond the current period.

2. An investment in a company made by a creditor, normally backed by a contract that states an interest rate and a maturity date as well as other terms.

3. An investment in a company made by an owner who in return has a right to influence how the company is managed as well as a right to the profits generated by the company in proportion to the owner's ownership interest.
4. Items acquired by a manager which are expected to generate revenues during the current period.

B. Arrange the following dollar amounts into a balance sheet that shows the assets at a company's disposal that can be used to generate revenues and the sources that financed those assets.

Equity capital $600; Debt capital $800; Producing assets $1,200; Operating assets $200

SOLUTION

A.

1. Producing assets
2. Debt capital
3. Equity capital
4. Operating assets

B.

Operating assets	$ 200
Producing assets	1,200
Total assets	$1,400
Debt capital	$ 800
Equity capital	600
Total	$1,400

LEARNING OBJECTIVE 2

Explain the concept of net income, who owns it and what they can do with it.

The owners seem to be satisfied because the balance sheet clearly lays out what assets the business has, and how these assets have been financed (i.e., where the assets came from). The next step is to open for business and see if customers are willing to pay more for the goods and services you offer than it costs you to deliver them.

You hire an assistant to help you run Gone Fishin', and much to your delight there seems to be a demand in your area for exactly what you offer. Over the next 12 months, a steady stream of customers comes through buying boats, fishing equipment, food, and incidentals; they rent your boats and equipment at daily or weekly rates, and you build a respectable reputation as a guide because you always seem to find the good fishing holes for your clients. As far as you can tell, it's been a good year.

It is time again to report back to the other two owners, who are very curious about whether their investment is paying off. You compile the results of your operations in the form of a basic income statement (Figure 2–4), and you illustrate it along with the balance sheet you sent earlier.

This format shows that during the year you used the producing and operating assets, provided by the equity and debt capital contributions, to generate $150,000 in revenues—$50,000 from providing rentals and guiding services and $100,000 from the sale of products, including boats, fishing equipment, food and drinks, and incidentals. The cost to Gone Fishin' of the goods (products) sold during the year was $40,000, meaning that, on average, the sales prices for these items were marked up by you 2.5 times ($100,000/$40,000) over their cost. Expenses necessary to operate the business and generate the revenues totaled $76,000 for the year and included such items as your salary, your assistant's wages, utility costs, insurance, maintenance and repairs, and

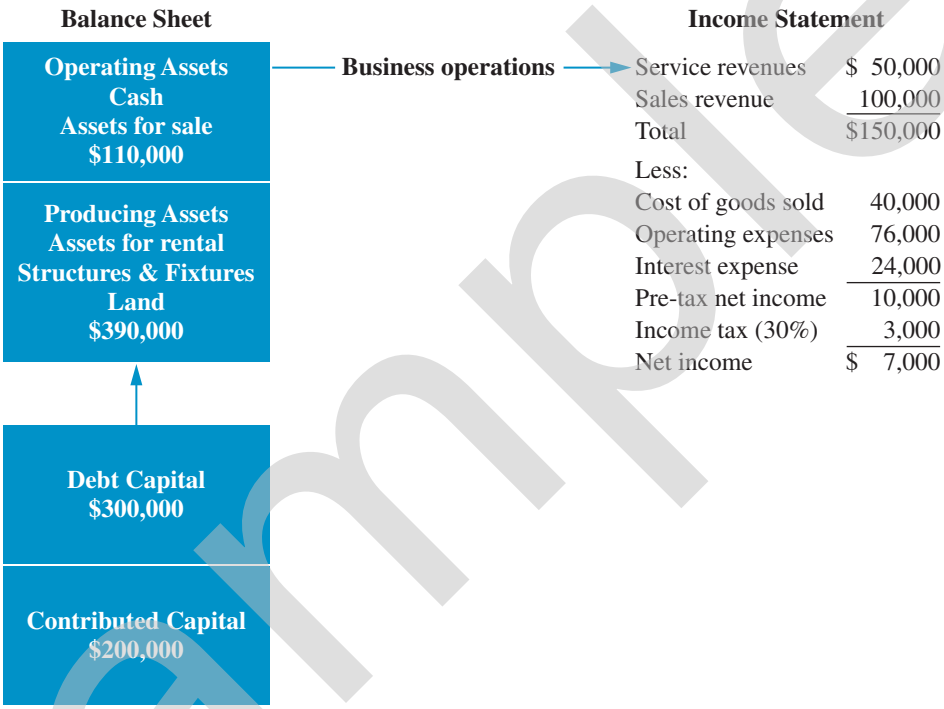

FIGURE 2–4 Results of operations

other miscellaneous items just to keep the operation moving. Also considered an expense is the interest cost associated with the $300,000 bank loan (8 percent × $300,000), and the U.S. federal government took its share (30 percent) of the business's profits in the form of income tax, leaving a net income number of $7,000.

Your partners are pleased. They've been around for a while and know that booking a profit in the first year of operations is not all that common. Granted, the profit number is not huge, only 1.4 percent of the total assets invested ($7,000/$500,000) and only 3.5 percent of their investment in the business ($7,000/$200,000), but still it is a positive number. The customer base will likely grow in the future, and a year of experience will help you run the operation more efficiently. They agree that you are off to a good start.

One of the owners did pose an interesting question, though: Where are the profits and what should be done with them? You explain that the profits were earned gradually during the year creating additional assets that you, as the manager, chose to reinvest in the business. Some could have gone to increase the cash balance or other operating assets (e.g., more fishing equipment on the shelves waiting to be sold), some could have been invested in additional producing assets (e.g., an additional boat to rent), or some could have been used to pay off debt (e.g., reduce the $300,000 owed to the bank) or even buy out equity investors. You explain that during the year the cash balance increased a little and the investment in inventory (products available for sale) grew. You did not pay down any of the $300,000 debt obligation, and no payments were made to buy out owners. The profits, it seems, have all been reinvested in additional assets. Make no mistake—they are not sitting in a jar full of cash labeled "profits."

You then address what should be done with the profits. While they are sitting in the business right now, you remind the owners that they (and you) have a right to the profits and can choose to withdraw them. You note further that the company's cash balance has grown from $10,000 at opening to $12,000, meaning that there is enough cash to pay a $7,000 dividend if the owners wish to withdraw all the profits. After some discussion, the owners decide to each withdraw $1,000, and leave $4,000 in the business. In other words, a dividend of $3.33 per share

($1,000/300 shares) was declared by the owners and paid to them, leaving $4,000 of the profits in the business, as illustrated in Figure 2–5.

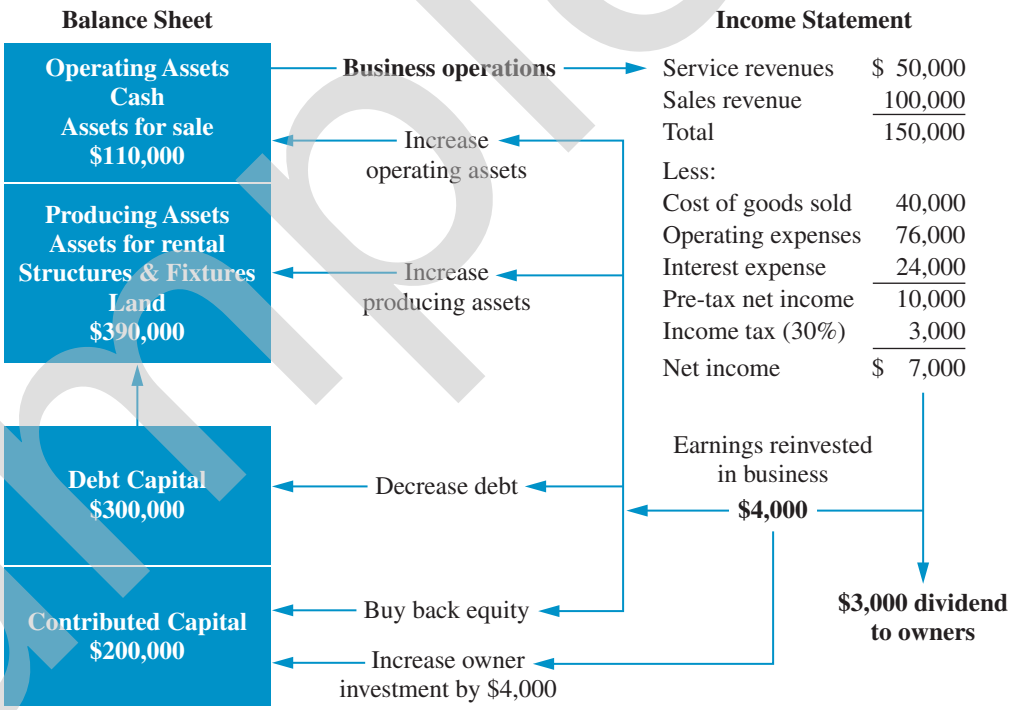

FIGURE 2–5 What happens to net income?

This means that the second year of Gone Fishin's operations will start with $4,000 more in assets and an additional $4,000 invested by the owners as a result of its profitable activities, bringing the total investment by the owners to $204,000 ($200,000 contributed capital + $4,000 retained earnings).

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 2

1. During 2014 Caterpillar, a world-leading manufacturer of construction and mining equipment, reported (dollars in billions) sales revenue = $52.1, service revenue = $3.0, expenses = $51.4, and dividends = 1.6. Compute the 2014 net income for Caterpillar and how much of the net income was allowed by the owners to remain invested in the business.

SOLUTION

Sales revenue	$ 52.1
Service revenue	3.0
Total revenue	$ 55.1
Expenses	(51.4)
Net income	$ 3.7
Dividends withdrawn by shareholders	(1.6)
Amount of net income reinvested	$ 2.1

Gone Fishin's Financial Statements

LEARNING OBJECTIVE 3

Define the three major activities of a business.

Balance Sheet and Income Statement

Your record keeping throughout the year, as the manager of Gone Fishin', established the basis for a complete set of financial statements. Just before you began operations, your **balance sheet** listed the operating and producing assets of the company along with where they came from—debt and equity capital. You then started operations and created an **income statement** as you earned revenues and recognized expenses, leading to a profit for the year of $7,000.

Statement of Cash Flows

The statement of cash flows would contain the cash inflows and outflows associated with three categories of business activities: operating, investing, and financing. Figure 2–6 highlights the nature of each of these categories: operating activities (green), investing activities (blue), and financing activities (red). **Cash flows from operating activities** would include cash collections from customers and clients, who bought products or services, reduced by cash payments to purchase operating assets (inventories) and pay expenses (wages, utilities, repairs), including interest paid on the bank loan. **Cash flows from investing activities** would include cash payments to purchase producing assets (land, structures, assets for rent), plus any cash receipts from selling these assets. **Cash flows from financing activities** would include cash inflows from borrowings and contributions from shareholders and cash outflows associated with payments to creditors (excluding interest) and shareholders in the form of dividend or share buybacks.

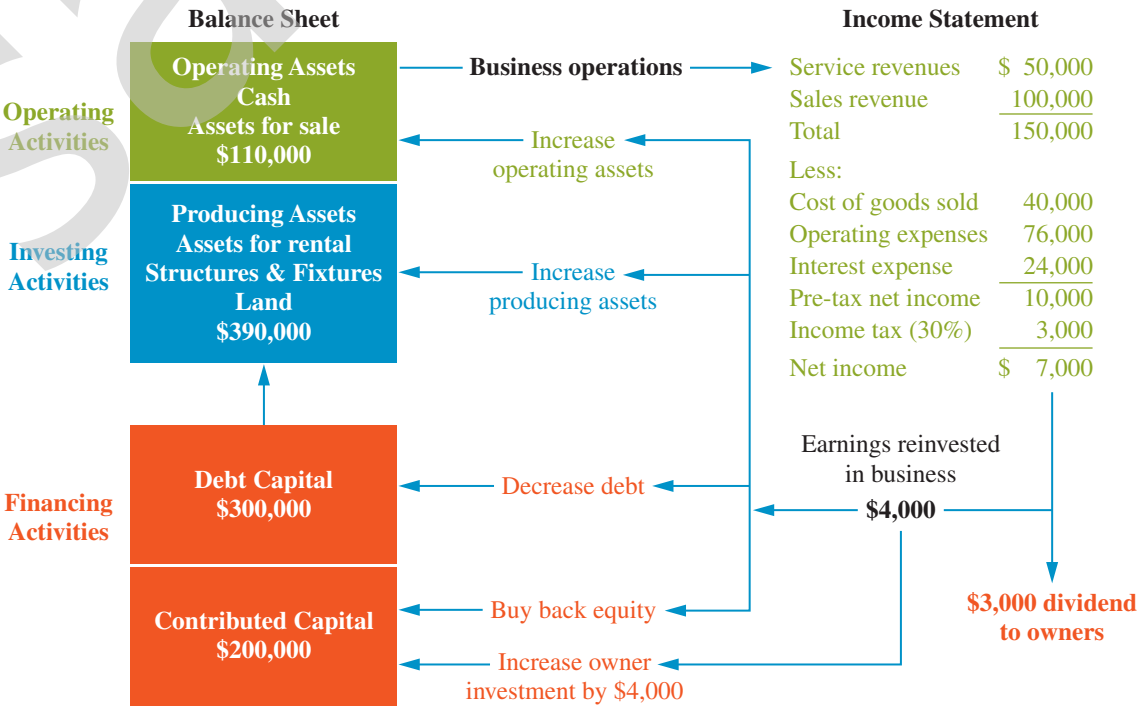

FIGURE 2–6
Operating, investing, and financing activities

Statement of Shareholders' Equity

The statement of shareholders' equity, illustrated in red in Figure 2–7, would include the exchanges with the owners: contributions made directly to the business by the shareholders, reinvested earnings (called **retained earnings**), dividend payments to the shareholders, and any payments to the shareholders to buy back their stock.

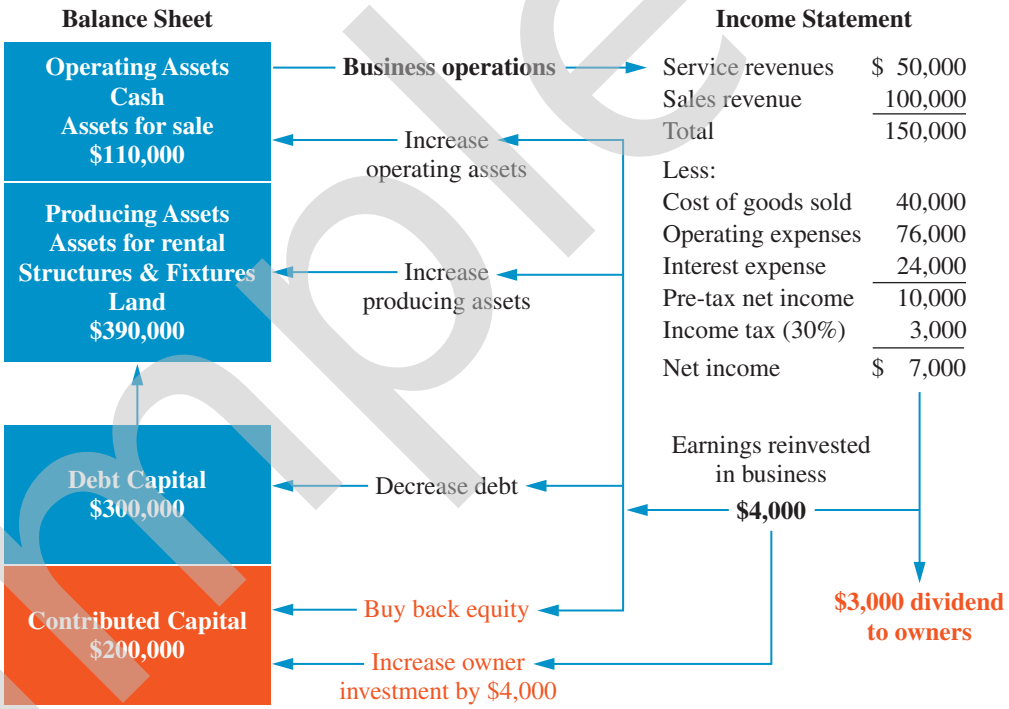

FIGURE 2–7 Statement of shareholders' equity

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 3

1. During 2014, Home Depot participated in the transactions described below. Indicate for each transaction whether it is an operating activity, an investing activity, or a financing activity.
   - Home Depot issued 7 million shares of stock, receiving $122 million.
   - Home Depot sold merchandise with a sales price of $83 billion.
   - Home Depot recognized $16.8 billion in selling, general and administrative expense, paying cash for most of it.
   - Home Depot paid $1.44 billion mostly to acquire new stores.
   - Home Depot paid dividends to its owners of $2.5 billion.
   - Home Depot paid $200 million to acquire new business.
   - Home Depot paid $7 billion to buy back its previously issued stock.

SOLUTION

- Financing activity
- Operating activity
- Operating activity
- Investing activity
- Financing activity
- Investing activity
- Financing activity

The Classified Balance Sheet

LEARNING OBJECTIVE 4

Describe the four financial statements in greater detail.

Figure 2–8 is a balance sheet for Harbour Island Company as of December 31, 2016. It is entitled a **classified balance sheet** because the asset and liability accounts are grouped into classifications: current assets, long-term investments, long-lived assets, current liabilities, and long-term liabilities.

Harbour Island Company
Classified Balance Sheet
December 31, 2016

ASSETS			
Current assets			
Cash		$ 220	
Short-term investments		150	
Accounts receivable	$ 350		
Less: Allowance for doubtful accounts	(5)	345	
Inventory		600	
Prepaid expenses		100	
Total current assets			$ 1,415
Long-term investments			
Notes receivable		$1,000	
Land		500	
Investments		2,500	
Total long-term investments			4,000
Long-lived assets			
Property		6,000	
Plant and equipment	7,500		
Intangible assets	2,100		
Less: Accumulated depreciation and amortization	(2,400)	7,200	
Total long-lived assets			13,200
Total assets			$18,615
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities			
Accounts payable		$ 250	
Salaries and wages payable		25	
Interest payable		155	
Short-term notes payable		75	
Current maturities of long-term debts		60	
Unearned revenues		75	
Other payables		100	
Total current liabilities			$ 740
Long-term liabilities			
Long-term notes payable		$1,500	
Bonds payable		5,440	
Total long-term liabilities			6,940
Shareholders' equity			
Common stock		$9,900	
Retained earnings		1,385	
Less: Treasury stock		(350)	
Total shareholders' equity			10,935
Total liabilities and shareholders' equity			$18,615

FIGURE 2–8

A Photograph of Financial Condition

Think of the balance sheet as a photograph of the business at a specific point in time. The title includes a specific date (December 31, 2016). As of this date, the balance sheet measures the financial condition of Harbour Island Company. In fact, some companies refer to the balance sheet as the *statement of financial condition*. This "photograph" of financial condition shows that as of December 31, 2016, Harbour Island has total assets of $18,615 comprised of current assets ($1,415), long-term investments ($4,000), and long-lived assets ($13,200). The sources of these assets are current liabilities ($740), long-term liabilities ($6,940), common stock ($9,900), and retained earnings ($1,385), reduced by $350 in an account called treasury stock, which reflects purchases by the company of its own previously issued outstanding stock.

As of December 31, 2014, The Boeing Company, the largest airplane manufacturer in the world, reported almost $100 billion in total assets, over 90 percent of which were financed by debt!

Liquidity on the Balance Sheet

The assets on the balance sheet are divided into categories, and both the categories and the accounts within them are ordered on the basis of **liquidity**. The assets near the top of the balance sheet and the top of each category are expected to be converted into cash within a shorter time period than those listed at or near the bottom. They are considered to be more liquid. Current assets represent the most liquid assets with cash, the most liquid of all assets, understandably listed at the top.

Many non-U.S. companies that publish IFRS-based balance sheets list their assets in the opposite order, starting with noncurrent assets followed by current assets.

The same is true of the liability categories and the order of the liability accounts. Current liabilities are expected to result in cash payments sooner than long-term liabilities and accounts payable is expected to result in a cash payment sooner than any of the others.

Current Assets

Assets categorized as current are expected to be realized or, in most cases, converted into cash in the near future, usually within one year.[1] They are grouped into a separate category because they are considered to be highly liquid. **Current assets** include cash, short-term investments, accounts receivable, inventory, and prepaid expenses.

Over 68 percent of Boeing's total assets are classified as current.

[1] The actual definition of "current asset" is an asset expected to be converted into cash or used within one year or the operating cycle, whichever is longer. Operating cycles are discussed later in the text.

Cash

Cash represents the currency a company has access to as of the balance sheet date. It may be in a bank savings account, a checking account, or perhaps on the company premises in the form of petty cash.

Short-Term Investments

Short-term investments include stocks (equity investments in other companies), bonds (debt investments in the government or other companies), and similar investments. These securities are both *readily marketable* (i.e., able to be sold immediately) and intended by management to be sold within a short period of time, usually less than one year. A company often purchases these kinds of securities to earn income with cash that would otherwise be idle for a short time. The dollar value of this account is the total selling price (market value) of securities held by a company as of the balance sheet date.

Accounts Receivable

The **accounts receivable** account represents the amount of money a company expects to collect from its customers. Such receivables arise from sales of products or services for which customers have not yet paid. These sales are often referred to as *credit sales* or *sales on account*. The dollar amount appearing on the balance sheet for this account is computed by taking the total dollar amount of the receivables owed and subtracting an estimate for *uncollectibles* or *doubtful accounts*, accounts not expected to be collected.

Inventory

Inventory represents items or products on hand that a company intends to sell to its customers. It is often called **merchandise inventory**. The balance sheet value of inventory is the cost of acquiring (purchasing or producing) it or the cost of replacing it as of the balance sheet date, whichever is lower.[2]

Inventory is Boeing's primary current asset, comprising over 60 percent, followed by cash, accounts receivable, and short-term investments.

A second kind of inventory account is called *supplies inventory*. It represents items used to support a company's operations; office supplies and spare parts are two common examples. The dollar amount of this account on the balance sheet is usually the cost of acquiring the items. Major manufacturers often carry a substantial inventory of spare parts.

Normally about 10 percent of The Boeing Company's total inventory is composed of spare parts.

Prepaid Expenses

Prepaid expenses are exactly what the name suggests: expenses that have been paid by a company before the corresponding services or rights are actually used. Insurance premiums, for example, are normally paid prior to the period of coverage. Rent is usually paid before the rental period. A prepaid expense, therefore, is considered an asset because it represents a benefit to be enjoyed by the company in the future; it is not considered an expense. It appears on the balance sheet until it is used, at which time it is converted to an expense and matched against the revenues it helped to generate on the income statement. Prepaid expenses are originally recorded on the balance sheet at the cost of acquiring them.

[2] For short-term investments, how to record these assets at market value will be discussed in Chapter 9; for accounts receivable, how to record uncollectible amounts will be discussed in Chapter 6; and for inventory, how to record these assets at the lower of cost or replacement cost will be discussed in Chapter 7.

Long-Term Investments

Long-term investments are acquired by companies to provide benefits for periods of time extending beyond one year. Examples include long-term notes receivable and investments in land and debt and equity securities.

The notes receivable account includes company receivables that are backed by promissory notes. *Promissory notes* are contracts (formal, legally enforceable documents) that state the face value of the receivable, the date when the face value is due, and the periodic interest payments to be made while the note is outstanding. The date when the receivable is due, called the *maturity date*, is often beyond one year, so this account is often listed in the long-term investment section of the balance sheet. However, if the maturity date of a note receivable is within one year, it should be included as a current asset. Like accounts receivable, an estimate—often subjective—for doubtful accounts must be provided for notes receivable.

The long-term investment section of the balance sheet can also include a number of other investments. Land, for example, may be purchased and held as a long-term investment. Investments in debt and equity securities that are not intended to be sold in the near future represent other common examples. Most major U.S. companies have made significant investments in the equity securities of other, usually smaller, companies, intending to exert long-term influence over their management.

Boeing carries over $3 billion of notes receivable on its balance sheet, mostly from major airlines that have purchased Boeing airplanes and are making payments over time. The company also has over $1 billion in investments in equity securities, most of which refers to a 50 percent ownership interest in a company called United Launch Alliance.

Long-Lived Assets

Long-lived assets include property, plant, and equipment and intangible assets. This section of the balance sheet includes assets acquired for use in the day-to-day operations of the business, and they are called "long-lived" because they are expected to support the generation of revenues for a period of time beyond the current one. Earlier in this chapter we referred to these as **producing assets**.

The **property** account represents the land on which the company conducts its operations. It is carried on the balance sheet at the original cost of the land, which is not adjusted as the value of the property appreciates (i.e., increases). Be sure not to confuse this account with land in the long-term investment section. That land is held for investment purposes only and is not used in the operations of the business.

Plant and equipment represent the physical structures that a company owns and uses in its operations. The plant account, for example, includes the cost of factories, office buildings, stores and warehouses, while the equipment account includes machinery, vehicles, furniture, and similar items. The dollar amount in these accounts on the balance sheet is the original cost at the time the assets were purchased, reduced by an amount that loosely approximates the asset's lost usefulness or deterioration over time. This amount is called *accumulated depreciation*. Subtracting accumulated depreciation from the acquisition cost results in the *net value* or **net book value** of the assets.

Intangible assets are so named because they have no physical substance. In most cases, they represent legal rights to the use or sale of valuable names, items, processes, or information. Many companies, such as Coca-Cola, have patents on certain formulas that grant them the sole legal right to produce and sell certain products. Pharmaceuticals (like Merck or Pfizer) make huge investments

to acquire patents that give them exclusive rights to manufacture and sell certain drugs. In a similar way, the cost a company incurs to acquire a trademark (e.g., the golden arches of McDonald's) or its name brand (e.g., Google) can also be accounted for as an intangible asset.

Perhaps the most common intangible asset is *goodwill*, which represents the cost of purchasing another company over and above the total market price of that company's individual assets and liabilities. The goodwill account is prominent on the balance sheets of many major U.S. companies because they often grow by purchasing other companies, called *subsidiaries*.

When acquired, intangible assets are recorded on the balance sheet at cost. While in use, some intangible assets are subject to amortization over their useful lives, much like the plant and equipment account is subject to depreciation. These intangible assets are carried on the balance sheet at net book value—the original cost less the *accumulated amortization*. Other intangible assets, like goodwill, are not subject to amortization because they do not have a determinable useful life.

Long-lived assets on Boeing's balance sheet, split about evenly between property, plant, and equipment and intangible assets, total approximately $22 billion, which represents about 22 percent of total assets. The largest intangible asset is goodwill at a little over $5 billion.

Current Liabilities

Current liabilities are obligations expected to be paid (or services expected to be performed) with the use of assets listed in the current asset section of the balance sheet. Examples include *accounts payable*, *wages payable*, *interest payable*, *short-term notes payable*, *income taxes payable*, *current maturities of long-term debts*, and *unearned revenues (sometimes called deferred revenue)*.

Accounts payable are usually obligations to a company's suppliers for merchandise purchases made on account. Salaries and wages payable are obligations to a company's employees for earned but unpaid salaries and wages as of the balance sheet date. Interest payable and short-term notes payable are dollar amounts owed to creditors, often banks and other financial institutions. Income taxes payable are amounts owed to the government for taxes assessed on a company's income. **Current maturities of long-term debts** are portions of long-term liabilities that are due in the current period. They often arise when the principal amounts of long-term liabilities are due in installments over time. Unearned revenues represent services yet to be performed by a company for which cash payments have already been collected.

Many non-U.S. companies that publish IFRS-based balance sheets list current liabilities directly below current assets, leading to the computation of net current assets or what many call working capital (current assets − current liabilities). This format emphasizes the point that management should manage current assets and current liabilities together.

Long-Term Liabilities

Long-term liabilities are obligations expected to require payment over a period of time beyond the current year. These obligations are usually evidenced by formal contracts that state their principal amounts, the periodic interest payments, and maturity dates. The form of these debt contracts, however, can vary widely. Common examples include accounts like *long-term notes payable* and *bonds payable*.

Long-term **notes payable** refer to obligations on loans that are normally due more than one year beyond the balance sheet date. They usually involve either direct borrowings from financial

institutions or arrangements to finance the purchase of assets. **Bonds payable** represent notes that have been issued for cash to a large number of debt investors (called *bondholders*).

Current liabilities on Boeing's 2014 balance sheet are over $57 billion, well over half of Boeing's $99 billion total asset number. Long-term debt, including notes and bonds, is about $33 billion.

Shareholders' Equity

The **shareholders' equity** section of the balance sheet consists of common stock, retained earnings, and treasury stock. Referring to Figure 2–8, common stock ($9,900) represents investments contributed by the owners when they have purchased common stock issued by the company. Such contributions by the owners are often called contributed capital. Retained earnings ($1,385) represent investments made by the owners by not exercising their right to withdraw via dividends prior net income amounts, allowing these profits to remain in the company. Treasury stock (−$350) represents the dollar amount paid by the company to purchase previously issued common stock. This amount is negative because such purchases reduce the investment made by the owners. The total amount of shareholders' equity ($10,935) represents the dollar amount invested in the company by Harbour Island's owners as of December 31, 2016. It is also equal to total assets ($18,615) less total liabilities ($7,680), and when viewed in this way is referred to as the *net book value* of the company.

As of December 31, 2014, the investment made in Boeing by its shareholders was $8.6 billion, which also is equal to Boeing's net book value.

The Income Statement

The income statement, sometimes called the statement of operations, measures operating performance over a particular period—the activities associated with the acquisition and sale of the company's inventories or services. An example for the Harbour Island Company, covering the year ended December 31, 2016, is illustrated in Figure 2–9. It consists of three categories: operating revenues ($5,400), operating expenses ($3,895), and nonoperating revenues and expenses (−$20). The net amount of these three numbers less income for expense yields a number called *net income* or *loss*, *net earnings*, or *profits* ($1,085). Most analysts, investors, creditors, and managers agree that net income is the most important number disclosed on the financial statements because it represents the company's ability to sell its products and services for more than it costs to provide them.

For 2014 Boeing reported net income of $5.4 billion on revenues of $90.8 billion.

Operating Revenues

Operating revenues represent the inflow of assets (or decrease in liabilities) due to a company's operating activities over a period of time. Examples include sales and service revenues (sometimes called fees earned). The ability to generate operating revenues is often viewed as one of the important keys to success for a company.

Harbour Island Company Income Statement For the Year Ended December 31, 2016		
Operating revenues		
Sales revenue	$4,100	
Service revenue	1,300	
Total operating revenues		$5,400
Less: Operating expenses		
Cost of goods sold	$1,500	
Salaries and wages	1,000	
Rent	295	
Selling and administrative	300	
Depreciation and amortization	800	
Total operating expenses		(3,895)
Operating income		$1,505
Nonoperating revenues and expenses		
Nonoperating revenues	$ 880	
Less: Interest expenses	900	
Net nonoperating revenues and expenses		(20)
Net income before taxes		$1,485
Income tax expense		(400)
Net income		$1,085

FIGURE 2–9

Of Boeing's $90.8 billion in 2014 revenue, 89 percent came from sales of products and 11 percent from providing services.

Sales or **sales revenue** is perhaps the most common revenue account. It represents a measure of asset increases (usually in the form of cash or accounts receivable) due to selling a company's products or inventories. If a company provides a service (e.g., a law firm or accounting firm) instead of selling a product, the revenue account reflecting such activity is called **fees earned** or **service revenue**.

Many non-U.S. companies, especially in Europe, use the term turnover instead of revenue.

Operating Expenses

Operating expenses represent the periodic and usual outflow of assets (or creation of liabilities) required to generate operating revenues. Examples include cost of goods sold and expenses related to wages, rent, selling, depreciation, and amortization.

The **cost of goods sold** account represents the original cost of the inventory items (purchase price or cost of manufacturing) that are sold to generate sales revenue. For retail and manufacturing companies, this *inventory expense* is normally separated from other operating expenses

because it is comparatively large, and it is often compared to sales revenue to indicate the relationship between the selling price of the inventory and its cost.

In 2014, Boeing's cost of goods sold was 85 percent of its sales revenue.

The remaining operating expenses differ based on the nature of a company's operations. For retailing companies, which simply purchase finished goods and then sell them (e.g., Walmart), this expense category contains accounts reflecting the decrease in assets (or creation of liabilities) due to such items as commissions to salespersons, salaries, wages, insurance, advertising, rentals, utilities, property taxes, and equipment maintenance. Manufacturing companies, on the other hand (e.g., General Motors), typically include only selling and administrative expenses in this category because cost of goods sold normally includes costs that retailers consider operating expenses. Note from the expenses listed on the income statement in Figure 2–9 that Harbour Island Company is a retailer.

A common expense item that we will address in detail later is called **depreciation** or **amortization**. It represents an estimate of the extent to which plant and equipment (depreciation) and intangible assets (amortization) are being used up each year. The idea is that these assets help to generate revenues over more than one year, and to measure net income we should match the cost of these assets against the revenues as the revenues are generated over the asset's useful life. Depreciation and amortization expense reflect that cost on the income statement.

During 2014, Boeing booked $1.9 billion of depreciation and amortization expense.

Operating revenues ($5,400) less operating expenses ($3,895) leads to operating income ($1,505), which is different from net income before taxes ($1,485). Operating income is often viewed as a more useful measure of performance because operating revenues and expenses refer to the normal and recurring core operating activities of the business. Net income before tax, on the other hand, includes items, discussed in the next section, that are either infrequent or not related to the main core activities of the business. Finally, because Harbour Island is a corporation, it is subject to corporate income taxes ($400), which are subtracted from net income before tax in the computation of "bottom-line" net income ($1,085).

Nonoperating Revenues and Expenses

The category *nonoperating revenues and expenses* can include a number of items. It usually contains revenues and expenses from activities not central to a company's operations; therefore, the dollar amount of this category is also usually small. Nonoperating revenues often include interest on bank accounts, rent collected on the rental of excess warehouse space, and book gains recognized when assets are sold for amounts that exceed those costs. Nonoperating expenses include interest on outstanding loans and book losses recognized when assets other than inventory are sold for amounts that are less than their original costs.

For Boeing during 2014, the only significant nonoperating item was interest expense, which approximated $330 million, an amount quite small compared to Boeing's net income before income taxes of over $7 billion.

The Statement of Cash Flows

The statement of cash flows is a summary of the activity in a company's cash account over a period of time. Understanding it is simply a matter of recognizing that certain transactions entered into by a company during a given period increase the cash account, while others decrease it. The statement summarizes these transactions and, in the process, explains how the cash balance at the beginning of the period came to be the cash balance at the end of the period. The statement of cash flows for Harbour Island Company for the year ended December 31, 2016, appears in Figure 2–10.

Harbour Island Company
Statement of Cash Flows
For the Year Ended December 31, 2016

Operating activities		
Cash collections from sales of goods	$4,800	
Cash collections from provision of services	800	
Cash collected from interest	10	
Less:		
Cash paid to suppliers	$1,800	
Cash paid to employees	1,050	
Cash paid for rent	290	
Cash paid for selling activities	300	
Cash paid for interest and taxes	700	
Net cash from operating activities		$ 1,470
Investing activities		
Cash paid for investment securities	$ (100)	
Cash paid to purchase property	(4,500)	
Cash collections from selling investment securities	500	
Net cash used by investing activities		(4,100)
Financing activities		
Cash received from short-term borrowing	$ 350	
Cash paid to reduce long-term debt	(400)	
Cash collections from issuing equity	3,100	
Cash paid to repurchase outstanding stock	(100)	
Cash paid to shareholders for dividends	(200)	
Net cash from financing activities		2,750
Increase in cash		$ 120
Cash balance at beginning of year (January 1, 2016)		100
Cash balance at end of year (December 31, 2016)		$ 220

FIGURE 2–10

The statement of cash flows is divided into three categories: (1) operating activities, (2) investing activities, and (3) financing activities. The transactions summarized within each of these three categories either increased or decreased cash during the period and the net result of the three totals explains the change in a company's overall cash balance. For example, on Harbour Island's cash flow statement, operating activities increased cash by $1,470, investment activities decreased cash by $4,100, and financing activities increased cash by $2,750. The net result was an increase in cash of $120 ($1,470 − $4,100 + $2,750), which boosted the cash balance from $100 at the beginning of 2016 to $220 at the end.

During 2014, Boeing's statement of cash flows indicates that its cash balance increased by $2.6 billion, from $9.1 billion at the beginning of 2014 to $11.7 billion at the end of 2014.

Cash Flows from Operating Activities

Cash flows from **operating activities** include those cash inflows and outflows associated with the acquisition and sale of a company's products and services. The items found in this section are closely related to the revenues and expenses found on the income statement because both measure operating inflows and outflows. However, the dollar amounts of these items on the statement of cash flows do not necessarily agree with the dollar amounts appearing for these items on the income statement. The statement of cash flows records only cash inflows and outflows; the income statement consists of revenues and expenses, which are not the same as cash inflows and outflows (to be discussed later). Harbour Island, for example, reported net income of $1,085 but net cash from operations of $1,470.

Cash Flows from Investing Activities

Cash flows from **investing activities** include the cash inflows and outflows associated with the purchase and sale of a company's producing assets, including investments and long-lived assets. Cash effects from the purchase or sale of a company's investments in securities or property, plant, and equipment are common examples. Figure 2–10 shows that Harbour Island used $100 and $4,500 to purchase long-term investment securities and property, respectively. It also generated $500 in cash by selling long-term investments. These transactions in total reduced Harbour Island's cash balance by $4,100.

Cash Flows from Financing Activities

Cash flows from **financing activities** include the cash inflows and outflows associated with a company's two sources of outside capital: liabilities and owner investments. Cash proceeds from and cash principal payments on short- and long-term liabilities are reflected in this section of the statement of cash flows. As indicated in Figure 2–10, Harbour Island borrowed additional short-term debt of $350 during 2016 and made cash principal payments on long-term debt ($400). Harbour Island also collected $3,100 in cash from issuing (selling) equity to shareholders, spent $100 to purchase some of its outstanding shares of common stock from shareholders, and paid cash dividends of $200 to its shareholders.

During 2014, Boeing generated almost $8.8 billion in cash from operating activities, added another $2.4 billion in cash from investing activities (boosted by a large sale of investments), and spent about $8.6 billion in cash through its financing activities (attributed mostly to large treasury stock purchases and a hefty dividend payment to its shareholders). These activities account for the $2.6 billion cash increase reported earlier.

The Statement of Shareholders' Equity

The statement of shareholders' equity, illustrated for Harbour Island in Figure 2–11, explains the changes in the shareholders' equity accounts over a period. It represents a summary of the activity in the accounts that keep track of the shareholders' investment in the company. The

Harbour Island Company
Statement of Shareholders' Equity
For Year Ended December 31, 2016

	Common Stock	Retained Earnings	Treasury Stock	Total
December 31, 2015	$6,800	$ 500	(250)	$ 7,050
Net income		1,085		1,085
Less: Dividends		(200)		(200)
Issuance of equity	3,100			3,100
Purchased treasury stock			(100)	(100)
December 31, 2016	$9,900	$1,385	(350)	$10,935

FIGURE 2–11

shareholders' investment increases when capital is collected from the sale (issuance) of equity securities (contributed capital) and when profits, which belong to the shareholders, are reinvested in the business (retained earnings). Dividends paid to the shareholders and treasury stock purchases from the shareholders reduce their investment in the company. The beginning dollar balances, which come from the December 31, 2015, balance sheet, are adjusted for the activity during 2016 leading to the ending dollar balances, which appear on the December 31, 2016, balance sheet. During 2016, Harbour Island collected $3,100 from common stock issuances, recorded net income of $1,085, paid dividends of $200, and purchased $100 in treasury stock.

During 2014, the investment in Boeing by its shareholders decreased from almost $15 billion to less than $9 billion. The two major reasons for the decrease were a large dividend and a very large treasury stock purchase.

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 4

Match the four financial statements with the descriptions below.

Balance sheet; Income statement; Statement of cash flows; Statement of shareholders' equity

1. This statement provides a measure of the company's performance by indicating the extent to which it can sell its good and services for prices that exceed the costs of providing them.
2. This statement keeps track of changes in the investments made by the company's owners in the company.
3. This statement distinguishes the core activities of a business from activities that are either unusual or infrequent.
4. This statement lists the resources that management can use to generate revenues and how these resources have been financed.
5. This statement distinguishes current obligations from obligations requiring payment farther into the future.
6. This statement is divided into three categories based on the company's operating, investing, and financing activities.
7. This statement shows what portion of the profits in a given year have been retained in the business and not paid to the shareholders in the form of dividends.
8. This statement explains the change in a company's cash balance during a given year.

SOLUTION

1. Income statement
2. Statement of shareholders' equity
3. Income statement
4. Balance sheet
5. Balance sheet
6. Statement of cash flows
7. Statement of shareholders' equity
8. Statement of cash flows

LEARNING OBJECTIVE 5

Discuss how the financial statements can be viewed as a package and use the package to assess five fundamental metrics of a company's performance.

Financial Statements As a Package and Five Fundamental Performance Metrics

Figure 2–12 presents a general overview of the four financial accounting statements for Harbour Island Company with a special emphasis on how they relate to one another and form a package for financial analysis. Take some time to study it.

Note the four statements: a balance sheet at the end of 2015 (left side), statements of cash flow, income, and shareholders' equity covering 2016 (middle), and a balance sheet at the end of 2016 (right side). See Figures 2–8 through 2–11 for the details of 2016 statements. This format illustrates how the three statements in the middle (cash flows, income, and shareholders' equity) explain how the balance sheet at the beginning of 2016 became the balance sheet at the end of 2016; that is, how Harbour Island's financial condition at the beginning of 2016 became its financial condition at the end of 2016, explained in terms of cash management, operating performance, and shareholder investments in the company.

The statement of cash flows explains the activity during the year in the company's cash account. At the beginning of 2016, the balance in the cash account was $100. During the year, management engaged in operating, investing, and financing transactions that affected the cash balance, and the end result was $220. The statement of cash flows explains how the $100 cash balance on the 2015 balance sheet grew to the $220 cash balance on the 2016 balance sheet.

> ? In its 2014 annual report, Zimmer Holdings, Inc., a well-known medical parts manufacturer, reported cash provided by operating activities of over $1.0 billion, cash used by investing activities of $469.4 million, and cash used for financing activities of $562.4 million. Describe some of the transactions that led to each of these three cash flow numbers.

The statement of shareholders' equity, like the statement of cash flows, also explains the activity in balance sheet accounts during 2016. In this case the accounts are common stock, retained earnings, and treasury stock, which appear in the shareholders' equity section of each balance sheet. During the year, transactions with the shareholders concerning their investment in Harbour Island explain the changes in these accounts from the beginning to the ending balance sheets. Note also that the $3,100 equity issuance, the $200 dividend, and the $100 treasury stock purchase all involve cash and, therefore, appear not only in the statement of shareholders' equity but also in the financing section of the statement of cash flows.

> ? Johnson & Johnson consistently pays significant dividends to its shareholders—normally on the order of 30 to 40 percent of net income. How would this be reported on the financial statements, and what portion of earnings is normally reinvested in the business?

FIGURE 2–12 A financial statement package for Harbour Island Company

Balance Sheet
12/31/15

Assets	
Cash	**$ 100**
Other current assets	1,300
Long-term investments	3,500
Long-lived assets	10,500
Total	$15,400
Liabilities and shareholders' equity	
Current liabilities	$ 900
Long-term liabilities	7,450
Common stock	**6,800**
Retained earnings	**500**
Treasury stock	**(250)**
Total	$15,400

Statement of Cash Flows
For Year Ended 12/31/16

Net cash from operating activities	$1,470
Net cash used by investing activities	(4,100)
Net cash from financing activities	2,750
Increase in cash	120
Beginning cash (1/1/16)	**100**
Ending cash (12/31/16)	**$ 220**

Income Statement
For Year Ended 12/31/16

Operating revenues	$5,400
Operating expenses	(3,895)
Net nonoperating revenues and expenses	(20)
Net income before tax	1,485
Income tax expense	(400)
Net income	**$1,085**

Balance Sheet
12/31/16

Assets	
Cash	**$ 220**
Other current assets	1,195
Long-term investments	4,000
Long-lived assets	13,200
Total	$18,615
Liabilities and shareholders' equity	
Current liabilities	$ 740
Long-term liabilities	6,940
Common stock	**9,900**
Retained earnings	**1,385**
Treasury stock	**(350)**
Total	$18,615

Statement of Shareholders' Equity
For Year Ended 12/31/16

	Common Stock	Retained Earnings	Treasury Stock	Total
Beginning balance (1/1/16)	**$6,800**	**$ 500**	**$(250)**	**$ 7,050**
Net income		**1,085**		**1,085**
Less: Dividends		(200)		(200)
Issuance of equity	3,100			3,100
Purchase of treasury stock			(100)	(100)
Ending balance (12/31/16)	**$9,900**	**$1,385**	**$(350)**	**$10,935**

December 31, 2015 → December 31, 2016

The income statement contains revenues and expenses, leading to the $1,085 net income, which is also reflected in the statement of shareholders' equity because it belongs to the shareholders and, therefore, increases their investment in the company. The $200 dividend, a withdrawal by the shareholders, decreases the shareholder investment, and the difference between the $1,085 net income and the $200 dividend represents the $885 increase in the retained earnings account; the final retained earnings balance ($1,385) appears on the 2016 balance sheet.

After three years as a well-known, publicly traded company, Amazon.com reported a deficit in retained earnings of over $800 million. Explain how this could have occurred.

The major point here is that all four financial statements are interrelated. Transactions entered into by a company always affect at least two of the statements and sometimes all four. Understanding these interrelationships will really help you as we move forward in this textbook.

Under IFRS, the requirement for a complete set of financial statements (balance sheet, income statement, statement of cash flows, and statement of shareholders' equity) is very similar to that under U.S. GAAP.

Using the Financial Statement Package to Compute Five Fundamental Metrics of Performance

Financial statements analysis involves using the financial statements to assess a company's financial performance. Such analysis can be quite extensive and we tackle it in more detail in Chapter 5. In the meantime, however, we introduce financial analysis in this section by using the financial statement package in Figure 2–12 to address five fundamental and important questions about Harbour Island's financial performance.

1. How profitable was Harbour Island?

Companies must be profitable to succeed. They must be able to consistently sell their goods and services at prices that exceed the costs of providing them. Revenues must consistently exceed expenses, providing profits for the shareholders. Harbour Island's income statement, which shows net income of $1,085, indicates that it was profitable in 2016, and the retained earnings balances on the two balance sheets and statement of shareholder' equity indicate that Harbour Island's past profits have served as a source of financing its investment in assets.

2. How large an investment in assets was required to make those profits?

Successful companies not only make profits, but they do so without requiring too large an investment in assets. Making $1 of profit on an asset investment of $1,000 is not nearly as desirable as making $1 of profit on an asset investment of $10. Assets have to be financed at a cost, and efficient companies manage their assets to produce as much profit as possible.

At the beginning of 2016, Harbour Island's balance sheet indicates that the company had invested $15,400 in its assets, which grew during 2016 to $18,615. Consequently, on average, Harbour Island carried an asset investment of $17,008 [($15,400 + $18,615)/2] during the year. This asset investment was managed to earn $1,085 in profit, leading to a return on assets of 6.4 percent ($1,085/$17,008) for 2016.

3. Where did the assets come from, or how were they financed?

Asset investments must be paid for, and there are two basic ways to pay for them: money borrowed from creditors (debt) or investments made by the shareholders (equity). At the beginning of 2016, Harbour Island's balance sheet indicates that 54.2 percent of its assets were financed with debt or liabilities [($900 + $7,450)/$15,400], which means that 45.8 percent of the assets [($6,800 + $500 − 250)/$15,400] must have been financed with equity (shareholder investments). By the end of 2016, the reliance on debt as a source of financing the assets decreased to 41.3 percent [($740 + $6,940)/$18,615], and the reliance on equity increased to 58.7 percent [($9,900 + $1,385 − $350)/$18,615]. Note that the primary reasons for the shift in favor of equity as a source of financing was the $3,100 equity issuance, followed by $885 ($1,085 − $200) of reinvested profits, both of which are forms of equity financing.

4. How much cash did Harbour Island generate through its operating activities and how was it managed?

Harbour Island's statement of cash flows shows that during 2016 the company generated a net amount of $1,470 in cash from the sale of its good and services. It also raised a net amount of $2,750 from its financing activities—the $3,100 equity plus $350 from short-term debt less payments to reduce debt ($400), pay dividends ($200), and purchase treasury stock ($100). Most of this cash was used to invest in property ($4,100), leading to a $120 increase in the company's cash balance.

5. What happened to the investment made by the shareholders and how large a return was generated for the shareholders on that investment?

The statement of shareholders' equity tells us that the investment made by Harbour Island's shareholders increased from $7,050 at the end of 2015 to $10,935 at the end of 2016. The equity issuance ($3,100) and net income ($1,085) increased this investment, while the dividends ($200) and treasury stock purchase ($100) decreased it. Consequently, on average, the shareholders carried an investment in the company of $8,993 [($7,050 + $10,935)/2] during the year. The $1,085 net income amount, which belongs to the shareholders, creates a return on the shareholders' investment (return on equity) of 12.1 percent ($1,085/$8,993) for 2016.

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 5

A. Choose the best response.

1. Which financial statements are immediately affected when a company completes a service for a customer and at that time receives cash payment?

a. The income statement only
b. The balance sheet only
c. The income statement, balance sheet, and statement of cash flows
d. All four financial statements

2. Which financial statements are immediately affected when a company pays off a loan to the bank?

a. The income statement and the balance sheet
b. The income statement, balance sheet, and statement of shareholders' equity
c. The balance sheet and statement of cash flows
d. All four financial statements

3. Which financial statements are immediately affected when a company issues stock and receives cash from the shareholders?

a. The income statement and the balance sheet
b. The income statement, balance sheet, and statement of cash flows

c. The balance sheet, statement of cash flows, and statement of shareholders' equity
d. All four financial statements

B. The following information was taken from the 2014 financial statements of Alphabet, the holding company that contains Google (dollars in billions). Use this information to answer the five fundamental questions of financial analysis.

	2014	2013
Income statement:		
Net income	$ 2,692	
Balance sheet:		
Total assets	131,133	$110,920
Total shareholders' equity	105,500	87,309
Statement of cash flows:		
Net cash from operating activities	16,619	
Net cash from investing activities	(13,056)	
Net cash from financing activities	1,229	
Statement of shareholders' equity		
Issuance of common stock	465	
Dividends	0	

SOLUTION

A.

1. d. All four financial statements. When a company completes a service for a customer, it recognizes revenue, which is reflected on the income statement. This affects net income, which increases the investment made by the shareholders, is recorded on the statement of shareholders' equity and increases retained earnings, and is reflected on the balance sheet. The cash receipt affects both the balance sheet cash account and increases cash from operating activities on the statement of cash flows.

2. c. The balance sheet and statement of cash flows. When a company uses cash to pay off a loan, the cash balance and a liability on the balance sheet are decreased. Cash flows from financing activities on the statement of cash flows are also decreased.

3. c. The balance sheet, statement of cash flows, and statement of shareholders' equity. When cash is received from an equity issuance, the cash balance and the common stock account on the balance sheet are increased. The equity issuance is also an increase in the shareholders' investment, reflected on the statement of shareholders' equity, and an increase to cash from financing activities on the statement of cash flows.

B.

1. Alphabet generated net income or profits during 2014 of $2,692.

2. The return on assets for 2014 was 2.2 percent [$2,692/($131,133 + $110,920)/2].

3. As of 2013, 78.7 percent ($87,309/$110,920) of the assets were financed by equity, growing to 80.5 percent ($105,500/$131,133) as of the end of 2014.

4. An amount of $16,619 in cash was generated through Alphabet's operating activities, which more than covered Alphabet's investment in producing assets ($13,056). It also increased its cash balance by collecting a net of $1,229 from its capital providers, increasing its ending cash balance by almost $5 trillion.

5. The return during 2014 to Alphabet's shareholders on their investment was 2.8 percent [$2,692/($105,500 + $87,309)/2].

APPENDIX 2A

Organizational Form and the Equity Section

LEARNING OBJECTIVE 6

Discuss forms of business organizations.

A business entity in the United States can be legally organized in either of two basic ways: as a corporation or as a partnership (called a *proprietorship* if there is only one owner).[3] A **corporation** is a legal entity that is separate and distinct from its owners. It can be taxed or sued, and the owners, called *shareholders* or *stockholders*, are legally liable only for the amount of their original contributions to the corporation. Shareholders acquire ownership interests by purchasing shares of stock in the corporation. Their interests give them the right to vote for its board of directors at annual shareholders' meetings as well as the right to corporate profits, which can be withdrawn in the form of dividends. Both rights are based on their percent of ownership, and normally the board of directors decides on dividends, which are distributed on a pro-rata (per-share) basis.

A **partnership** or **proprietorship**, on the other hand, is not a legal entity. It can neither be taxed nor sued, and the legal liability of the owners, called *partners* or *proprietors*, is not limited to their original contributions. Asset distributions to partners are called *withdrawals*.

The differences between corporations and partnerships are reflected in differences in the equity sections of their balance sheets. The shareholders' equity section of a corporate balance sheet, as illustrated on the Harbour Island balance sheet, draws a distinction between contributed capital, the measure of the assets directly contributed by the shareholders, and retained earnings, the assets generated through the company's operating activities and not returned to shareholders in the form of dividends.

On the other hand, the equity section on a partnership's balance sheet, called **owners' equity**, makes no distinction between contributed capital and retained earnings. Instead, it consists of separate accounts for each partner, showing the status of each partner's personal capital balance, reflecting all contributions less withdrawals. The chart that follows illustrates the differences between the shareholders' equity section of a corporation and the owners' equity section of a partnership with two partners. Throughout the remainder of the text, the discussion and illustrations assume the corporate form of organization.

Corporation		Partnership	
Shareholders' equity:		Owners' equity:	
Common stock	$20,000	Capital account, Ms. A	$12,000
Retained earnings	14,000	Capital account, Mr. B	22,000
Total shareholders' equity	$34,000	Total owners' equity	$34,000

? The Boeing Company and almost all major U.S. companies are corporations.

[3] Other business forms exist that have characteristics of both partnerships and corporations. Examples include subchapter S corporations and limited liability corporations.

Review

REVIEW PROBLEM

The following information was taken from the annual report of Bed Bath & Beyond. All dollar values are in thousands. Analyze each of the four financial statements and assess the five fundamental metrics of financial performance.

Consolidated Statements of Earnings
Bed Bath & Beyond Inc. and Subsidiaries

	FISCAL YEAR ENDED		
(in thousands, except per share data)	**February 28, 2015**	**March 1, 2014**	**March 2, 2013**
Net sales	**$11,881,176**	$11,503,963	$10,914,585
Cost of sales	**7,261,397**	6,938,381	6,525,830
Gross profit	**4,619,779**	4,565,582	4,388,755
Selling, general, and administrative expenses	**3,065,486**	2,950,995	2,750,537
Operating profit	**1,554,293**	1,614,587	1,638,218
Interest income, net	**50,458**	1,140	4,159
Earnings before provision for income taxes	**1,503,835**	1,613,447	1,634,059
Provision for income taxes	**546,361**	591,157	596,271
Net earnings	**$ 957,474**	$ 1,022,290	$ 1,037,788
Net earnings per share—Basic	**$ 5.13**	$ 4.85	$ 4.62
Net earnings per share—Diluted	**$ 5.07**	$ 4.79	$ 4.56
Weighted average shares outstanding—Basic	**186,659**	210,710	224,623
Weighted average shares outstanding—Diluted	**188,880**	213,363	227,723

	February 28, 2015	**March 1, 2014**
Assets		
Current assets:		
Cash and cash equivalents	**$ 875,574**	$ 366,516
Short-term investment securities	**109,992**	489,331
Merchandise inventories	**2,731,881**	2,578,956
Other current assets	**366,156**	354,184
Total current assets	**4,083,603**	3,788,987
Long-term investment securities	**97,160**	87,393
Property and equipment, net	**1,676,700**	1,579,804
Goodwill	**486,279**	486,279
Other assets	**415,251**	413,570
Total assets	**$ 6,758,993**	$ 6,356,033
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	**$ 1,156,368**	$ 1,104,668
Accrued expenses and other current liabilities	**403,547**	385,954

Continued

	February 28, 2015	March 1, 2014
Merchandise credit and gift card liabilities	**306,160**	284,216
Current income taxes payable	**76,606**	60,298
Total current liabilities	**1,942,681**	1,835,136
Deferred rent and other liabilities	**493,137**	486,996
Income taxes payable	**79,985**	92,614
Long-term debt	**1,500,000**	—
Total liabilities	**4,015,803**	2,414,746
Commitments and contingencies		
Shareholders' equity:		
Preferred stock—$0.01 par value; authorized—1,000 shares; no shares issued or outstanding	**—**	—
Common stock—$0.01 per value; authorized—900,000 shares; issued 336,667 and 334,941 shares, respectively; outstanding 174,178 and 205,405 shares, respectively	**3,367**	3,350
Additional paid-in capital	**1,796,692**	1,673,217
Retained earnings	**9,553,376**	8,595,902
Treasury stock, at cost	**(8,567,932)**	(6,317,335)
Accumulated other comprehensive loss	**(42,313)**	(13,847)
Total shareholder's equity	**2,743,190**	3,941,287
Total liabilities and shareholder's equity	**$ 6,758,993**	$ 6,356,033

See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Cash Flows

Bed Bath & Beyond Inc. and Subsidiaries

	FISCAL YEAR ENDED		
(in thousands)	February 28, 2015	March 1, 2014	March 2, 2013
Cash Flows from Operating Activities:			
Net earnings	**$ 957,474**	$ 1,022,290	$ 1,037,788
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	**239,193**	220,116	195,117
Stock-based compensation	**66,539**	56,244	47,163
Tax benefit from stock-based compensation	**6,686**	12,846	13,217
Deferred income taxes	**(22,295)**	11,729	17,567
Other	**(2,244)**	(1,784)	702
(Increase) decrease in assets, net of effect of acquisitions:			
Merchandise inventories	**(161,506)**	(117,926)	(200,197)
Trading investment securities	**(9,530)**	(11,382)	(6,206)
Other current assets	**19,012**	(5,287)	(43,703)
Other assets	**(254)**	(3,812)	(9,690)
Increase (decrease) in liabilities, net of effect of acquisitions:			
Accounts payable	**44,563**	179,522	105,434
Accrued expenses and other current liabilities	**18,494**	(1,336)	(22,167)
Merchandise credit and gift card liabilities	**22,520**	33,014	36,972

Continued

Consolidated Statements of Cash Flows (Continued)
Bed Bath & Beyond Inc. and Subsidiaries

	FISCAL YEAR ENDED		
(in thousands)	**February 28, 2015**	**March 1, 2014**	**March 2, 2013**
Income taxes payable	**3,768**	(4,406)	6,588
Deferred rent and other liabilities	**3,428**	3,735	17,640
Net cash provided by operating activities	**1,185,848**	1,393,563	1,196,225
Cash Flows from Investing Activities:			
Purchase of held-to-maturity investment securities	**(298,094)**	(1,156,634)	(730,976)
Redemption of held-to-maturity investment securities	**677,500**	1,117,500	1,031,249
Redemption of available-for-sale investment securities	**—**	—	31,715
Capital expenditures	**(330,637)**	(320,812)	(315,937)
Investment in unconsolidated joint venture	**—**	(3,436)	—
Payment for acquisitions, net of cash acquired	**—**	—	(643,098)
Payment for acquisition of trademarks	**—**	—	(40,000)
Net cash provided by (used in) investing activities	**48,769**	(363,382)	(667,047)
Cash Flows from Financing Activities:			
Proceeds from exercise of stock options	**41,197**	54,815	56,377
Proceeds from issuance of senior unsecured notes	**1,500,000**	—	—
Payment of deferred financing costs	**(10,092)**	—	—
Excess tax benefit from stock-based compensation	**7,202**	7,289	5,021
Payment for credit facility assumed in acquisition	**—**	—	(25,511)
Repurchase of common stock, including fees	**(2,250,597)**	(1,283,995)	(1,001,280)
Net cash used in financing activities	**(712,290)**	(1,221,891)	(965,393)
Effect of exchange rate changes on cash and cash equivalents	**(13,269)**	(6,745)	(1,980)
Net increase (decrease) in cash and cash equivalents	**509,058**	(198,455)	(438,195)
Cash and cash equivalents:			
Beginning of period	**366,516**	564,971	1,003,166
End of period	**$ 875,574**	$ 366,516	$ 564,971

SOLUTION

Bed Bath & Beyond's consolidated statement of earnings shows that the company was profitable in 2013, 2014, and 2015 on consistently growing revenues (net sales). Net earnings for 2015 ($957,474) represents about a 6 percent drop-off from 2014, suggesting that while revenues increased from 2014 to 2015, expenses increased by a greater amount.

The 2015 and 2014 consolidated balance sheets indicate that the company's investment in assets as of the end of these two years was $6,758,993 and $6,356,033, respectively, about 60 percent of which was represented by current assets, comprised primarily of merchandise inventory—not surprising for a retailer. The average investment in assets during 2015 was $6,557,513 [($6,758,993 + $6,356,033)/2], leading to a return on assets for the year of 14.6 percent ($957,474/$6,557,513).

The balance sheets indicate that total liabilities as a percent of total assets rose from 38 percent ($2,414,746/$6,356.033) as of the end of 2014 to over 59 percent ($4,015,803/$6,758,993) at the end of 2015. This big jump in the reliance on debt as a source of asset financing was due primarily to the addition of $1,500,000 in long-term debt during 2015, which appears on both the 2015 balance sheet and the financing section of the consolidated statement of cash flows.

Consolidated Statements of Shareholders' Equity

Bed Bath & Beyond Inc. and Subsidiaries

(*in thousands*)	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Treasury Stock Shares	Treasury Stock Amount	Accumulated Other Comprehensive Loss	Total
Balance at February 25, 2012	330,576	$3,306	$1,417,337	$6,535,824	(95,061)	$(4,032,060)	$ (1,879)	$3,922,528
Net earnings				1,037,788				1,037,788
Other comprehensive loss							(2,441)	(2,441)
Shares sold under employee stock option plans, net of taxes	1,489	15	74,323					74,338
Issuance of restricted shares, net	626	6	(6)					—
Stock-based compensation expense, net			48,520					48,520
Director fees paid in stock	5		277					277
Repurchase of common stock, including fees					(16,146)	(1,001,280)		(1,001,280)
Balance at March 2, 2013	332,696	3,327	1,540,451	7,573,612	(111,207)	(5,033,340)	(4,320)	4,079,730
Net earnings				1,022,290				1,022,290
Other comprehensive loss							(9,527)	(9,527)
Shares sold under employee stock option plans, net of taxes	1,375	14	74,766					74,780
Issuance of restricted shares, net	868	9	(9)					—
Stock-based compensation expense, net			57,842					57,842
Director fees paid in stock	2		167					167
Repurchase of common stock, including fees					(18,329)	(1,283,995)		(1,283,995)
Balance at March 1, 2014	334,941	3,350	1,673,217	8,595,902	(129,536)	(6,317,335)	(13,847)	3,941,287
Net earnings				957,474				957,474
Other comprehensive loss							(28,466)	(28,466)
Shares sold under employee stock option plans, net of taxes	1,033	10	54,907					54,917
Issuance of restricted shares, net	691	7	(7)					—
Stock-based compensation expense, net			68,408					68,408
Director fees paid in stock	2		167					167
Repurchase of common stock, including fees					(32,953)	(2,250,597)		(2,250,597)
Balance at February 28, 2015	**336,667**	**$3,367**	**$1,796,692**	**$9,553,376**	**(162,489)**	**$(8,567,932)**	**$(42,313)**	**$2,743,190**

The statement of cash flows also shows that Bed Bath & Beyond has consistently generated net cash from its operating activities, providing some $3.8 billion over the past three years (2015, 2014, and 2013). A little less than $1 billion of that cash was used to invest in capital expenditures (new stores) and acquisitions of other companies over the three-year period, and during that same time period financing activities used up about $2.9 billion. Interestingly, over the three-year period the company bought back over $4.5 billion in treasury stock, and during 2015 a large portion of the $2.25 billion repurchase of common stock (treasury stock purchase) was financed with the $1.5 billion long-term debt (senior unsecured notes).

Finally, the consolidated statement of shareholders' equity shows that during 2015 the investment made in Bed Bath & Beyond by its shareholders decreased from $3,941,287 to $2,250,597. The company's 2015 net earnings increased this investment by $957,474 and Bed Bath & Beyond paid no dividends, but the $2.25 billion treasury stock purchase during the year more than made up for those increases. On average, the shareholder investment during 2015 was $3,342,239 [($3,941,287 + $2,743,190)/2], leading to a return on the shareholders' investment (return on equity) of 28.6 percent ($957,474/$3,342,239).

REVIEW OF LEARNING OBJECTIVES

LO1. Describe the balance sheet in terms of equity and debt capital and producing and operating assets. The balance sheet is a "photo" of the financial condition of a company at a specific point in time. It lists the resources available to the company, called assets, which can be managed to generate revenues and ultimately profits in the future for the shareholders. The assets are divided into two groups based on the time period over which they are expected to generate revenues. Operating assets are expected to generate revenues within the current period, while producing assets are expected to generate revenues beyond the current period. The balance sheet also lists how these assets were financed or paid for—by either equity or debt. The shareholders' equity section reflects investments made by the shareholders to finance the assets, while the debts (or liabilities) represent asset financing provided by creditors.

LO2. Explain the concept of net income, who owns it and what they can do with it. Net income, which is computed on the income statement by subtracting expenses from revenues, represents the extent to which a company's managers are able to sell goods and services to customers and clients for prices that exceed the costs of providing them. It is critical to a company's success because it is the only way that managers can create value for the shareholders, who have a legal right to the net income or profits. The shareholders can choose to either leave the profits in the company, thereby increasing their investment in the company, or withdraw assets (usually cash) up to the amount of the profits in the form of dividends. For most well-known companies this choice is made by the board of directors on behalf of the shareholders.

LO3. Define the three major activities of a business. Businesses must first attract capital and then invest it in producing assets that can be used to produce goods and/or services sold to customers and clients. The three basic activities involved in conducting a business are (1) financing activities, (2) investing activities, and (3) operating activities. Financing activities involve the collection of capital through equity or debt issuances and any associated payments, such as dividends, treasury stock purchases, and debt principle payments. Investing activities involve the acquisition and sale of producing assets, which are used to produce and support the goods and services provided. These assets are expected to help generate revenues beyond the current period. Operating activities involve the sale of goods and services.

LO4. Describe the four financial statements in greater detail. The asset accounts reported on the balance sheet are listed in order of liquidity and are divided into four categories: (1) current assets, which include cash, short-term investments, accounts receivable, inventory, and prepaid expenses; (2) long-term investments, which include long-term notes receivable, land, securities, the cash value of life insurance, and special investment funds; (3) property, plant, and equipment; and (4) intangible assets, which include patents, trademarks, and other intangibles, such as goodwill.

Liabilities are divided into two categories: (1) current liabilities, which primarily include short-term payables; and (2) long-term liabilities, which include items such as long-term notes, bonds, and mortgages