FINANCIAL REPORTING AND ANALYSIS

Seventh Edition

Revsine
Collins
Johnson
Mittelstaedt
Soffer

McGraw Hill Education

FINANCIAL REPORTING & ANALYSIS

7th EDITION

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Late of Northwestern University

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The authors dedicate this work to:

Daniel W. Collins—Melissa, Theresa, Ann, and my late wife, Mary

W. Bruce Johnson—Diane and Cory

H. Fred Mittelstaedt—Laura and Grace

Leonard C. Soffer—Robin, Michael & Rachelli, Andy, Leah, and Amiel

About the Authors

Lawrence Revsine

At the time of his passing in 2007, Lawrence Revsine was the *John and Norma Darling Distinguished Professor of Financial Accounting,* Kellogg Graduate School of Management, Northwestern University. A graduate of Northwestern University, he joined its accounting faculty in 1971.

Larry was a leading authority on various financial reporting issues and published more than 50 articles in top academic journals. He was a consultant to the American Institute of Certified Public Accountants, the Securities and Exchange Commission, and the Financial Accounting Standards Board and served on the Financial Accounting Standards Advisory Council. He was also a consultant to industry on external reporting issues and regulatory cases and taught extensively in management development and continuing education programs in the United States and abroad.

Larry was a master at making accounting come alive in the classroom. He had an uncommon knack for creating a sense of mystery and excitement about seemingly mundane accounting topics. Each class had a clear message that Larry delivered with great energy and enthusiasm. And each class was sprinkled with anecdotes conveyed with an element of wit that only Larry could pull off. It was his deep understanding of the subject matter and his dynamic delivery that endeared him to so many Kellogg students over the years. Among the many awards he received for teaching excellence are: the American Accounting Association's Outstanding Educator Award; the Illinois CPA Society's Outstanding Educator Award; the Sidney J. Levy Teaching Award, presented by the Kellogg Dean's Office; and the 1995 Reunion Class Alumni Choice Faculty Award, given to the Kellogg faculty member who has had the greatest impact on the professional and personal lives of Kellogg alums.

Larry was passionate about changing the way financial accounting is taught, and he was the driving force behind this book. As you read this book, listen carefully and you will hear his voice echo from every page.

Daniel W. Collins

Henry B. Tippie Research Chair in Accounting, Tippie College of Business, The University of Iowa; BBA 1968, Ph.D. 1973, The University of Iowa

Professor Collins was the recipient of the University of Iowa Board of Regents Award for Faculty Excellence in 2000 and the American Accounting Association (AAA) Outstanding Educator Award in 2001. In 2016, Professor Collins received the Distinguished PhD Mentoring Award from the Financial Accounting and Reporting section of the AAA. His research focuses on the role of accounting numbers in equity valuation, earnings management, and the relation between firms' corporate governance mechanisms and cost of equity and debt financing. A frequent contributor to the top academic accounting journals, he has been recognized as one of the top 10 most highly cited authors in the accounting literature over the past 20 years.

Professor Collins has served on the editorial review boards of the *Journal of Accounting Research* and the *Journal of Accounting and Economics.* He has also served as associate editor of *The Accounting Review* and as director of publications for the AAA. Professor Collins has served on numerous AAA committees, including the Financial Accounting Standards Committee, and has chaired the Publications Committee, the National Program Committee, and the Doctoral Consortium Committee. He also served on the Financial Accounting Standards Advisory Council.

A member of the American Accounting Association, Professor Collins is a frequent presenter at research colloquia, conferences, and doctoral consortia in the United States, Australia, and Europe. He has also received outstanding teaching awards at both Michigan State University and The University of Iowa.

W. Bruce Johnson

Sidney G. Winter Professor of Accounting, Tippie College of Business, The University of Iowa; BS 1970, University of Oregon, MS 1973, Ph.D. 1975, The Ohio State University

W. Bruce Johnson joined the University of Iowa faculty in 1988 and has served as director of its McGladrey Institute for Accounting Education and Research, accounting group chairman, and associate dean for graduate programs. In the latter position, he was responsible for Iowa's MBA and Executive MBA programs.

Professor Johnson previously held faculty appointments at the University of Wisconsin, Northwestern University, the University of Chicago, and the China European International Business School (CEIBS).

His teaching and research interests include corporate financial reporting, financial analysis, value-driven management systems and investment strategies, executive compensation practices, and forensic accounting. He received the Gilbert P. Maynard Award for Excellence in Accounting Instruction and the Chester A. Phillips Outstanding Professor Award.

A well-respected author, Professor Johnson's articles have appeared in numerous scholarly publications and in academic and professional journals. He has served on the editorial boards of several academic journals and as a litigation consultant on financial reporting matters. He is a former member of the Financial Reporting Executive Committee (FinREC) of the American Institute of Certified Public Accountants and past president of the Financial Reporting and Accounting Section (FARS) of the American Accounting Association (AAA). He has also served as a research consultant to the Financial Accounting Standards Board and on the Research Advisory, Professional Practice Quality, and Outstanding Educator committees of the AAA. He is a member of the AAA and Financial Executives International. He was formerly senior vice president for Equity Strategy at SCI Capital Management, a money management firm.

H. Fred Mittelstaedt

Deloitte Foundation Professor of Accountancy, Mendoza College of Business, University of Notre Dame; BS 1979, MS 1982, Illinois State University, Ph.D. 1987, University of Illinois at Urbana

Fred Mittelstaedt joined the University of Notre Dame faculty in 1992. He has served as the Department of Accountancy chairman since 2007. Prior to coming to Notre Dame, he held a faculty appointment at Arizona State University.

Professor Mittelstaedt has taught financial reporting courses to undergraduates, masters in accountancy students, MBAs, and Executive MBAs. While at Notre Dame, he has received

the Kaneb Undergraduate Teaching Award and the Arnie Ludwig Executive MBA Outstanding Teacher Award.

His research focuses on financial reporting and retirement benefit issues and has been published in the *Journal of Accounting and Economics, The Accounting Review, Review of Accounting Studies,* the *Journal of Pension Economics and Finance,* and several other accounting and finance journals. He is a reviewer for numerous academic journals and has served on the Editorial Advisory and Review Board for *The Accounting Review.* In addition, he has testified on retiree health benefit issues before the U.S. House of Representatives Committee on Education and the Workforce.

Professor Mittelstaedt is a past president of the Federation of Schools of Accountancy (FSA), and he received the FSA 2016 Joseph A. Silvoso Award for his contributions to accounting education. He is a member of the American Accounting Association and the American Institute of Certified Public Accountants. Prior to joining academia, he was an auditor with Price Waterhouse & Co. and received an Elijah Watt Sells Award for exceptional performance on the Uniform CPA Exam.

Leonard C. Soffer

Clinical Professor of Accounting, Booth School of Business, The University of Chicago; BS 1977, University of Illinois at Urbana, MBA 1981, Kellogg School of Management, Northwestern University, Ph.D. 1991, University of California at Berkeley.

Leonard Soffer rejoined the faculty of the University of Chicago in 2007. He was previously an Associate Professor of Accounting and Associate Dean of the Honors College at the University of Illinois at Chicago, where he was named the Accounting Professor of the Year. He also has served on the faculty of Northwestern University's Kellogg School of Management.

Professor Soffer has taught financial reporting, managerial accounting, and corporate valuation courses to both MBAs and Executive MBAs. He previously taught the consolidations and foreign currency translation modules of a nationally recognized CPA review course. He also teaches a financial reporting course to executive education students.

Professor Soffer's research focuses on the use of accounting information and analyst reports, particularly in the context of corporate valuation. His research has been published in *The Journal of Accounting Research, The Review of Accounting Studies, Contemporary Accounting Research, Accounting Horizons, Managerial Finance,* and *The Review of Accounting and Finance*. He is a co-author of the book *Financial Statement Analysis: A Valuation Approach.*

Professor Soffer is a member of the American Accounting Association, The American Institute of Certified Public Accountants, and the Illinois CPA Society. He served for 12 years on the Accounting Principles Committee of the Illinois CPA Society, and chaired or co-chaired the committee for three years. Before entering academia, Professor Soffer worked in accounting and finance positions, most recently in the Mergers and Acquisitions group of USG Corporation. He was a winner of the prestigious Elijah Watt Sells Award for his performance on the Uniform CPA Exam.

Preface

One of our objectives in writing this book is to help students become skilled preparers and informed consumers of financial statement information. The financial reporting environment today is particularly challenging. Accountants, auditors, and financial analysts must not only know the reporting practices that apply in the United States (U.S. GAAP), they must also be aware of the practices allowed in other countries under International Financial Reporting Standards (IFRS). We believe it is essential for students to comprehend the key similarities and differences between current U.S. GAAP and IFRS.

The challenge is compounded by two major changes in accounting standards—for leasing and revenue recognition. The new leasing standard is a break from recent convergence efforts by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). While the FASB preserved the notion of a dual model for leases, albeit with major changes to one of the models, the IASB moved to a single model. As a result, for some companies, financial statements will look substantially different under U.S. GAAP than they would under IFRS. The new revenue recognition standard, in contrast, is substantially converged, but it will still challenge students and faculty alike to consider the question of when to recognize revenue under a completely different framework than they have in the past. We discuss both of these new standards in depth in the Seventh edition.

Our other objective in writing this book is to change the way the second-level course in financial accounting is taught, both to graduate and undergraduate students. Typically this course—often called Intermediate Accounting or Corporate Financial Reporting—focuses on the details of GAAP with little emphasis placed on understanding the economics of business transactions or how financial statement readers use the resultant numbers for decision making. Traditional accounting texts are encyclopedic in nature and approach, lack a unifying theme, and emphasize the myriad of intricate accounting rules and procedures that could soon become outdated by new standards.

In contrast, we wrote *Financial Reporting & Analysis,* Seventh Edition, to foster a "critical thinking" approach to learning the subject matter. Our approach develops students' understanding of the environment in which financial reporting choices are made, what the options are, how accounting information is used for various types of decisions, and how to avoid misusing financial statement data. We convey the exciting nature of financial reporting in two stages. First, we provide a framework for understanding management's accounting choices, the effect those choices have on the reported numbers, and how financial statement information is used in valuation and contracting. Business contracts, such as loan agreements and management compensation agreements, are often linked to accounting numbers. We show how this practice creates incentives for managers to exploit the flexibility in financial reporting standards to "manage" the reported accounting numbers to benefit themselves or shareholders. Second, we integrate current real-world financial statements and events into our discussions to illustrate vividly how financial statements affect contracts and reveal the financial health of a firm. To prepare students for future business and accounting challenges, we focus on fundamental measurement and reporting issues surrounding business transactions.

An important feature of our approach is that it integrates the perspectives of accounting, corporate finance, economics, and critical analysis to help students grasp how business transactions get reported and understand the decision implications of financial statement numbers. We cover all of the core topics of intermediate accounting as well as several topics often found in

advanced accounting courses, such as consolidations, joint venture accounting, and foreign currency translation. For each topic, we describe the underlying business transaction, the GAAP guidelines that apply, how the guidelines are implemented in practice, and how the financial statements are affected. We then go a step further and ask: What do the reported numbers mean? Does the accounting process yield numbers that faithfully present the underlying economic situation of a company? And, if not, what can financial statement users do to overcome this limitation in order to make more informed decisions? A Global Vantage Point discussion then summarizes the key similarities and differences between U.S. GAAP and IFRS, and previews potential changes to both.

Our book is ideal for professionals who use financial statements for making decisions. Our definition of financial statement "users" is broad and includes lenders, equity analysts, investment bankers, boards of directors, and others charged with monitoring corporate performance and the behavior of management. As such, it includes auditors who establish audit scope and conduct analytical review procedures to spot problem areas in external financial statements. To be effective, auditors must understand the incentives of managers, how the flexibility of U.S. GAAP and IFRS accounting guidance can be exploited to conceal rather than reveal underlying economics, and the potential danger signals that should be investigated. Our intent is to help financial statement readers learn how to perform better audits, improve cash flow forecasts, undertake realistic valuations, conduct better comparative analyses, and make more informed evaluations of management.

Financial Reporting & Analysis, Seventh Edition, provides instructors with a teaching/learning approach for achieving goals stressed by professional accountants and analysts. Our book is designed to instill capacities for thinking in an abstract, logical manner; solving unstructured problems; understanding the determining forces behind management accounting choices; and instilling an integrated, cross-disciplinary view of financial reporting. Text discussions are written, and exercises, problems, and cases are carefully chosen, to help achieve these objectives without sacrificing technical underpinnings. Throughout the book, we explain in detail the source of the numbers, the measurement methods used, and how transactions are recorded and presented. We have strived to provide a comprehensive user-oriented focus while simultaneously helping students build a strong technical foundation.

Key Changes in the Seventh Edition

The first six editions of our book have been widely adopted in business schools throughout the United States, Canada, Europe, and the Pacific Rim. Our book has been used successfully at both the graduate and undergraduate levels, and in investment banking, commercial lending, and other corporate training programs. Many of our colleagues who used the first six editions have provided us with valuable feedback. Based on their input, we have made a number of changes in this edition of the book to achieve more effectively the objectives outlined above.

Key changes include the following:

- Complete rewrite of Chapter 3 for the new revenue recognition standard.
- Complete rewrite of Chapter 12 for the new leasing standard.
- Expanded coverage of analysis and income taxes throughout the text.
- New end-of-book appendix on Segment Reporting.
- New or updated company examples throughout the book.
- New and revised end-of-chapter materials including exercises, problems, and cases tied to Global Vantage Point sections and new FASB and IASB standards.
- Updated Global Vantage Point sections
  - Identify key differences between U.S. GAAP and IFRS.
  - Discuss financial statement excerpts of companies that follow IFRS.
  - Summarize proposed new accounting standards issued by the FASB and/or the IASB.
- Incorporation of all FASB and IASB standards, exposure drafts, and discussion papers released through August 2016.

Chapter Revision Highlights

Chapter 1: The Economic and Institutional Setting for Financial Reporting

- Streamlined discussion of Why Financial Statements Are Important and Incentive Conflicts and Financial Reporting.
- Updated the Conceptual Framework discussion for the 2015 Proposed ASU on materiality.
- Updated the discussion on IFRS and differences between IFRS and U.S. GAAP.
- Updated the chapter appendix on U.S. GAAP for the Private Company Decision-Making Framework.

Chapter 2: Accrual Accounting and Income Determination

- Restructured the chapter to include all material on the income statement, except for revenue recognition.
- Updated to reflect the elimination of extraordinary item treatment of gains and losses under U.S. GAAP.
- Updated to reflect new requirements for discontinued operations treatment.
- Updated exhibits from company reports throughout the chapter.

Chapter 3: Revenue Recognition

- Completely new chapter discusses in depth the new revenue recognition standard and its 5-step model for determining when to recognize revenue.
- Discusses issues involved in the implementation of the new standard.
- Discusses expected financial statement effects of the new standard.
- All new end-of-chapter material tailored to the new standard.
- Because the existing revenue recognition standards will remain in effect through 2017, the chapter continues to include a discussion of existing revenue recognition standards.

Chapter 4: Structure of the Balance Sheet and Statement of Cash Flows

- Restructured chapters 4 and 17 to eliminate redundancies.
- Chapter 4 covers the structure of the cash flow statement and how it is derived. The cash flow effects of more complex transactions are deferred to chapter 17, after those transactions have been covered.
- The appendix previously appearing in chapter 17 is now in chapter 4. It describes how to use a spreadsheet to create a cash flow statement in a more compact format than a traditional t-account analysis.
- Updated exhibits from company reports throughout the chapter.

Chapter 5: Essentials of Financial Statement Analysis

- Updated the comprehensive Whole Foods financial analysis.
- Updated exhibits from company reports throughout the chapter.

Chapter 6: The Role of Financial Information in Valuation and Credit Risk Assessment

- Updated exhibits from company reports throughout the chapter.

Chapter 7: The Role of Financial Information in Contracting

- Updated exhibits from company reports throughout the chapter.

Chapter 8: Receivables

- Updated the Global Vantage Point section for recent work by the IASB and FASB on Financial Instruments.
- Updated chapter for *ASU 2014-09* (revenue recognition) and *ASU 2015-01* (extraordinary items).
- Streamlined receivable analysis discussion.
- Updated securitization and financial crisis discussion for lawsuit settlements and provided additional reference materials.
- Included Chesapeake Energy Corporation disclosures in the troubled debt restructuring section.

Chapter 9: Inventories

- Updated Lower of Cost or Market discussion for ASU 2015-11.
- New BlackBerry Limited illustration of inventory impairment.
- Revised primary LIFO example to be in an environment of rising prices.
- Moved discussion of absorption and variable costing into an appendix.
- Updated LIFO reserve and tax statistics.
- Updated illustrations throughout chapter.
- Updated Global Vantage Point section.

Chapter 10: Long-Lived Assets

- Updated and expanded Global Vantage Point section on the differences between U.S. GAAP and IFRS.
- New ExxonMobil interest capitalization illustration.
- Updated financial statement illustrations throughout chapter.
- New cases on capitalization of interest and asset impairment.
- New Disney purchase price allocation illustration.
- Added and updated new problems and cases.
- Updated web appendix on current value accounting for IFRS issues; available in Connect.

Chapter 11: Financial Instruments and Liabilities

- Updated chapter for *ASU 2015-01* (extraordinary items), *ASU 2015-03* (debt issue costs), *ASU 2016-01* (fair value option),and *IFRS 9* (fair value option and hedging).
- Streamlined coverage of debt-for-debt transactions.
- Removed discussion of off-balance-sheet issues addressed in Chapter 16.

- Replaced Dentsply with Chesapeake Energy for the debt note analysis.
- Revised figures, added figures, and revised discussion in the hedging section.
- Revised and added exercises, problems, and cases.

Chapter 12: Financial Reporting for Leases

- Provided more intuition on the economics of leasing at the beginning of the chapter.
- Revised the main lessor example to match the discount rate in the main lessee example.
- Expanded discussion of uneven lease payments and rent holidays.
- Streamlined discussion of lessor accounting.
- Provided separate discussions of *ASU 2016-02* (*ASC 842*) and *IFRS 16* within the lessee and lessor sections.
- Updated comparison of operating and capital lease obligations by industry.
- Updated Whole Foods example for illustrating disclosure and constructive capitalization.
- Changed approach in appendix to estimate effects of both *ASU 2016-02* and *IFRS 16*.
- Revised exercises, problems, and cases so that more than half of them address *ASU 2016-02* or *IFRS 16*.

Chapter 13: Income Tax Reporting

- Added discussion of semantics commonly used in discussions about income taxes.
- Added discussion of corporate inversions.
- Added explanation of forthcoming change in how deferred tax assets and liabilities are classified as current and noncurrent and how they are netted against each other.
- Revised the language in the text that relates to temporary differences in revenue recognition to conform to the new revenue recognition standard.
- Revised the end-of-chapter material to eliminate numerous examples with scheduled tax rate changes every year, which is no longer a likely scenario.
- Updated exhibits from company reports throughout the chapter.

Chapter 14: Pensions and Postretirement Benefits

- Updated Global Vantage Point section on differences between U.S. GAAP and IFRS and included excerpts from the pension note of Siemens.
- Revised the initial discussion of actuarial gains and losses and enhanced the comprehensive example to show how balance sheet accounts change.
- Added a figure to summarize the balance sheet effects of pension accounting.
- Updated statistics related to total pension plan assets, discount and expected rate of return assumptions, and plan funded status.
- Revised analysis for GE by condensing discussion of changes in plan assets and plan liabilities and updating for 2014 information.
- Revised exercises and problems added new financial statement based cases.

Chapter 15: Financial Reporting for Owners' Equity

- Updated or replaced examples throughout chapter.
- Expanded section on interpreting shareholders' equity on the balance sheet and the statement of shareholders' equity.
- Expanded discussion of stock option pricing models.
- Added a new section on taxation of share-based compensation that includes a discussion of *ASU 2016-09*.
- Added a new section on interpreting the share-based compensation disclosures of Whole Foods.
- Added exercises, problems, and cases on EPS and share-based compensation.

Chapter 16: Intercorporate Investments

- Added discussion of forthcoming change in accounting for minority-passive equity investments.
- Streamlined the discussion of merger and acquisition accounting under previously-permitted methods (purchase accounting and pooling of interests).
- Updated exhibits from company reports throughout the chapter.

Chapter 17: Statement of Cash Flows

- Streamlined the chapter by eliminating much of the overlap with chapter 4. Chapter 17 now focuses on more complex transactions and reasons why the cash flow statement may not seem to articulate with the balance sheet.
- Added a discussion of how the new lease standard affects the cash flow statement.
- Updated exhibits from company reports throughout the chapter.

Appendix B: Segment Reporting

- Moved from an appendix in Chapter 5 to a book appendix to facilitate individual instructor approach.
- Updated Harley-Davidson example.
- Added a ROA decomposition analysis for Harley-Davidson segments.
- Added discussion of foreign currency exchange rates and effects on segment results.
- Enhanced discussion of quantitative thresholds.
- Added exercises and a new case.

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Colleagues at Chicago, Iowa, Northwestern, and Notre Dame, as well other universities, have served as sounding boards on a wide range of issues over the past years, shared insights, and provided many helpful comments. Their input helped us improve this book. In particular, we thank: Jim Boatsman, Arizona State University; Brad Badertscher, Tom Frecka, Chao-Shin Liu, Bill Nichols, and Tom Stober, University of Notre Dame; Cristi Gleason and Ryan Wilson, University of Iowa; Tom Linsmeier, the Financial Accounting Standards Board; Larry Tomassini, The Ohio State University; Robert Lipe, University of Oklahoma; Don Nichols, Texas Christian University; Nicole Thibodeau, Willamette University; Paul Zarowin, New York University; and Stephen Zeff, Rice University.

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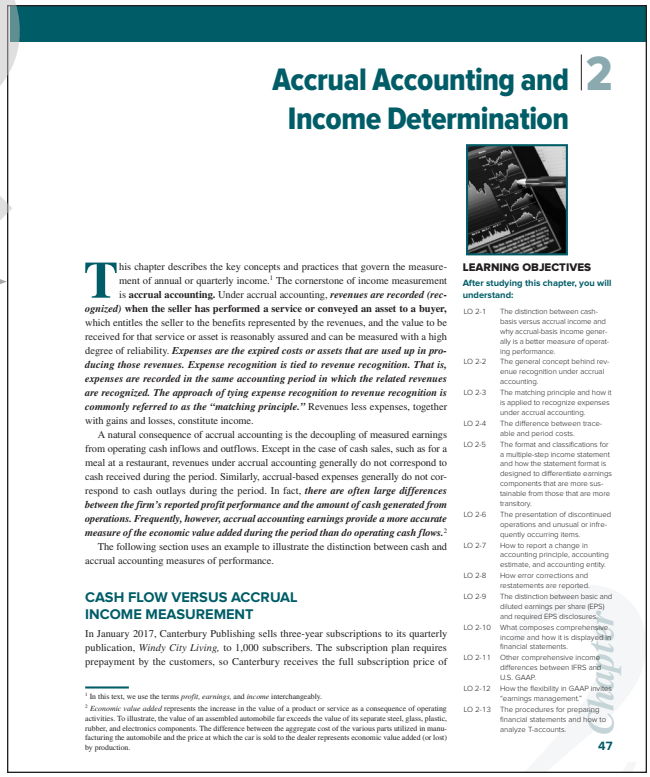
Our goal in writing this book was to improve the way financial reporting is taught and mastered. We would appreciate receiving your comments and suggestions.

—Daniel W. Collins
—W. Bruce Johnson
—H. Fred Mittelstaedt
—Leonard C. Soffer

Walkthrough

Chapter Objectives

Each chapter opens with a **brief introduction and summary of learning objectives** to set the stage for the goal of each chapter and prepare students for the key concepts and practices.



Accrual Accounting and Income Determination 2

This chapter describes the key concepts and practices that govern the measurement of annual or quarterly income.[1] The cornerstone of income measurement is **accrual accounting.** Under accrual accounting, ***revenues are recorded (recognized)* when the seller has performed a service or conveyed an asset to a buyer,** which entitles the seller to the benefits represented by the revenues, and the value to be received for that service or asset is reasonably assured and can be measured with a high degree of reliability. ***Expenses are the expired costs or assets that are used up in producing those revenues. Expense recognition is tied to revenue recognition. That is, expenses are recorded in the same accounting period in which the related revenues are recognized. The approach of tying expense recognition to revenue recognition is commonly referred to as the "matching principle."*** Revenues less expenses, together with gains and losses, constitute income.

A natural consequence of accrual accounting is the decoupling of measured earnings from operating cash inflows and outflows. Except in the case of cash sales, such as for a meal at a restaurant, revenues under accrual accounting generally do not correspond to cash received during the period. Similarly, accrual-based expenses generally do not correspond to cash outlays during the period. In fact, ***there are often large differences between the firm's reported profit performance and the amount of cash generated from operations. Frequently, however, accrual accounting earnings provide a more accurate measure of the economic value added during the period than do operating cash flows.***[2]

The following section uses an example to illustrate the distinction between cash and accrual accounting measures of performance.

CASH FLOW VERSUS ACCRUAL INCOME MEASUREMENT

In January 2017, Canterbury Publishing sells three-year subscriptions to its quarterly publication, *Windy City Living,* to 1,000 subscribers. The subscription plan requires prepayment by the customers, so Canterbury receives the full subscription price of

[1] In this text, we use the terms *profit, earnings,* and *income* interchangeably.

[2] *Economic value added* represents the increase in the value of a product or service as a consequence of operating activities. To illustrate, the value of an assembled automobile far exceeds the value of its separate steel, glass, plastic, rubber, and electronics components. The difference between the aggregate cost of the various parts utilized in manufacturing the automobile and the price at which the car is sold to the dealer represents economic value added (or lost) by production.

LEARNING OBJECTIVES

After studying this chapter, you will understand:

- LO 2-1 The distinction between cash-basis versus accrual income and why accrual-basis income generally is a better measure of operating performance.
- LO 2-2 The general concept behind revenue recognition under accrual accounting.
- LO 2-3 The matching principle and how it is applied to recognize expenses under accrual accounting.
- LO 2-4 The difference between traceable and period costs.
- LO 2-5 The format and classifications for a multiple-step income statement and how the statement format is designed to differentiate earnings components that are more sustainable from those that are more transitory.
- LO 2-6 The presentation of discontinued operations and unusual or infrequently occurring items.
- LO 2-7 How to report a change in accounting principle, accounting estimate, and accounting entity.
- LO 2-8 How error corrections and restatements are reported.
- LO 2-9 The distinction between basic and diluted earnings per share (EPS) and required EPS disclosures.
- LO 2-10 What composes comprehensive income and how it is displayed in financial statements.
- LO 2-11 Other comprehensive income differences between IFRS and U.S. GAAP.
- LO 2-12 How the flexibility in GAAP invites "earnings management."
- LO 2-13 The procedures for preparing financial statements and how to analyze T-accounts.

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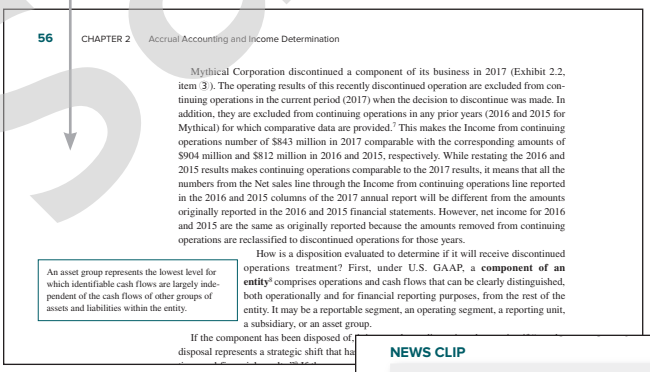
Boxed Readings

Sidebar margin boxes call out key concepts in each chapter and provide additional information to reinforce concepts.



56 CHAPTER 2 Accrual Accounting and Income Determination

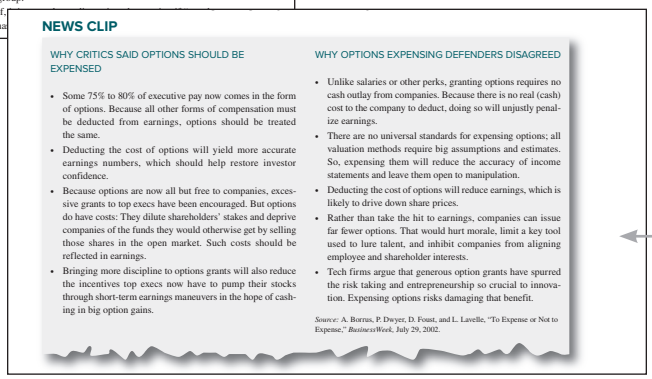
Mythical Corporation discontinued a component of its business in 2017 (Exhibit 2.2, item 3). The operating results of this recently discontinued operation are excluded from continuing operations in the current period (2017) when the decision to discontinue was made. In addition, they are excluded from continuing operations in any prior years (2016 and 2015 for Mythical) for which comparative data are provided.[7] This makes the Income from continuing operations number of $843 million in 2017 comparable with the corresponding amounts of $904 million and $812 million in 2016 and 2015, respectively. While restating the 2016 and 2015 results makes continuing operations comparable to the 2017 results, it means that all the numbers from the Net sales line through the Income from continuing operations line reported in the 2016 and 2015 columns of the 2017 annual report will be different from the amounts originally reported in the 2016 and 2015 financial statements. However, net income for 2016 and 2015 are the same as originally reported because the amounts removed from continuing operations are reclassified to discontinued operations for those years.

An asset group represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities within the entity.

How is a disposition evaluated to determine if it will receive discontinued operations treatment? First, under U.S. GAAP, a **component of an entity**[8] comprises operations and cash flows that can be clearly distinguished, both operationally and for financial reporting purposes, from the rest of the entity. It may be a reportable segment, an operating segment, a reporting unit, a subsidiary, or an asset group.

If the component has been disposed of,

disposal represents a strategic shift that ha



NEWS CLIP

WHY CRITICS SAID OPTIONS SHOULD BE EXPENSED

- Some 75% to 80% of executive pay now comes in the form of options. Because all other forms of compensation must be deducted from earnings, options should be treated the same.
- Deducting the cost of options will yield more accurate earnings numbers, which should help restore investor confidence.
- Because options are now all but free to companies, excessive grants to top execs have been encouraged. But options do have costs: They dilute shareholders' stakes and deprive companies of the funds they would otherwise get by selling those shares in the open market. Such costs should be reflected in earnings.
- Bringing more discipline to options grants will also reduce the incentives top execs now have to pump their stocks through short-term earnings maneuvers in the hope of cashing in big option gains.

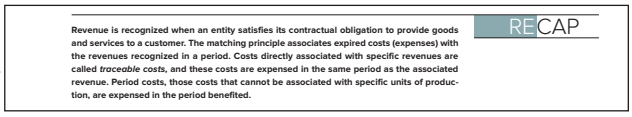
WHY OPTIONS EXPENSING DEFENDERS DISAGREED

- Unlike salaries or other perks, granting options requires no cash outlay from companies. Because there is no real (cash) cost to the company to deduct, doing so will unjustly penalize earnings.
- There are no universal standards for expensing options; all valuation methods require big assumptions and estimates. So, expensing them will reduce the accuracy of income statements and leave them open to manipulation.
- Deducting the cost of options will reduce earnings, which is likely to drive down share prices.
- Rather than take the hit to earnings, companies can issue far fewer options. That would hurt morale, limit a key tool used to lure talent, and inhibit companies from aligning employee and shareholder interests.
- Tech firms argue that generous option grants have spurred the risk taking and entrepreneurship so crucial to innovation. Expensing options risks damaging that benefit.

Source: A. Borrus, P. Dwyer, D. Foust, and L. Lavelle, "To Expense or Not to Expense," *BusinessWeek,* July 29, 2002.

News Clip boxes provide engaging news articles that capture real world financial reporting issues and controversies.

Recap boxes provide students a summary of each section, reminding them of the key points of what they just covered in small doses to reinforce what they just learned.



RECAP

Revenue is recognized when an entity satisfies its contractual obligation to provide goods and services to a customer. The matching principle associates expired costs (expenses) with the revenues recognized in a period. Costs directly associated with specific revenues are called *traceable costs,* and these costs are expensed in the same period as the associated revenue. Period costs, those costs that cannot be associated with specific units of production, are expensed in the period benefited.

Icons

Special "Getting Behind the Numbers" icons appear throughout the text to highlight and link discussions in chapters to the analysis, valuation, and contracting framework. Icons in the end-of-chapter materials signify a variety of exercises or direct students to Connect for additional resources.

International

Look for the International icon to read the new coverage of IFRS integrated throughout the text.

Analysis

Valuation

Contracting

STRETCH

Collaborative

AICPA ADAPTED

IMA ADAPTED

CFA ADAPTED

End-of-Chapter Elements

The text provides a variety of end-of-chapter materials to reinforce concepts. Learning objectives are included for each end-of-chapter item, making it easier than **ever** to tie your assignment back to the chapter material.

Exercises

EXERCISES

E8-1

Analyzing accounts receivable **(LO 8-2)**

AICPA ADAPTED

For the month of December 2017, Ranger Corporation's records show the following information:

Cash received on accounts receivable	$35,000
Cash sales	30,000
Accounts receivable, December 1, 2017	80,000
Accounts receivable, December 31, 2017	74,000

Summary

SUMMARY

Financial statements are an extremely important source of information about a company, its economic health, and its prospects. They help improve decision making and make it possible to monitor managers' activities.

- Equity investors use financial statements to form opinions about the value of a company and its stock.
- Creditors use statement information to gauge a company's ability to repay its debt and to

Problems/Discussion Questions

PROBLEMS / DISCUSSION QUESTIONS

P5-1

Comparing profitability **(LO 5-3)**

The following table presents ROA calculations for three companies in the retail grocery industry using earnings before interest (EBI) and balance sheet data for each company. The Kroger Company operates more than 2,600 supermarkets and multi-department stores. Publix Super Markets operates about 1,100 supermarkets in the Southeastern United States. Weis Markets operates 163 retail food stores in Pennsylvania and surrounding states.

Cases

CASES

Corrpro Companies, Inc., founded in 1984, provides corrosion control-related services, systems, equipment, and materials to the infrastructure, environmental, and energy markets. Corrpro's products and services include (a) corrosion control engineering services, systems, and equipment, (b) coatings services, and (c) pipeline integrity and risk assessment services. The following information was abridged from the company's March 31, Year 3, Form 10-K.

C2-1

Conducting financial reporting research: Discontinued operations **(LO 2-6)**

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The Connect Instructor Library is a repository for additional resources to improve student engagement in and out of class. You can select and use any asset that enhances your lecture. The Connect Instructor Library includes

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- Solutions manual
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  - TestGen is a complete, state-of-the-art test generator and editing application software that allows instructors to quickly and easily select test items from McGraw Hill's test bank content. The instructors can then organize, edit, and customize questions and answers to rapidly generate tests for paper **or online administration.** Questions can include stylized text, symbols, graphics, and equations that are inserted directly into questions using built-in mathematical templates. TestGen's random generator provides the option to display different text or calculated number values each time questions are used. With both quick-and-simple test creation and flexible and robust editing tools, TestGen is a complete test generator system for today's educators.
- Instructor's resource manual

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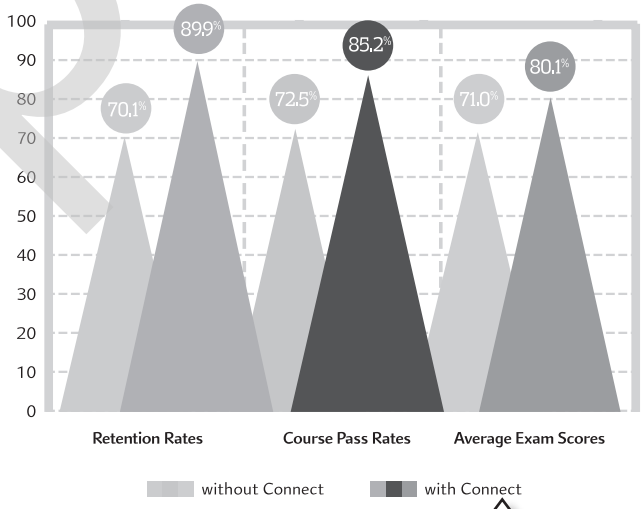

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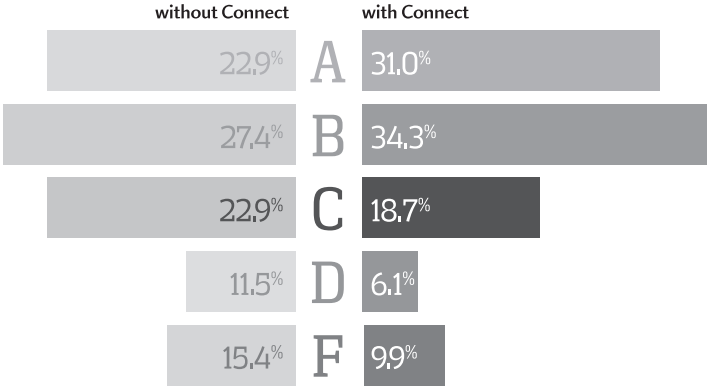

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Brief Contents

Contents

The Economic and Institutional Setting for Financial Reporting

1

"Accounting is at the basis of building businesses, states, and empires."[1]

Accounting is the key to understanding the economics of a business.[2] What activities generate sales and how much does it cost to generate them? How much does the company owe creditors and will it have enough cash flow in the future to pay the creditors? Did the company's wealth increase during the year? To answer these questions, we need a system that provides valid and useful information. This book helps you understand this system and how to use it to evaluate your business and other businesses.

WHY FINANCIAL STATEMENTS ARE IMPORTANT

Without adequate information, investors cannot properly judge the opportunities and risks of investment alternatives. To make informed decisions, investors use information about the economy, various industries, specific companies, and the products or services those companies sell. Complete information provided by reliable sources enhances the probability that the best decisions will be made. Of course, only later will you be able to tell whether your investment decision was a good one. What we can tell you now is that ***if you want to know more about a company, its past performance, current health, and prospects for the future, the best source of information is the company's own financial statements.***

Why? Because the economic events and activities that affect a company and that can be translated into accounting numbers are reflected in the company's financial statements. Financial statements and accompanying disclosures provide information about a company's economic wealth and changes in that wealth. Some financial statements provide a picture of the company at a moment in time; others describe changes that took place over a period of time. Both provide a basis for *evaluating* what happened in the

LEARNING OBJECTIVES

After studying this chapter, you will understand:

- LO 1-1 Why financial statements are valuable sources of information about companies.
- LO 1-2 How financial reporting addresses the information demands of current or potential stakeholders allocating resources and monitoring manager activities.
- LO 1-3 How the supply of financial information is influenced by the costs of producing and disseminating it and by the benefits it provides.
- LO 1-4 How accounting rules are established, and why management can shape the financial information communicated to outsiders and still be within those rules.
- LO 1-5 Why financial reporting philosophies and detailed accounting practices sometimes differ across countries.
- LO 1-6 Why International Financial Reporting Standards (IFRS) influence the accounting practices of U.S. companies.

[1] J. Soll (2014), *The Reckoning* (New York, NY: Basic Books), p. xi.

[2] This publication is designed to provide accurate and authoritative information in regard to the subject matter. It is sold with the understanding that the publishers and the authors are not engaged in rendering legal, accounting, investment, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

past and for *projecting* what might occur in the future. For example, what is the annual rate of sales growth? Are accounts receivable increasing at an even greater rate than sales? How do sales and receivable growth rates compare to those of competitors? Are expenses holding steady? What rates of growth can be expected next year? These trends and relationships provide insights into a company's economic opportunities and risks including market acceptance, costs, productivity, profitability, and liquidity. Consequently, ***a company's financial statements can be used for various purposes:***

- ***As an analytical tool.***
- ***As a management report card.***
- ***As an early warning signal.***
- ***As a basis for prediction.***
- ***As a measure of accountability.***

Financial statements contain information that investors need to know to decide whether to invest in the company. Others need financial statement information to decide whether to extend credit, negotiate contract terms, or do business with the company. Financial statements serve a crucial role in allocating capital to the most productive and deserving firms. Doing so promotes the efficient use of resources, encourages innovation, and provides a liquid market for buying and selling securities and for obtaining and granting credit. Periodic financial statements provide an economic history that is comprehensive and quantitative and, therefore, can be used to gauge company performance.[3] ***For this reason, financial statements are indispensable for developing an accurate profile of ongoing performance and prospects.***

Accounting scandals are not unique to U.S. firms. Prominent foreign firms where accounting irregularities have been uncovered include Livedoor (Japan), Royal Ahold (the Netherlands), Parmalat (Italy), and Satyam Computer Systems (India).

Management has some latitude in deciding what financial information will be made available and when it will be released. For example, although financial statements must conform to accepted standards, management has discretion over the particular accounting procedures used in the statements and the details contained in supplemental notes and related disclosures. To further complicate matters, ***accounting is not an exact science.*** Some financial statement items, such as the amount of cash on deposit in a company bank account, are measured with a high degree of precision and reliability. Other items are more judgmental and uncertain in their measurement because they are derived from estimates of future events, such as product warranty liabilities.

Financial statement fraud is rare.[4] Most managers are honest and responsible, and their financial statements are free from the type of intentional distortions that occurred at WorldCom, Health South, and Enron in the 2000s. However, these examples underscore the fact that investors and others should not simply accept the numbers in financial statements at face value. Instead, they must analyze the numbers in sufficient detail to assess the degree to which the financial statements faithfully represent the economic events and activities of the company.

Statement readers must:

- Understand current financial reporting standards.
- Recognize that management can shape the financial information communicated to outside parties.

[3] Published financial statements do not always contain the most up-to-date information about a company's changing economic fortunes. To ensure that important financial news reaches interested parties as soon as possible, companies send out press releases or hold meetings with analysts. Always check the company's investor relations website for any late-breaking news.

[4] See *2012 Report to the Nation on Occupational Fraud & Abuse* (Austin, TX: Association of Certified Fraud Examiners Inc., 2012). To learn more about the wave of financial statement errors and irregularities uncovered at U.S. companies during the past two decades, see S. Scholz, *The Changing Nature and Consequences of Public Company Financial Restatements: 1997–2006* (Washington, DC: The Department of the Treasury, April 2008).

- Distinguish between financial statement information that is highly reliable and information that is judgmental.

All three considerations weigh heavily in determining the quality of financial statement information—and thus the extent to which it should be relied on for decision-making purposes. By **quality of information,** we mean the degree to which the financial statements are grounded in facts and sound judgments and thus are free from distortion. The analytical tools and perspectives in this and later chapters will enable you to understand and better interpret the information in financial statements and accompanying disclosures as well as to appreciate fully the limitations of that information.

ECONOMICS OF ACCOUNTING INFORMATION

In the United States and other developed economies, the financial statements of business enterprises serve two key functions. First, they provide a way for company management to transfer information about business activities to people outside the company, which helps solve an important problem known as **information asymmetry.** Second, financial statement information is often included in contracts between the company and other parties (such as lenders or managers) because doing so improves **contract efficiency.**

Information asymmetry just means that management has access to more and better information about the business than do people outside the company. The details vary from one business to another, but the idea is that information initially available only to management can help people outside the company form more accurate assessments of past economic performance, resource availability, future prospects, and risks. Financial statements are the primary formal mechanism for management to communicate some of this private information to outside parties.

Managers have a **stewardship** responsibility to investors and creditors. The company's resources belong to investors and creditors, but managers are "stewards" of those resources and are thus responsible for ensuring their efficient use and protecting them from adversity. To learn more about the stewardship role of accounting, see V. O'Connell, "Reflections on Stewardship Reporting," *Accounting Horizons* (June 2007): pp. 215–227.

Business enterprises enter into many different types of contracts. Examples include compensation contracts with managers who work for the company, debt contracts with bankers who loan money to the company, and royalty contracts with inventors who license products to the company for sale to consumers. Often these contracts contain language that refers to verifiable financial statement numbers such as "operating profit" for calculating managers' bonuses, "free cash flow" for determining loan compliance, and product "sales" for computing royalty payments. Contracts tied to financial statement numbers can restrict the range of decisions made by management and thereby align management's incentives with those of the other contracting parties (Chapter 7 explains how).

Financial statements are demanded because of their value as a source of information about the company's performance, financial condition, and resource stewardship. People demand financial statements because the data reported in them improve decision making.

The supply of financial statement information is guided by the costs of producing and disseminating it and the benefits it will provide to the company. Firms weigh the benefits they may gain from financial disclosures against the costs they incur in making those disclosures.

To see financial statement demand and supply at work, consider a company that seeks to raise money by issuing common stock or debt securities. Here financial statements provide information that can reduce investor uncertainty about the company's opportunities and risks. Reduced uncertainty translates into a lower cost of capital (the price the company must pay for new money). Investors *demand* information about the company's past performance, opportunities, and risks so that the stock or debt securities can be properly priced at issuance. Because companies need to raise capital at the lowest possible cost, they have an economic incentive to *supply* the information investors want. In this section, you will see that the amount

and type of financial accounting information provided by companies depend on demand and supply forces much like the demand and supply forces affecting any economic good. Of course, regulatory groups such as the SEC, the Financial Accounting Standards Board (FASB), and the International Accounting Standards Board (IASB) influence the amount and type of financial information companies disclose as well as when and how it is disclosed.

Demand for Financial Statements

The benefits of financial statement information stem from its usefulness to decision makers. People outside the company whose decisions demand financial statement information as a key input include:

1. Shareholders and investors.
2. Managers and employees.
3. Lenders and suppliers.
4. Customers.
5. Government and regulatory agencies.

The **efficient markets hypothesis** says a stock's current market price reflects the knowledge and expectations of all investors. Those who adhere to this theory consider it futile to search for undervalued or overvalued stocks or to forecast stock price movements using financial statements or other public data because any new development is quickly and correctly reflected in a firm's stock price.

Shareholders and Investors Shareholders and investors, including investment advisors and securities analysts, use financial information to help decide on a portfolio of securities that meets their preferences for risk, return, dividend yield, and liquidity.

Financial statements are crucial in investment decisions that use **fundamental analysis** to identify mispriced securities: stocks or bonds selling for substantially more or less than they seem to be worth. Investors who use this approach consider past sales, earnings, cash flow, product acceptance, and management performance to predict future trends in these financial drivers of a company's economic success or failure. Then they assess whether a particular stock or group of stocks is undervalued or overvalued at the current market price. Fundamental investors buy undervalued stocks and avoid overvalued stocks.

Investors who believe in the **efficient markets hypothesis**—and who thus presume they have no insights about company value beyond the current security price—also find financial statement data useful. To efficient markets investors, financial statement data provide a basis for assessing risk, dividend yield, or other firm attributes that are important to portfolio selection decisions.

Of course, shareholders and investors themselves can perform investment analysis as can professional securities analysts who may possess specialized expertise or some comparative advantage in acquiring, interpreting, and analyzing financial statements.

Shareholders and investors also use financial statement information when evaluating the performance of the company's top executives. This use is referred to as the stewardship function of financial reports. When earnings and share price performance fall below acceptable levels, disgruntled shareholders voice their complaints in letters and phone calls to management and outside directors. If this approach doesn't work, dissident shareholders may launch a campaign, referred to as a **proxy contest,** to elect their own slate of directors at the next annual meeting. New investors often see this as a buying opportunity. By purchasing shares of the underperforming company at a bargain price, these investors hope to gain by joining forces with existing shareholders, replacing top management, and "turning the company around."

The focal point of the proxy contest often becomes the company performance as described in its recent financial statements. Management defends its record of past accomplishments while perhaps acknowledging a need for improvement in some areas of the business. Dissident

shareholders point to management's past failures and the need to hire a new executive team. Of course, both sides are pointing to the same financial statements. Where one side sees success, the other sees only failure, and undecided shareholders must be capable of forming their own opinion on the matter.

Managers and Employees Although managers regularly make operating and financing decisions based on information that is much more detailed and timely than the information found in financial statements, they also need—and therefore demand—financial statement data. Their demand arises from contracts (such as executive compensation agreements) that are linked to financial statement variables.

Executive compensation contracts usually contain annual bonus and longer term pay components tied to financial statement results. Using accounting data in this manner increases the efficiency of executive compensation contracts. Rather than trying to determine firsthand whether a manager has performed capably during the year (and whether the manager deserves a bonus), the board of directors' compensation committee needs to look only at reported profitability or some other accounting measure that functions as a summary of the company's (and thus the manager's) performance.

Employees demand financial statement information for several reasons:

- To learn about the company's performance and its impact on employee profit sharing and employee stock ownership plans.
- To monitor the health of company-sponsored pension plans and to gauge the likelihood that promised benefits will be provided on retirement.
- To know about union contracts that may link negotiated wage increases to the company's financial performance.
- More generally, to help employees assess their company's current and potential future profitability and solvency.

Lenders and Suppliers Financial statements play several roles in the relationship between the company and those who supply financial capital. Commercial lenders (banks, insurance companies, and pension funds) use financial statement information to help decide the loan amount, the interest rate, and the security (called **collateral**) needed for a business loan. Loan agreements contain contractual provisions (called **covenants**) that require the borrower to maintain minimum levels of working capital, debt to assets, or other key accounting variables that provide the lender a safety net. Violation of these loan provisions can result in technical default and allow the lender to accelerate repayment, request additional security, or raise interest rates. So, lenders monitor financial statement data to ascertain whether the covenants are being adhered to or violated.

Suppliers demand financial statements for many reasons. A steel company may sell millions of dollars of rolled steel to an appliance manufacturer on credit. Before extending credit, careful suppliers scrutinize the buyer's financial position in much the same way that a commercial bank does—and for essentially the same reason. That is, suppliers assess the financial strength of their customers to determine whether they will pay for goods shipped. Suppliers continuously monitor the financial health of companies with which they have a significant business relationship.

Customers Repeat purchases and product guarantees or warranties create continuing relationships between a company and its customers. A customer needs to know whether the seller has the financial strength to deliver a high-quality product on an agreed-upon schedule

and whether the seller will be able to provide replacement parts and technical support after the sale. You wouldn't buy a personal computer from a door-to-door vendor without first checking out the product and the company that stands behind it. Financial statement information can help current and potential customers monitor a supplier's financial health and thus decide whether to purchase that supplier's goods and services.

In the United States and most other industrialized countries, the accounting rules that businesses use for external financial reporting purposes differ from those required for income taxation purposes. As a consequence, corporate financial reporting choices in the United States are seldom influenced by the U.S. Internal Revenue Code. See Chapter 13 for details.

Government and Regulatory Agencies Government and regulatory agencies demand financial statement information for various reasons. For example, the SEC requires publicly traded companies to compile annual financial reports (called *10-Ks*) and quarterly financial reports (called *10-Qs*). These periodic financial reports are filed with the SEC and then made available to investors and other interested parties. This process of **mandatory reporting** allows the SEC to monitor compliance with the securities laws and to ensure that investors have a "level playing field" with timely access to financial statement information.

Taxing authorities sometimes use financial statement information as a basis for establishing tax policies designed to enhance social welfare. For example, the U.S. Congress could point to widespread financial statement losses as justification for instituting a corporate income tax reduction during economic downturns.

Government agencies are often customers of businesses. For example, the U.S. Army purchases weapons from suppliers whose contracts guarantee that they are reimbursed for costs and that they get an agreed-upon profit margin. So, financial statement information is essential to resolving contractual disputes between the Army and its suppliers and for monitoring whether companies engaged in government business are earning profits beyond what the contracts allow.

Financial statement information is used to regulate businesses—especially banks, insurance companies, and public utilities such as gas and electric companies. To achieve economies of scale in the production and distribution of natural gas and electricity, local governments have historically granted exclusive franchises to individual gas and electric companies serving a specified geographical area. In exchange for this monopoly privilege, the rates these companies are permitted to charge consumers are closely regulated. Accounting measures of profit and of asset value are essential because the accounting **rate of return**—reported profit divided by asset book value—is a key factor that regulators use in setting allowable charges.[5] If a utility company earns a rate of return that seems too high, regulators can decrease the allowable charge to consumers and thereby reduce the company's profitability.

Banks, insurance companies, and savings and loan associations are subject to regulation aimed at protecting individual customers and society from insolvency losses—for example, a bank's inability to honor deposit withdrawal requests or an insurance company's failure to provide compensation for covered damages as promised. Financial statements aid regulators in monitoring the health of these companies so that corrective action can be taken when needed.

Regulatory intervention (in the form of antitrust litigation, protection from foreign imports, government loan guarantees, price controls, etc.) by government agencies and legislators constitutes another source of demand for financial statement information.

[5] This regulation process is intended to enhance economic efficiency by precluding the construction of duplicate facilities that might otherwise occur in a competitive environment. Eliminating redundancies presumably lowers the ultimate service cost to consumers. Regulatory agencies specify the accounting practices and disclosure policies that must be followed by companies under their jurisdiction. As a result, the accounting practices that utility companies use in preparing financial statements for regulatory agencies sometimes differ from those used in their shareholder reports.

RECAP

Financial statement information has value either because it reduces uncertainty about a company's future profitability or economic health or because it provides evidence about the quality of its management, about its ability to fulfill its obligations under supply agreements or labor contracts, or about other facets of the company's business activities. Financial statements are demanded because they provide information that helps improve decision making or makes it possible to monitor managers' activities.

Disclosure Incentives and the Supply of Financial Information

Commercial lenders sometimes possess enough bargaining power to allow them to compel companies to deliver the financial information they need for analysis. For example, a cash-starved company applying for a bank loan has a strong incentive to provide all of the data the lender requests. Most financial statement users are less fortunate, however. They must rely on mandated reporting (for example, SEC 10-K filings), voluntary company disclosures that go beyond the minimum required reporting (for example, corporate "fact" books), and sources outside the company (for example, analysts and reporters) for the financial information needed to make decisions.

What forces induce managers to supply information? Browse through several corporate financial reports and you will notice substantial differences across companies—and perhaps over time—in the quality and quantity of the information provided. Some companies routinely disclose operating profits, production levels, and order backlogs by major product category so analysts and investors can quickly spot changes in product costs and market acceptance. Other companies provide detailed descriptions of their outstanding debt and their efforts to hedge interest rate risk or foreign currency risk. Still other companies seem to disclose only the bare minimum required. What explains this diversity in the quality and quantity of financial information?

If the financial reporting environment were unregulated, disclosure would occur *voluntarily* as long as the incremental benefits to the company and its management from supplying financial information exceeded the incremental costs of providing that information. In other words, management's decisions about the scope, timing, and content of the company's financial statements and notes would be guided solely by the same cost and benefit considerations that influence the supply of any commodity. Managers would assess the benefits created by voluntary disclosures and weigh those benefits against the costs of making the information available. Any differences in financial disclosures across companies and over time would then be due to differences in the benefits or costs of voluntarily supplying financial information.

In fact, however, financial reporting in the United States and other developed countries is regulated by public agencies such as the SEC and by private agencies such as the FASB. The various public and private sector regulatory agencies establish and enforce financial reporting requirements ***designed to ensure that companies meet certain minimum levels of financial disclosure.*** Nevertheless, companies frequently communicate financial information that exceeds these minimum levels. They apparently believe that the benefits of the "extra" disclosures outweigh the costs. What are the potential benefits from voluntary disclosures that exceed minimum requirements?

The SEC passed Regulation Fair Disclosure, known as "Reg FD," to prevent selective disclosure by companies to market professionals and certain shareholders. Reg FD helps to level the playing field between individual investors and institutional investors by limiting what management can say in private conversations with an analyst or investor, or in meetings and conference calls where public access is restricted.

Disclosure Benefits Companies compete with one another in capital, labor, and product markets. This competition creates incentives for management to reveal "good news" financial information about the firm. The news itself may be about a successful new product

introduction, increased consumer demand for an existing product, an effective quality improvement, or other matters favorable to the financial perception of the company. By voluntarily disclosing otherwise unknown good news, the company may be able to obtain capital more cheaply or get better terms from suppliers.

To see how these incentives work, consider the market for raising financial capital. Companies seek capital at the lowest possible cost. They compete with one another in terms of both the return they promise to capital suppliers and the characteristics of the financial instrument they offer. The capital market has two important features:

1. Investors are uncertain about the quality (that is, the riskiness) of each debt or equity instrument offered for sale because the ultimate return from the security depends on future events.
2. It is costly for a company to be mistakenly perceived as offering investors a low-quality ("high-risk") stock or debt instrument—a "lemon."[6]

This lemon cost has various forms. It could be lower proceeds received from issuing stock, a higher interest rate that will have to be paid on a commercial loan, or more stringent conditions, such as borrowing restrictions, placed on that loan.

These market forces mean that owners and managers have an economic incentive to supply the amount and type of financial information that will enable them to raise capital at the lowest cost. A company offering attractive, low-risk securities can avoid the lemon penalty by voluntarily supplying financial information that enables investors and lenders to gauge the risk and expected return of each instrument accurately. Of course, companies offering higher risk securities have incentives to mask their true condition by supplying overly optimistic financial information. However, other forces partially offset this tendency. Examples include requirements for audited financial statements and legal penalties associated with issuing false or misleading financial statements. Managers also want to maintain access to capital markets and establish a reputation for supplying credible financial information to investors and analysts.

Financial statement disclosures can convey economic benefits to firms—and thus to their owners and managers. However, firms often cannot obtain these benefits at zero cost.

Disclosure Costs

Four costs can arise from informative financial disclosures:

1. Information collection, processing, and dissemination costs.
2. Competitive disadvantage costs.
3. Litigation costs.
4. Political costs.

Many firms promise to pay some of the health care costs of retired employees. See Chapter 14 for details.

The costs associated with **financial information collection, processing, and dissemination** can be high. Determining the company's obligation for postretirement employee health care benefits provides an example. This disclosure requires numerous complicated actuarial computations as well as future health care cost projections for existing or anticipated medical treatments. Whether companies compile the data themselves or hire outside consultants to do it, the cost of generating a reasonable estimate of the company's postretirement obligation can be considerable. The costs of developing and presenting financial information also include the cost incurred to audit the accounting statement item (if the information is audited).

[6] "Lemon," when describing an automobile, refers to an auto with hidden defects. In financial capital markets, "lemon" refers to a financial instrument (for example, stock or debt securities) with hidden risks. See G. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics,* August 1970, pp. 488–500.

Owners—who are the shareholders—ultimately pay all of these costs, just as they ultimately bear all other company costs.

Another financial disclosure cost is the possibility that competitors may use the information to harm the company providing the disclosure. Several disclosures—financial and nonfinancial—might create a **competitive disadvantage:**

- Details about the company's strategies, plans, and tactics, such as new products, pricing strategies, or new customer markets.
- Information about the company's technological and managerial innovations, such as new manufacturing and distribution systems, successful process redesign and continuous quality improvement methods, or uniquely effective marketing approaches.
- Detailed information about company operations, such as sales and cost figures for individual product lines or narrow geographical markets.[7]

Disclosing sales and profits by individual product line or geographical area may highlight opportunities previously unknown to competitors, thereby undermining a company's marketplace advantage. For example, Uniroyal Inc., an automobile tire manufacturer, objected to disclosing its financial data by geographical area because

> this type of data would be more beneficial to our competition than to the general users of financial data. This is especially true in those countries or geographical areas where we might not be as diversified as we are in the United States. In these cases, the data disclosed could be quite specific, thereby jeopardizing our competitive situation.[8]

Labor unions, major suppliers, or key customers may also use the company's financial information to improve their bargaining power, which would increase the company's costs and possibly weaken its competitive advantage.

Litigation costs result when shareholders, creditors, and other financial statement users initiate court actions against the company and its management for alleged financial misrepresentations. For example, it's common for shareholders to initiate litigation when there's a sudden drop in stock price soon after the company has released new financial information. Shareholders who sue will claim that they would not have purchased company shares if they had known then (back when they bought the stock) what they know now (after the company's disclosure).

The costs of defending against suits, even those without merit, can be substantial. Beyond legal fees and settlement costs is the damage to corporate and personal reputations and the distraction of executives from productive activities that otherwise would add value to the company.

There are potential **political costs** of financial reporting, especially for companies in highly visible industries such as oil and pharmaceuticals. Politically vulnerable firms with high earnings are often attacked in the financial and popular press, which alleges that those earnings constitute evidence of anticompetitive business practices. Politicians sometimes respond to (or exploit) heightened public opinion. They propose solutions to the "crisis" that is causing high earnings, thereby gaining media exposure for themselves and improving their chances for reelection or reappointment. These "solutions" are often political initiatives designed to impose taxes on unpopular companies or industries. The windfall profits tax levied on U.S. oil companies in the early 1980s is one example. This tax was

[7] R. B. Stevenson, Jr., *Corporations and Information: Secrecy, Access, and Disclosure* (Baltimore, MD: Johns Hopkins University Press, 1994).

[8] Uniroyal Inc. correspondence as reported in G. Foster, *Financial Statement Analysis* (Upper Saddle River, NJ: Prentice Hall, 1986), p. 185.

prompted, in part, by the large profit increases that oil companies reported during several years prior to enactment of the legislation.[9]

Antitrust litigation, environmental regulations, and the elimination of protective import quotas are other examples of the costs politicians and government bureaucrats can impose on unpopular companies and industries. Financial reports are one source of information that politicians and bureaucrats can use to identify target firms or industries. For this reason, astute managers carefully weigh political considerations when choosing what financial information to report and how best to report it. As a result, some highly profitable—but politically vulnerable—firms may make themselves appear less profitable than they really are.[10]

RECAP

A company's financial reporting decisions are driven by economic considerations and thus by cost-benefit trade-offs. Companies that confront distinctly different competitive pressures in the marketplace and that face different financial reporting costs and benefits are likely to choose different accounting and reporting practices. A clear understanding of the economic factors that influence a company's financial reporting choices can help you to assess more keenly the quality of the provided information. That's what we'll help you do in this textbook.

A CLOSER LOOK AT PROFESSIONAL ANALYSTS

"To perform good audits, we need more skills than just forensic accounting . . . general accounting skills, tax planning, risk management, and securities analysis are all vital competencies for auditors to possess." Samuel DiPiazza, Jr., former global CEO of PricewaterhouseCoopers.

Financial statement users have diverse information needs because they face different decisions or may use different approaches to making the same kind of decision. For example, a retail customer deciding which brand of automobile to purchase needs far less financial information about each automotive manufacturer than does a long-term equity investor who is planning to purchase stock in one of those companies. Similarly, a commercial banker engaged in asset-based lending—meaning the borrower's inventory or receivables are pledged to repay the loan—needs far different financial information about the business than does a banker who lends solely on the basis of the borrower's projected future cash flows.

It would be difficult (maybe impossible!) to frame our examination of corporate financial reporting and analysis around the diverse information needs of all potential users—investors, lenders, customers, suppliers, managers, employees, regulators, and so on—and the varied decisions they might possibly confront. Instead, we focus attention on professional analysts. But we define *analyst* broadly to include investors, creditors, financial advisors, and auditors—anyone who uses financial statements to make decisions as part of their job. Let's see what professional analysts do.

Analysts' Decisions

The task confronting **equity investors** is first to form an educated opinion about the value of the company and its equity securities—common and preferred stock—and then to make investment decisions based on that opinion. Investors who follow a *fundamental analysis approach* estimate the value of a stock by assessing the amount, timing, and uncertainty of future cash flows that will accrue to the company issuing the stock (Chapter 6 shows how). The company's financial statements and other data are used to develop projections of its future cash flows. These cash flow estimates are then discounted for risk and the time value of money.

[9] There is another side to this "excessive profits" story. Politicians sometimes respond to public concern over record losses at highly visible companies by providing subsidies in the form of government loan guarantees (for example, Chrysler Corporation), import tariffs (for example, Harley-Davidson), and restrictions on the activities of competitors.

[10] To learn more about the costs and benefits of accounting disclosures, see A. Beyer, D. Cohen, T. Lys, and B. Walther, "The Financial Reporting Environment: Review of Recent Literature," *Journal of Accounting and Economics* (2010).

The discounted cash flow estimate or **fundamental value** (say, $25 per share) is then compared to the current price of the company's stock (say, $18 per share). This comparison allows the investor to make decisions about whether to buy, hold, or sell the stock. ***Financial statement information is essential, in one way or another, to this and other equity investment strategies.***

Creditors' decisions require an assessment of the company's ability to meet its debt-related financial obligations through the timely payment of interest and principal or through asset liquidation in the event interest and principal cannot be repaid. Creditors include commercial banks, insurance companies and other lenders, suppliers who sell to the company on credit, and those who invest in the company's publicly traded debt securities. Creditors form educated opinions about the company's **credit risk** by comparing required principal and interest payments to estimates of the company's current and future cash flows (Chapter 5 explains how). Companies that are good credit risks have projected operating cash flows that are more than sufficient to meet these debt payments, or they possess **financial flexibility:** the ability to raise additional cash by selling assets, issuing stock, or borrowing more.

Companies judged to be high credit risks are charged higher rates of interest and may have more stringent conditions—referred to as **covenants**—placed on their loan agreements. These loan covenants may restrict the company from paying dividends, selling assets, buying other companies, forming joint ventures, or borrowing additional funds without the lender's prior approval. Other types of covenants, particularly those based on reported accounting figures, protect the lender from deterioration in the borrower's credit risk. This is why creditors must monitor the company's ongoing ability to comply with lending agreement covenants. ***Financial statement information is indispensable for assessing credit risk and monitoring loan covenant compliance.***

"Consideration of Fraud in a Financial Statement Audit," *Statement of Auditing Standards No. 99* (New York: AICPA, 2002)—also known as AU Section 240—provides examples of **fraud risk factors** that auditors must be aware of in designing audit procedures: rapid growth or unusual profitability compared to other firms in the same industry; unduly aggressive financial targets; a significant portion of management pay tied to accounting numbers; an excessive interest by management in maintaining or increasing the firm's stock price or earnings trend; and ineffective board of directors or audit committee oversight of the financial reporting process.

Financial advisors include securities analysts, brokers, credit rating agencies, portfolio managers, and others who provide information and advice to investors and creditors. They are often able to gather, process, and evaluate financial information more economically and accurately than individual investors and creditors can because they possess specialized skills or knowledge (for example, industry expertise) or because they have access to specialized resources provided by their organizations. As a consequence, financial advisors can play a crucial role in the decision-making process of investors and creditors. Securities analysts and credit rating agencies, in particular, are among the most important and influential users of financial statements.

Independent auditors carefully examine financial statements prepared by the company prior to conducting an audit of those statements. An understanding of management's reporting incentives coupled with detailed knowledge of accounting rules enables auditors to recognize vulnerable areas where financial reporting abuses are likely to occur. Astute auditors choose audit procedures designed to ensure that major improprieties can be detected.

But the Treadway Commission believes that independent auditors can (and should) do more:

> The potential of analytical review procedures for detecting fraudulent financial reporting has not been realized fully. Unusual year-end transactions, deliberate manipulations of estimates or reserves, and misstatements of revenues and assets often introduce aberrations in otherwise predictable amounts, ratios, or trends that will stand out to a skeptical auditor.[11]

[11] *Report of the National Commission of Fraudulent Financial Reporting* (Washington, DC: 1987), p. 48. The "Treadway Commission"—officially the National Commission on Fraudulent Financial Reporting—was formed in 1985 to study the causal factors that can lead to fraudulent financial reporting and to develop recommendations for public companies and their independent auditors, for the SEC and other regulators, and for educational institutions.

Analytical review procedures are the tools auditors use to illuminate relationships among the data. These procedures range from simple ratio and trend analysis to complex statistical techniques—a tool kit not unlike that used by any financial analyst. The auditor's goal is to assess the general reasonableness of the reported numbers in relation to the company's activities, industry conditions, and business climate. Astute auditors are careful to "look behind the numbers" when the reported figures seem unusual.

Current auditing standards require independent auditors to use analytical review procedures on each engagement. Why? Because they can help auditors avoid the embarrassment and economic loss from accounting "surprises," such as the one uncovered at WorldCom.

Independent auditors need to be well versed in the techniques of financial analysis to design effective audits. That's why auditors are included among those people we call "analysts." Current auditing standards echo the lessons of past audit failures: ***You can't build a bulletproof audit unless you know how the game is played.*** That means understanding the incentives of managers and being a skilled financial analyst.

RECAP

Financial statement information helps investors assess the value of a firm's debt and equity securities, creditors assess the company's ability both to meet its debt payments and to abide by loan terms, financial advisors and securities analysts to do their job of providing information and advice to investors and creditors, and auditors both to recognize potential financial reporting abuses and to choose audit procedures to detect them.

FUNDAMENTAL CONCEPTS OF FINANCIAL REPORTING

"There's virtually no standard that the FASB has ever written that is free from judgment in its application."

—D. R. Beresford, chairman of the FASB (1987–1997)[12]

Financial statements and notes describe a firm's economic wealth at a specific point in time and changes in economic wealth over a specific period of time, say a year. The statements consider prior transactions and events and estimate their effects on the firm's economic wealth. For example, if a company sells products on credit, the accountant must estimate how much cash will ultimately be collected (see Chapters 3 and 8). The financial statements provide analysts a jumping-off point for forecasting future earnings, future cash flows, and the ability to pay interest and dividends in the future. Analysts use the projected information to estimate the value of a company or its ability to repay debt.

To extrapolate into the future from financial statement data, investors, creditors, and their financial advisors must first understand the accounting measurement rules, estimates, and judgments used to produce the data. The linkage between economic events and how those events are depicted in a financial statement can sometimes seem mysterious or confusing. For example, some companies record sales revenue *before* goods are actually delivered to customers. Other companies record revenue at the date of customer delivery. And still others record revenue only when payment for the goods is received from the customer, which can be long *after* delivery. The timing of revenue recognition for accounting purposes depends of the specific contract (implicit or explicit) between the company and its customer (see Chapter 3). We'll now look more closely at the principles that govern accounting and financial reporting practices.

[12] As quoted by F. Norris, "From the Chief Accountant, a Farewell Ledger," *The New York Times,* June 1, 1997.

Generally Accepted Accounting Principles

Over time, the accounting practitioners and standards setters have developed a network of conventions, rules, and procedures, collectively referred to as **generally accepted accounting principles (GAAP).** The principles and rules that govern financial reporting continue to develop and evolve in response to changing business conditions. Consider, for example, the lease of retail store space at a shopping mall. As people moved from the city to the suburbs, shopping malls emerged as convenient and accessible alternatives to traditional urban retail stores. Leasing became a popular alternative to ownership because it enabled retailing companies to gain access to store space without having to bear the burden of the large dollar outlay necessary to buy or build the store. Leasing was also attractive because it shared risks—such as the risk of competition from a new mall opening nearby—between the retailer and shopping mall owner. As leasing increased in popularity, the accounting profession developed practices, some complex, that are followed when accounting for leases. The practices that evolved are now part of GAAP and are discussed in detail in Chapter 12.

Since the 1960s, accounting standards setters in the United States have been building a **conceptual framework** for financial reporting—a coherent system of objectives and fundamentals intended to guide the evolution of GAAP. These *Statements of Financial Accounting Concepts* establish the basics, such as why general purpose financial reports are produced and what kinds of information they should provide, but they are not actual accounting rules.

The goal of GAAP is to ensure that a company's financial statements clearly represent its economic condition and performance. To achieve this goal, financial statements should possess certain qualitative characteristics (summarized in Figure 1.1) that make the reported information useful:[13]

- ***Relevance:*** The financial information is capable of making a difference in a decision. Relevant information helps users form more accurate predictions about the future (*predictive value*), or it allows them to better understand how past economic events have affected the business (*confirmatory value*).

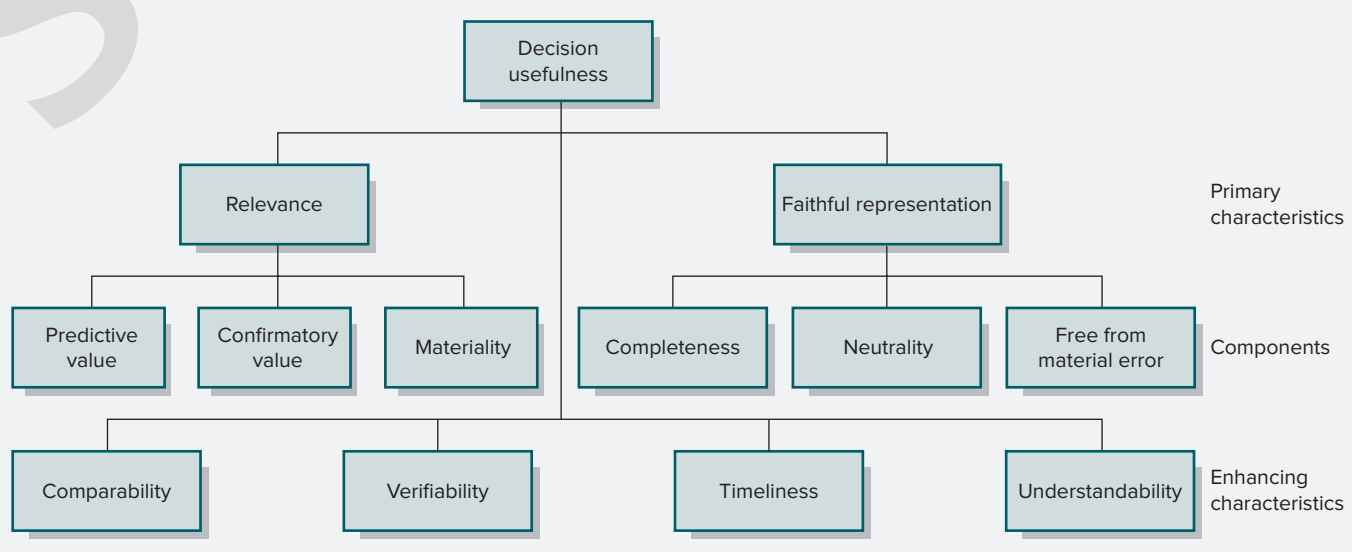

Figure 1.1 DESIRABLE CHARACTERISTICS OF ACCOUNTING INFORMATION

SOURCE: "Conceptual Framework for Financial Reporting: Chapter 1, *The Objective of General Purpose Financial Reporting,* and Chapter 3, *Qualitative Characteristics of Useful Financial Information,"* Statement of Financial Accounting Concepts No. 8 (Norwalk, CT: FASB, September 2010).

[13] See "Conceptual Framework for Financial Reporting: Chapter 1, *The Objective of General Purpose Financial Reporting,* and Chapter 3, *Qualitative Characteristics of Useful Financial Information," Statement of Financial Accounting Concepts No. 8* (Norwalk, CT: FASB, September 2010). This concept statement replaces *SFAC No. 1* and *No. 2.*

- ***Predictive value:*** The information improves the decision maker's ability to forecast the future outcome of past or present events. For example, suppose a company's balance sheet lists accounts receivable of $200,000 and an allowance for doubtful accounts of $15,000. This information has value for predicting future cash collections—management is saying that only $185,000 ($200,000 − $15,000) of the receivables will be collected.
- ***Confirmatory value:*** The information confirms or alters the decision maker's earlier beliefs. For example, suppose we learn next year that the company mentioned above collected $190,000 of its accounts receivable instead of the $185,000 originally forecasted. This information has confirmatory value and indicates that management's earlier estimate of doubtful accounts was too high.
- ***Materiality:*** Omission or misstatement of the information could influence the decisions that financial statement users make about a specific reporting entity.
- ***Faithful Representation:*** The financial information actually depicts the underlying economic event. If a company's balance sheet reports trade accounts payable of $254.3 million when the company actually owes suppliers $266.2 million, then the reported figure is not a faithful representation of the amount owed. To achieve faithful representation, the financial information must be complete, neutral, and free from material error.
- ***Completeness:*** Financial information can be false or misleading if important facts are omitted. Including all pertinent information helps to ensure that the economic event is faithfully represented.
- ***Neutrality:*** Information cannot be selected to favor one set of interested parties over another. For example, accountants and auditors cannot allow a company to reduce an estimated doubtful accounts expense just so the company can evade a bank loan covenant.
- ***Free from material error:*** Many economic events depicted in financial reports are measured under uncertainty. Because estimates and judgments are common, we should not expect all accounting measurements to be error-free. However, some minimum level of accuracy is also necessary for an estimate to be a faithful representation of an economic event.

Materiality plays a critical role, first in management's judgments in preparing the financial statements, and then in the judgments of independent accountants who audit the statements. Suppose management unintentionally fails to record a $100,000 expense and the bookkeeping error is discovered shortly after the end of the quarter. Unless this error is corrected, quarterly earnings will be overstated by, say, 2.4%, but the overstatement will reverse out next quarter when the expense is eventually recorded. Is the misstatement material? Should the quarterly financial statements be corrected now? Or is the self-correcting misstatement immaterial and unimportant?

According to both the FASB and the SEC, the answer depends on both *quantitative* (the amount of the misstatement) and *qualitative* (the possible impact of the misstatement) considerations. Financial statements are materially misstated when they contain omissions or misstatements that would alter the judgment of a reasonable person.[14] Quantitative materiality thresholds, such as "an item is material if it exceeds 5% of pre-tax income," are inadequate because they fail to recognize how even small misstatements can impact users' perceptions. For example, a small percentage misstatement can be material if it allows the company to avoid a loan covenant violation, reverses an earnings trend, or transforms a loss into a profit.

[14] Material misstatements can result either from errors, which are unintentional, or fraud, which is intentional and meant to deceive financial statement users. See "Materiality," *SEC Staff Accounting Bulletin No. 99* (Washington, DC: SEC, August 12, 1999); and the FASB's *Accounting Standards Codification (ASC)* 250-10-S99-1 Accounting Changes and Error Corrections—Overall—SEC Materials—Materiality.

As part of its Disclosure Framework project, in 2015, the FASB issued an exposure draft that would define materiality as a legal concept.[15] The FASB changed the definition because it viewed the *Concept No. 8* definition of materiality, based on the ability of the information to affect *user* decisions to be inconsistent with the current United States legal definition, based on the ability of information to affect *reasonable resource provider* decisions. In addition, the FASB believed that the new definition of materiality would encourage firms to eliminate immaterial disclosures. The revised definition of materiality was criticized in numerous comment letters.[16] These comment letters questioned whether the current *Concept No. 8* definition is in fact inconsistent with the current United States legal definition and whether the change would improve financial disclosure effectiveness. Comment letters argued that materiality is a financial reporting concept that requires professional judgment. In addition, they expressed the concern that a legal concept of materiality may require additional consultation with lawyers, thereby increasing costs of preparing and auditing financial statements. As this book goes to press, the FASB is analyzing comment letters.[17]

Figure 1.1 also identifies four qualitative characteristics—comparability, verifiability, timeliness, and understandability—that enhance the decision usefulness of relevant and representationally faithful financial information. **Comparability** across companies allows analysts to identify real economic similarities in and differences between underlying economic events because those similarities or differences are not obscured by accounting methods or disclosure practices. *Consistency,* another facet of comparability, occurs when the same accounting methods and disclosure practices are used to describe similar events from period to period. Consistency allows trends—and turning points—in economic performance or condition to be identified because the trends are not masked by changes in accounting methods or disclosure practices.

Verifiability means that independent measurers should get similar results when using the same yardstick. For example, the 2015 sales of $15,389 million reported by Whole Foods Market, the organic grocery chain, is verifiable to the extent that knowledgeable accountants and auditors would agree on this amount after examining the company's sales transactions for the year. So, verifiability refers to the degree of consensus among measurers. Financial information that lacks verifiability is less reliable for decision purposes. **Timeliness** refers to information that is available to decision makers while it is still fresh and capable of influencing their decisions. An example is sales to customers made during the current quarter as opposed to sales made a distant quarter ago. **Understandability** is the characteristic of information that enables users to comprehend its meaning. Management has a responsibility to ensure that the company's financial information is properly assembled, classified, characterized, and presented clearly and concisely. Professional analysts also have a responsibility. They must not only possess a reasonable understanding of the business and economic events, they must also be able to read financial reports and be willing to study the information.

Conservatism means that when there is uncertainty about the correct accounting approach for an event, accountants choose the approach that leads to lower assets or higher liabilities. Accounting strives to ensure that business risks and uncertainties are adequately reflected in the financial reports. For example, it is prudent to record possible losses from product liability litigation as soon as those losses become probable and measurable. Doing so helps statement readers assess the potential cash flow implications of the litigation even though an exact dollar amount has not yet been determined. Unfortunately, conservatism is sometimes used to defend poor accounting judgments such as understating income for "big bath" restructuring costs or "cookie-jar" reserves described in Chapter 3.[18] *Today's understatement of income leads to tomorrow's overstatement of income.*

No single accounting method has all of these characteristics all of the time. In fact, GAAP frequently requires financial statement users to accept a compromise that favors some

[15] See FASB *Conceptual Framework for Financial Reporting (Chapter 3: Qualitative Characteristics of Useful Financial Information)—Proposed Amendments to Statement of Financial Accounting Concepts* (Norwalk, CT: September 2015).

[16] For example, see the letters submitted by Deloitte & Touche LLP, KPMG LLP, and the Auditing Standards Committee of the Auditing Section of the American Accounting Association at www.fasb.org for Reference Number: 2015-300.

[17] M. Siegel, "For the Investor: Disclosure Effectiveness-How Materiality Fits In," *FASB Outlook,* Q1, 2016.

[18] See R. Watts, "Conservatism in Accounting, Part I: Explanations and Implications," *Accounting Horizons,* September 2003, pp. 207–21; and R. Watts, "Conservatism in Accounting, Part II: Evidence and Research Opportunities," *Accounting Horizons,* December 2003, pp. 287–301.

qualitative characteristics over others. For example, GAAP financial statements would show a real estate company's office building investment at its historical cost (original purchase price) minus accumulated depreciation. The most *relevant* measure of the office building is often the discounted present value of its expected future rental revenues, but this measure is not as *representationally faithful* or *verifiable* as historical cost because future vacancy rates are unpredictable and must be estimated. GAAP's use of historical cost trades off increased representational faithfulness and verifiability for decreased relevance. Qualitative trade-offs such as this arise frequently and make it difficult to identify what are the "best" accounting methods and disclosure practices. Of course, **cost** also is a pervasive constraint on the information that financial statements can provide. GAAP recognizes that financial reporting costs must be justified by the benefits of reporting that information.

Who Determines the Standards?

The U.S. federal government, through the SEC, has the ultimate authority to determine the rules to be followed in preparing financial statements by companies whose securities are sold to the general public in the United States. This authority was given to the SEC when it was established in 1934 by Congress in response to the severe stock market decline of 1929. The SEC requires companies to file both annual *and* quarterly financial statements as well as other types of reports. The SEC's Electronic Data Gathering and Retrieval (EDGAR) system receives, processes, and disseminates more than 500,000 financial statements every year. In 2009 alone, the EDGAR website logged over 1 billion searches.

Prior to the establishment of the FASB, the **American Institute of Certified Public Accountants (AICPA)** had the primary responsibility for setting accounting standards in the United States. We discuss the evolution of accounting in the United States in Appendix 1A.

Although the SEC has the ultimate legal authority to set accounting principles in the United States, it has looked to private-sector organizations to establish these principles. (The SEC retains enforcement authority.) The FASB, or simply "the Board," is the organization that currently sets accounting standards in the United States. The SEC monitors the FASB's activities and works closely with the FASB in formulating reporting rules. Although the FASB is funded through accounting support fees levied against issuers of securities (as provided for by the Sarbanes-Oxley Act of 2002), it exists as an independent group with seven full-time members and a large staff. Board members are appointed to five-year terms and are required to sever all ties with the companies and institutions they served prior to joining the Board.

Prior to 2002, the AICPA established auditing standards for both private and public companies. After auditing scandals related to WorldCom and Enron, the Sarbanes–Oxley Act of 2002 (SOX) created the **Public Company Accounting Oversight Board (PCAOB),** a private-sector, nonprofit corporation, to regulate the audits of *public* companies. PCAOB has two central roles: (1) to establish standards for auditing and ethics at public accounting firms under its jurisdiction and (2) to inspect and investigate the auditing practices of public accounting firms. The PCAOB can bar a person from participating in audits of public companies in the United States. SOX prohibits auditing firms that are not registered with the PCAOB from auditing public companies in the United States. The SOX act also requires foreign accounting firms that audit U.S. companies to comply with PCAOB rules. Currently, about 2,400 U.S. and foreign accounting firms are registered with the PCAOB.

International

How are financial reporting standards determined outside the United States? In some countries, it's by professional accounting organizations akin to the FASB, and in other countries, it's by commercial law and/or tax law requirements. The growth of global investing has spurred the development of worldwide accounting standards. These standards are now written by the **International Accounting Standards Board (IASB).** The IASB works to formulate accounting standards, promote their worldwide acceptance, and achieve greater convergence of financial reporting regulations, standards, and procedures across countries. The IASB has

issued 16 International Financial Reporting Standards (IFRS), and still retains many of the 41 International Accounting Standards (IAS) issued by the IASB's predecessor body, the International Accounting Standards Committee (IASC). The IASB reviews existing IAS and often issues revised guidance as IFRS. We discuss the IASB and IFRS in greater detail later in the chapter.

The Politics of Accounting Standards

Standard setting in the United States and most other countries is a political as well as technical process. FASB members make choices among financial reporting alternatives, and the particular alternative selected is unlikely to satisfy everyone. In making these choices, FASB is expected to serve a diverse constituency that includes preparers, auditors, and users of financial statements as well as the public interest. The preference of any one constituent may differ substantially from that of some other constituent, and those divergent viewpoints can be difficult (if not impossible) to reconcile. To ensure that their voice is heard in the standards-setting process, professional associations, industry trade groups, regulatory agencies, individual companies (e.g., Apple) and even prominent individuals (e.g., Warren Buffett) can and do exert pressure on the FASB as new accounting rules are being deliberated. Disgruntled constituents lobby FASB, the SEC, and Congress, and sometimes take more direct action:

- Congress enacted the **investment tax credit (ITC)** in 1962 as part of an economic stimulus package. Under the ITC, businesses were permitted to reduce their income tax payable in the year in which a qualifying asset (think "equipment") is purchased and put to use. A newly established accounting standard spread GAAP recognition of the ITC benefit over several years instead of recording it immediately. Many companies were not pleased by this approach because it presented a less favorable near-term income picture. Under pressure from industry, accounting firms, and the Kennedy administration, the SEC stepped in and allowed immediate recognition, thus forcing a change to established GAAP.
- As part of the Energy Policy and Conservation Act of 1975, Congress instructed the SEC to require all oil and gas companies to use the same accounting method in their financial statements. At the time, companies could choose between two alternatives—one that expensed the costs of unsuccessful wells immediately and one that expensed the costs over the lives of the successful wells. Based on accounting theory, the FASB required that costs of unsuccessful wells be expensed immediately. However, most small and medium-sized oil and gas producers used the other approach. They vigorously protested FASB's decision and enlisted support in Congress, the Departments of Energy and Justice, and the Federal Trade Commission. Those agencies believed that immediate expensing would cause many producers to curtail their exploration activities (thus contributing to an oil shortage) or drive them into mergers with big oil companies (thus reducing the number of competitors in the industry). Once again, the SEC stepped in and overruled FASB's position.[19]
- By the 1990s, employee stock options were a popular form of compensation especially among cash-starved high-technology firms. One reason was that GAAP did not require firms to record an expense when stock options were doled out. FASB was increasingly uncomfortable with this approach and moved to require a recorded expense. An unprecedented lobbying campaign by small, high-technology firms secured congressional support and prevented FASB from requiring recognition of the stock option expense in companies' financial statements. Chapter 15 tells you more of the story.

[19] A chronology of the events surrounding this oil and gas accounting controversy can be found in G. Foster, "Accounting Policy Decisions and Capital Markets," *Journal of Accounting and Economics,* March 1980, pp. 29–62.

Political pressure exerted by interested parties continues to shape the debates surrounding sensitive and controversial U.S. accounting standards. Some industry representatives and politicians blamed a type of **fair value accounting** (called *mark-to-market accounting*) for contributing to the global financial crisis and the ensuing collapse of many banks. Many continue to blame fair value accounting despite research results to the contrary.[20]

Chapter 7 describes fair value accounting and the role it may have played in the crisis.

Although the intensity and frequency of political influence on financial reporting practices is unlikely to diminish in the future, it is important to remember that accounting standards reflect both:

1. Sound concepts coupled with independent and objective decision making by standards setters such as FASB.
2. Compromises necessary to ensure that proposed standards are generally acceptable.[21]

FASB Accounting Standards Codification™

Over the years, the FASB and its predecessors in the United States have published a seemingly endless stream of pronouncements—concept statements, standards, opinions, interpretations, bulletins, and so on—that collectively constitute GAAP. Financial statement preparers (company accountants) and their independent auditors struggled to determine where to look for answers to financial accounting and reporting questions. For instance, at one time more than 200 pronouncements described GAAP revenue recognition rules. Many of the pronouncements were industry specific and some produced conflicting results for economically similar transactions.

Because the pronouncements were not equally authoritative, eventually the need arose to establish a pecking order among them. Responding to this need in 1975, the AICPA defined the phrase *generally accepted accounting principles* and established a GAAP hierarchy in *Statement on Auditing Standards No. 69.*[22] According to the AICPA, GAAP is

> . . . a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures. (para. 2.02)

ASC includes some authoritative rules issued by the SEC, but the Codification is not the official source of SEC guidance on accounting and financial reporting matters and does not contain all SEC rules, regulations, interpretive releases, and staff guidance.

The GAAP hierarchy provided preparers and auditors with guidance about where to look for answers to financial accounting and reporting questions such as how to value convertible debt securities or when to record asset impairment charges. The hierarchy also provided guidance on how to resolve matters when the underlying pronouncements suggested different accounting approaches for the same business transaction. But it did not eliminate conflicting guidance or the need to search a voluminous GAAP literature for answers.

In 2009, the FASB completed a five-year effort to distill the existing GAAP literature into a single database by creating the **Accounting Standards Codification** (or **ASC**), an online filing cabinet that groups all authoritative rules into roughly 90 topics.[23] ASC is now the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). **Accounting Standards**

[20] For example, see B. Badertscher, J. Burks, and P. Easton, "A Convenient Scapegoat: Fair Value Accounting by Commercial Banks during the Financial Crisis," *The Accounting Review,* January 2012, pp. 59–90.

[21] To learn more about the politics of U.S. accounting standards, see Z. Palmrose, "Science, Politics, and Accounting: A View from the Potomac," *The Accounting Review,* March 2009, pp. 281–98; and S. Zeff "The Evolution of U.S. GAAP: The Political Forces behind Professional Standards," *The CPA Journal,* January 2005, pp. 19–27 and February 2005, pp. 19–29.

[22] "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles," *Statement of Auditing Standards No. 69* (New York: AICPA, 1975).

[23] "The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles—a Replacement of *FASB Statement No. 162," Statement of Financial Accounting Standards No. 168* (Norwalk, CT: FASB, 2009), which is codified as FASB ASC 105, *Generally Accepted Accounting Principles.*

Updates (or ASUs) modify the codification, provide background information about the revised guidance, and provide the basis for conclusions on changes made to ASC.

The ASC synthesizes the standards that were published before the Codification (**pre-Codification standards**), and it does not contain the background information included in the pre-Codification standards or the ASUs. Consequently, to fully understand the guidance provided in the Codification, one must often refer to the superseded pre-Codification standards or the ASUs. The FASB's website (www.FASB.org) provides the full text of the superseded standards in the Reference Library under "Superseded Standards" and the ASUs in the Standards under "Accounting Standards Updates Issued." The ASUs are referenced at the beginning of each Topic within the ASC, and the pre-Codification references are obtained using the Cross-reference tab within the ASC.

ASC Topical Structure and Referencing

The ASC uses a structure in which the FASB's authoritative accounting guidance is organized into topics, subtopics, sections, subsections, and paragraphs. *Topics,* the broadest categorization of related guidance, are grouped into four areas: *presentation* matters relating to financial statements or notes; *financial statement accounts* such as Receivables, Inventory, or Revenue; *broad transactions* including business combinations and derivatives; and *industries* where specialized GAAP unique to an industry (airlines or gaming) or type of activity (software development) is described. *Subtopics* represent subdivisions of a topic and are generally distinguished by type or scope. For example, Operating Leases and Capital Leases are two subtopics of the Lease topic. *Sections* are subdivisions such as Recognition, Measurement, or Disclosure that denote the nature of the content in a subtopic. *Subsections* and *paragraphs* allow further segregation and navigation of content.

Throughout this book, we use ASC numerical references when mentioning current U.S. GAAP, but we use the original pronouncement reference (e.g., *SFAS No. 162*) when tracing the evolution of U.S. accounting practices.

Topics, subtopics, and sections are numerically referenced and correlate very closely to International Financial Reporting Standards (IFRS). An example of the numerical referencing is ASC 305-10-05 where 305 is the "Cash and Cash Equivalents" topic, 10 denotes the "Overall" subtopic, and 05 is the "Overview and Background" section.

INCENTIVE CONFLICTS AND FINANCIAL REPORTING

GAAP permits alternatives (such as LIFO versus FIFO for inventory valuation), requires estimates (for example, the useful life of depreciable assets), and incorporates management judgments (are assets impaired?). Managers have a degree of flexibility in choosing specific accounting techniques and reporting procedures, and the resulting financial statements are sometimes open to interpretation.

Managers have reasons to exploit this flexibility. Their interests may conflict with the interests of shareholders, lenders, and others who rely on financial statement information. Some companies adopt exemplary reporting standards while others tend to be less forthright. Analysts who understand these conflicting incentives as well as the flexibility available under GAAP will see that a decision based on uncritical acceptance of financial statement data may turn out to be naïve—and financially dangerous.

A new leasing standard would move these types of leases to the balance sheet in 2019, but we still have concerns about how they are treated on the income statement. See Chapter 12 for our discussion of the current and proposed standards.

The flexibility of GAAP financial reporting standards provides opportunities to use accounting methods that make the company seem less risky than it really is. For instance, some real liabilities such as equipment leases can be transformed into off-balance-sheet (and thus less visible) items. The company would then appear, from the balance sheet data alone, to have less debt and more borrowing capacity than is really the case. Commercial lenders who fail to spot off-balance-sheet liabilities of this sort can underestimate the credit risk lurking in their loan portfolios.

Companies can also smooth reported earnings by strategically timing the recognition of revenues and expenses to dampen the normal ups and downs of business activity. This strategy projects an image of a stable company that can easily service its debt even in a severe business downturn. The benefits of such deceptions can be large if lenders are fooled.[24] Furthermore, once the loan is granted, the company has additional incentives to report its financial results in ways that avoid default on loan covenants tied to accounting numbers.

Self-interest sometimes drives executives to manage the reported financial statement numbers to earn bonuses linked to sales or earnings (income) targets. For example, if earnings are down late in the fiscal year, product deliveries may be accelerated to increase recognized revenues and income before year-end. Managers may also delay until next year discretionary expenses such as building repairs and maintenance if earnings this year are expected to be too low. On the other hand, if earnings are comfortably above the bonus goal, managers may write off obsolete equipment and inventory or increase allowances for uncollectible trade receivables, whereas those same accounting adjustments are often postponed when earnings are inadequate.

Manville Corporation's 1982 bankruptcy changed the way analysts view legal contingencies. Although some people had been asking questions about the company's exposure to asbestos-related litigation for quite some time, Manville's bankruptcy announcement caught most analysts and investors by surprise. That's because the company's last quarterly report prior to bankruptcy estimated the total cost of settling asbestos-related claims at about $350 million, less than half of Manville's $830 million of shareholders' equity. Manville's bankruptcy announcement put the potential damages at no less than $2 billion, and the company's stock plunged by 35% the next day.

Another way in which financial reporting practices can be molded to suit management's interests is to downplay the significance of contingent liabilities, such as unresolved product liability lawsuits, that may affect firm value. For many reasons, management is likely to understate the true significance of a major legal contingency. In a lawsuit, candid disclosure could compromise the company's legal strategy. Similarly, public disclosure of impending financial hardships may harm the company if creditors respond by accelerating loan repayment schedules, curtailing trade credit, or seeking to liquidate the business.

This discussion states the case boldly and may portray the motives underlying financial reporting practices in an unflattering light. In reality, most companies strive to provide fair and reasonable disclosure of their financial affairs. Some of these companies are undoubtedly motivated as much by honor and integrity as by the knowledge that they will be rewarded for being forthright. Other companies take full advantage of the leeway available under GAAP.

The SEC and the FASB provide constraints that limit the range of financial statement discretion. Auditors, sound corporate governance practices, and the courts further counterbalance opportunistic financial reporting practices. Nevertheless, the analyst should recognize the conflicting reporting incentives, maintain a healthy skepticism, and understand that financial disclosures sometimes conceal more than they reveal. The flexibility inherent in GAAP can have dire consequences for those caught unaware. Throughout this book, we point out opportunities for income management and explain techniques for recomputing financial amounts and ratios to make the information more meaningful.

AN INTERNATIONAL PERSPECTIVE

Because financial reporting practices vary widely in countries outside the United States and because international business transactions are now more frequent and complex, the professional life of an analyst—in any country—has become more difficult. Multinational companies are regularly shifting resources throughout the world. These shifts cannot be accomplished

[24] Lenders are fooled when they mistakenly assign too little risk (thus charging too low an interest rate) to the borrowing. An interest cost savings of one-half of a percentage point on $1 billion of borrowings equates to $5 million (pre-tax) per year. If the company is in a 34% tax bracket and its stock trades at 15 times earnings, the payoff for concealing credit risk on financial statements is $49.5 million in share value. This value increase represents a wealth transfer to shareholders from creditors.

efficiently without reliable financial information that permits careful analysis of investment opportunities and continuous control over how resources are deployed. Multinational companies must also resolve differences in national currencies and accounting rules when combining the financial statements of all their foreign and domestic businesses into consolidated reports.

The Coca-Cola Company, for example, conducts business in more than 200 countries, hedges foreign currency cash flows, and uses foreign loans to finance investments outside the United States. Sales in North America (Canada and United States) represented 49.2% of 2015 worldwide revenues and generated 28.5% of worldwide operating income. By contrast, Latin America sales were only 9% of 2015 operating revenues, but this region produced 24.9% of Coca-Cola's worldwide operating income.

Understanding the economic, political, and cultural factors that contribute to regional differences in operating performance is daunting even for the most experienced financial analyst. Yet assessing a multinational company's current performance and future prospects requires experience, knowledge, and skill with these factors.

Global competition is prevalent in most industries today as companies facing mature domestic markets look outside their home borders for new customers and growth. Exhibit 1.1 presents sales, net income, and assets for three automobile manufacturers that compete on a worldwide basis: Ford Motor Company, Fiat S.A., and Honda Motor Company. Honda, a Japanese firm, reports financial statements in Japanese yen, Ford uses U.S. dollars, and Fiat, an Italian company, uses the euro for financial reporting purposes. Which company was the most profitable?

In the upper part of Exhibit 1.1, the financial statement amounts reported by these three companies are not directly comparable because each firm uses a different currency. For example, Honda had sales of 10,011,241 million yen but how does this yen-denominated amount compare to Ford's revenue of $129,166 million? The yen/dollar exchange rate averaged 110.10 for the year. This means that each U.S. dollar was worth about 110.10 yen. In the case

EXHIBIT 1.1 Ford, Fiat, and Honda

Revenue, Net Income, and Assets (in millions)

	Ford Motor Co. (United States)	Fiat S.A. (Italy)	Honda Motor Co. (Japan)
As reported in local currency			
Revenue	129,166	59,380	10,011,241
Net income	(14,672)	1,721	137,005
Assets	218,328	61,722	11,818,917
U.S. dollar equivalents			
Revenue	129,166	87,368	100,012
Net income	(14,672)	2,532	1,369
Assets	218,328	87,009	121,510
Local currency	U.S. dollar	Euro	Yen
Accounting methods	U.S. GAAP	IFRS	U.S. GAAP
Fiscal year-end	December 31	December 31	March 31

Note: Sales and net income in the lower part of the table are restated into U.S. dollars using the average exchange rate for the fiscal year because the flows occur throughout the year. Year-end assets are restated into U.S. dollars using the exchange rate as of the end of fiscal year.

Source: Company financial statements.

of Fiat, the euro/dollar exchange rate averaged about 0.68 for the year. The lower part of the exhibit shows each company's sales, net income, and assets expressed in U.S. dollars. Here, you can see that Ford has the largest sales ($129,166 million), but Fiat is the most profitable ($2,532 million).

Another factor complicates our analysis. Financial statement comparisons of this type become less meaningful when accounting standards and measurement rules vary from one country to another. Both Ford and Honda use U.S. GAAP, but Fiat prepares its financial statements using IFRS. As a result, Fiat's lower reported sales and net income might not be attributable to economic factors if IFRS income recognition rules are more conservative than U.S. rules. Analysts must be aware of potential differences in accounting standards and guard against the tendency to assume that financial statements are readily comparable across national borders.

International Financial Reporting

Stock exchanges around the world now offer domestic investors the opportunity to purchase securities (primarily common stock) issued by foreign companies. Foreign companies comprise roughly 22% of the stocks listed on the New York Stock Exchange (NYSE) and over 35% of those listed on the London Stock Exchange (LSE). Clearly, investors who choose to concentrate on a specific industrial or commercial sector are compelled to think globally these days.

This approach originated and evolved in both the United Kingdom and the United States. In turn, this Anglo-American accounting perspective influenced financial reporting practices in most British Commonwealth countries and many others. The phrase **true and fair view** is central to this perspective because it expresses the notion that a company's financial statements must reflect the underlying economic performance and conditions experienced by the company.

Before the early 1990s—when cross-border investing was nascent—accounting standards for use by domestic companies were developed by home-country organizations (e.g., Accounting Standards Board in the United Kingdom and the French Conseil National de la Comptabilité in France).[25] The resulting diversity of financial reporting recognition, measurement, and disclosure rules used in different countries complicated global investment decisions. Even the philosophy and objective of financial reporting varied considerably between nations.

Two widely divergent financial reporting approaches existed. First was a group of countries whose financial statements were intended (at least in principle) to capture and reflect the underlying economic performance and condition of the reporting entity. Financial reporting rules in those countries were designed to achieve this goal and thereby help investors and creditors make informed decisions. We'll call this reporting philosophy the **economic performance approach.**

Examples include France, Italy, and Belgium, where national tax laws still heavily influence financial statements prepared for domestic distribution. In Germany, Japan, and Switzerland, both commercial and tax laws influence the accounting and reporting standards. For example, to qualify for the extra depreciation tax deduction allowed by German tax law, a company's financial statements must show the same depreciation charges shown on the tax return. Conformity requirements of this sort greatly restrict the ability of financial statements to reflect economic performance.

The second group of countries had financial accounting and reporting rules that did not necessarily try to capture "economic reality." Instead, financial statements in those countries simply conformed to mandated laws or detailed tax rules designed to achieve purposes such as raising tax revenues to fund government activities or stimulate capital investment. We'll call this other reporting philosophy the **commercial and tax law approach.** Because this approach was widespread, investors reading foreign financial statements were often confronted with unfamiliar reporting rules, unique tax-driven financial statement items, and country-specific nuances. Happily, this confusing array of cross-border financial reporting options has been greatly simplified in recent years.

[25] To learn more about differences in accounting practices around the globe and the evolution of international accounting standards, see T. Doupnik and H. Perera, *International Accounting,* 4th Edition (New York, NY: McGraw-Hill Education, 2014)

Why Do Reporting Philosophies Differ across Countries? A country's financial reporting philosophy does not exist in a vacuum. Instead, it evolves from and reflects the specific legal, political, and financial institutions within the country as well as social customs. As one example, German workers have been entitled to representation on the governing boards of German companies since the early 1950s. Understandably, these labor representatives championed accounting practices that would ensure firm continuity—and thus future employment opportunities. Partially as a consequence of labor's active board participation, Germany developed ultraconservative accounting rules and dividend guidelines designed to protect companies' survival prospects and workers' jobs. So, financial reporting differences across countries sometimes mirror societal differences.

Cross-country differences in financial reporting practices also arise from differences in how companies obtain financial capital. In countries where the bulk of capital is attracted from a broad base of external investors, those investors understandably want comprehensive data to help them select appropriate securities. So, external investors who provide capital demand a reporting system that accurately depicts a company's past economic performance and its future prospects. The United States, United Kingdom, and Canada are examples of this type of broad-based ownership because an exceedingly large portion of firms' capital requirements in these countries are provided by individual debt and equity investors—either through direct investment in companies or indirectly through pension plans and mutual funds. ***The financial reporting environment in these countries has evolved to meet this public financial market demand for information.***

By contrast, in countries such as Japan and Germany, only a small amount of firms' financial capital has historically been provided by individual investors. The primary capital providers in Germany have been several large banks—and the government itself. The German stock market is small. Similarly, large banks provide much of the financing in Japan; in addition, companies there also raise capital from members of their associated corporate group. Individual investors were relatively unimportant in Japan. In countries such as Germany and Japan, these few important capital providers wield great power including the ability to acquire information directly from the firm seeking capital. ***Because of this concentrated power and the insignificance of the public financial market, the demand for economically realistic reporting standards was low.*** Instead, financial reporting standards conformed to income tax rules or commercial law.

But sources of financing do shift over time. When this happens in a country, changes in the financial reporting environment occur as well.

These loosely interconnected corporate associations are called *keiretsu.* Keiretsu members typically own shares of other member firms, an arrangement that provides a source of capital and further aligns the group's incentives toward mutual benefits. Cross-ownership in the 20% to 30% range is not unusual.

Globalization and the Rise of IFRS

As cross-border barriers in markets for goods, labor, and capital relaxed in the mid-1990s, international competitiveness increased. Companies throughout the world sought new global buyers for their goods and services by expanding and investing in new facilities and technologies. This expansion fueled a need for companies to access new and ever-larger sources of capital to finance these initiatives. But in countries that used the commercial and tax law approach to financial reporting such as France, Germany, and Japan, companies faced a severe disadvantage in raising capital. Foreign investors and other potential capital providers demanded transparent financial reports prepared using familiar reporting standards that reflected underlying firm economic performance. Statements based on narrow, national commercial law or tax rules, which companies in these countries normally provided, were deemed unsuitable. Consequently, many firms in countries where financial reports used the commercial and tax law approach felt compelled to provide foreign investors with supplemental

IFRS—like U.S. GAAP—embrace the economic performance approach to financial reporting. Statements prepared using IFRS are designed to provide a "fair presentation" of the underlying economic conditions experienced by the company.

financial statements prepared using U.S. GAAP or international standards, International Financial Reporting Standards, called IFRS. The hope was that the financial statements would be more understandable to foreign investors if they were prepared using procedures required by potential investors' home countries. Daimler-Benz began issuing U.S. GAAP financial statements in 1996, and Hoechst AG issued IFRS reports beginning in 1995. These two German companies apparently believed that U.S. GAAP- or IFRS-based financial reports would help attract more capital from investors outside their home country.

As this trend accelerated, a two-tiered financial report system emerged in many countries that previously had used the commercial and tax law approach to financial reporting. In the first financial reporting tier, rigid **book/tax conformity** is maintained in **parent company** financial statements. The parent is an amalgamation that corresponds to the tax-paying and statutory entities comprising the firm—often (but not always) in the form of a holding company. Because the parent company statements conform to the commercial or tax law, they satisfy national legal rules. In the second financial reporting tier, separate statements directed to potential foreign investors are prepared. They are called **consolidated financial statements** (or **group statements** in foreign accounting terminology). These group statements include all of the company's various operating subsidiaries. Firms hoped that these group statements—prepared using more investor-friendly and familiar U.S. GAAP or IFRS rules—would facilitate access to foreign capital.

Consolidated financial statements are described in Chapter 16.

In 2001 and 2002, accounting scandals at companies such as Enron, WorldCom, HealthSouth, and Global Crossing tarnished the reputation of U.S. financial reporting practices and lowered the appeal of U.S. GAAP for some foreign firms. Many believed this tipped the scale in favor of IFRS rather than U.S. GAAP as companies began to cope with the financial reporting demands of globalization. In June 2002, the Council of the European Union (EU) required all publicly traded EU companies to adopt by 2005 IFRS for financial reporting in consolidated statements. In the words of the European Commission:

> The regulation will help eliminate barriers to cross-border trading in securities by ensuring that company accounts throughout the EU are more reliable and transparent and that they can be more easily compared.[26]

The regulation affected approximately 8,000 companies in the EU and dramatically enhanced the visibility of IFRS.

International Accounting Standards Board (IASB) International Financial Reporting Standards are established by the IASB, an organization formed in 2001. Its predecessor, the International Accounting Standards Committee (IASC), was created in July 1973 following an agreement by professional accounting organizations in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, Ireland, the United Kingdom, and the United States. The IASB has four stated goals:

1. To develop a single set of high-quality, understandable, enforceable, and globally accepted international financial reporting standards (IFRS).
2. To promote the use and rigorous application of those standards.
3. To take account of the financial reporting needs of emerging economies and small and medium-sized entities.
4. To promote and facilitate the adoption of IFRS through the convergence of national accounting standards and IFRS.

[26] European Commission Press Release, June 7, 2002.

The IASB and its predecessor committee have issued 57 standards and 53 interpretations of those standards. The accounting practices set forth in these international standards are now required in 125 countries, although jurisdictional variations persist. These variations arise because each country still has its own accounting standards-setting organization that must approve IFRS for use by domestic companies, and approval is not automatic. For example, some countries may exclude specific parts of new standards.

The European Commission, in conjunction with the Accounting Regulatory Committee (a group composed of representatives of the Member State governments), must "endorse" IFRS for required use by EU companies. The Economic and Monetary Affairs Committee of the European Parliament can initiate delaying actions, and the Parliament has veto power over Commission endorsement.

IFRS generally provide less detailed guidance than does U.S. GAAP. IFRS frequently follow a more generalized overview approach than do U.S. GAAP standards. This difference in the level of standards-setting detail has generated a strong debate about which of the two approaches is preferable. Critics of the IASB approach (often called **principles-based**) contend that IFRS are so general and the implementation guidance so ambiguous that company managers have excessive latitude in choosing accounting practices. This latitude makes it easier for them to evade debt covenant restrictions, realize bonus targets, reach earnings goals, and/or achieve other contracting incentives. Critics of IFRS contend that they are not more principles-based; they are simply less mature than U.S. GAAP.

Supporters of the IASB approach counter that IFRS are built on broad principles and are not narrowly defined, detailed standards (sometimes called **rules-based**) such as those found in U.S. GAAP. They further assert that under a broad principles approach, the standard's financial reporting objective is made clear. This leads to closer conformity between the financial statement numbers and the underlying economic reality. By contrast, they argue that narrow U.S. GAAP rules allow managers to invent loopholes that conform to the letter of the standard but simultaneously violate its spirit. These critics point to examples like Enron's use of off-balance-sheet special purpose entities (SPEs) to mask corporate profitability and hide corporate liabilities. Provided that certain narrow guidelines were satisfied, U.S. GAAP did not require SPE consolidation, thereby allowing Enron's consolidated financial statements to conceal its deteriorating real business condition from investors and creditors.[27]

Both the SEC and FASB admit that certain GAAP standards provide too much detailed guidance and too many scope exceptions.[28] Since 2004, the FASB has endeavored to draft standards that clearly identify the accounting objective, explain the accounting principle(s) being applied, avoid bright-line rules, and provide enough implementation guidance for consistent application.[29] In recent years, the FASB has worked jointly with the IASB to draft new pronouncements, thereby improving both sets of standards.

The March toward Convergence Consider the financial reporting choice faced by Toyota Motor Company, the Japanese automobile manufacturer. The company's stock is traded on the Tokyo Stock Exchange and on the New York Stock Exchange. Investors worldwide can buy or sell Toyota shares on either exchange. Which set of presently available country-specific accounting standards—Japanese GAAP or U.S. GAAP—should Toyota use to prepare its financial statements?

Perhaps the best answer is neither! Suppose there is a third choice, a single set of accounting standards accepted worldwide and one that more fairly presents Toyota's economic

[27] This loophole is now mostly closed in U.S. GAAP. See the Variable Interest Entities Subsections under ASC Topic 810: Consolidation (pre-Codification *FASB Interpretation No. 46*). SPEs are discussed in Chapters 8 and 16.

[28] See Securities and Exchange Commission (SEC), *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (Washington, DC: SEC, July 2003); and FASB, *Proposal: Principles-Based Approach to U.S. Standard Setting* (Norwalk, CT: FASB, October 2002).

[29] See "On the Road to an Objectives-Oriented Accounting System," *The FASB Report* (Norwalk, CT: FASB, August 2004).

performance and condition to global investors. This is the goal of the growing movement toward international convergence of accounting standards.

The arguments favoring convergence are both clear and compelling. Differences in accounting practices and reporting systems make cross-border comparisons difficult and costly and impose an increasing burden on economic efficiency. Without convergence, some countries might be tempted to reduce the quality of their accounting standards in a short-sighted attempt to attract foreign firms to list on their local stock exchanges. As a first step toward achieving convergence, more and more countries outside the United States are requiring their listed companies to adopt IFRS rather than domestic GAAP.

The FASB and IASB have also worked toward eliminating differences between U.S. GAAP and IFRS. The process began with the October 2002 Norwalk Agreement that focused on short-term projects aimed at convergence improvements in accounting for nonmonetary exchanges, business combinations, and changes in accounting policies. In 2006, the FASB and IASB signed a memorandum of understanding, endorsed by the SEC and European Commission, which outlined a process for achieving even greater convergence.[30] These efforts have achieved some success, in part because U.S. GAAP and IFRS are grounded in the same economic performance philosophy. However, important differences between U.S. GAAP and IFRS remain. Here are four examples:

1. *Reversal of inventory write-downs.* Both IFRS and U.S. GAAP require companies to write down inventory if its market value declines below what the company paid for it (Chapter 9 tells you why and how). Under IFRS, the inventory value is also written back up to the higher initial figure if its market value recovers but U.S. GAAP does not permit "loss reversals."
2. *Investment property.* Investment property consists of assets such as land, buildings, and equipment that are held to earn rentals, for capital appreciation, or for both. Under IFRS, firms have the choice to carry investment properties at either amortized historical cost or fair value. U.S. GAAP does not contain separate guidance for investment property and requires amortized historical cost for all long-lived assets. See Chapter 10 for additional discussion.
3. *Research and development costs.* U.S. GAAP requires R&D expenditures to be charged to expense in the period when they are made (Chapter 10). IFRS is more lenient and allows "development phase" expenditures to be capitalized if technical feasibility and other criteria demonstrating value creation are attained.
4. *Operating leases.* Under the new leasing standard, U.S. GAAP continues the concepts of operating and finance (capital) leases. However, IFRS require finance lease accounting in most cases. See Chapter 12 for a full discussion.

In late 2009, the IASB and FASB agreed to redouble their convergence efforts with an aim of achieving solutions by June 2011 on several major projects that address consolidation, financial instruments, revenue recognition, leases, and financial statement presentation among other topics. Despite their efforts, there are significant differences in accounting for financial instruments and leases. ***Full convergence will not be achieved anytime soon.*** Throughout the book, we point out differences and explain approaches to making financial statements comparable.

Meanwhile, the SEC has been considering whether it might allow U.S. firms to adopt IFRS. While acknowledging that IFRS use may benefit some U.S. companies, the SEC also

[30] See *A Roadmap for Convergence between IFRSs and U.S. GAAP—2006 Memorandum of Understanding between the FASB and the IASB* (Norwalk, CT: FASB, 2006).

has expressed concern that (1) the transition to IFRS might be prohibitively expensive; (2) the United States may not have sufficient influence over IASB standards setting; and (3) that the U.S. legal environment relies heavily on contract language that refers to "U.S. GAAP." As a result, the SEC staff is exploring other (more time-consuming) approaches such as standard-by-standard GAAP revisions aimed toward convergence.[31] The SEC and others also have expressed concerns about uneven enforcement and application of IFRS around the world. Consequently, the U.S. adoption of IFRS still would not achieve true comparability.[32]

The SEC already permits foreign businesses to list their securities on a U.S. stock exchange as long as certain procedures are followed. Foreign businesses not using U.S. GAAP or IFRS must file a **Form 20-F** each year with the SEC. This form is designed for the convenience of U.S. financial statement readers because it reconciles the company's reported financial results—specifically, earnings and shareholders' equity—as shown in foreign GAAP or IFRS to what those numbers would have been under U.S. GAAP. This presumably allows investors to evaluate the performance of foreign issuers relative to U.S. companies using a common reporting basis—U.S. GAAP. However, the Form 20-F reconciliation may not fully achieve this goal. The reason is that SEC rules do not require foreign firms to prepare complete financial statements on a U.S. GAAP basis. It requires only that Form 20-F identify the differences between the company's home-country financial statements and U.S. GAAP. When no "finalized" financial statements in U.S. GAAP are provided by the foreign firm, the burden of constructing financial statements comparable to those provided by U.S. companies falls on the analyst. This task is often not straightforward.

All companies listed on the London Stock Exchange are required to use IFRS.

Foreign issuers are given six months to file the Form 20-F reconciliation, a substantial delay after the issuance of current home-country financial statements.

RECAP

The diversity in international accounting practices has narrowed in recent years as more countries around the globe embrace IFRS. The FASB and IASB have been working toward eliminating differences between U.S. GAAP and IFRS, and the SEC has shown some (albeit cautious) interest in potentially adopting IFRS in the United States. Nonetheless, diversity in accounting practice remains a fact of life. Readers of financial statements must never lose sight of this diversity.

SUMMARY

Financial statements are an extremely important source of information about a company, its economic health, and its prospects. They help improve decision making and make it possible to monitor managers' activities.

- Equity investors use financial statements to form opinions about the value of a company and its stock.
- Creditors use statement information to gauge a company's ability to repay its debt and to check whether the company is complying with loan covenants.
- Stock analysts, brokers, and portfolio managers use financial statements as the basis for their recommendations to investors and creditors.
- Auditors use financial statements to help design more effective audits by spotting areas of potential reporting abuses.

[31] *Final Staff Report: Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers* (Washington, DC: SEC, July 2012).

[32] See M. Barth, "Commentary on Prospects for Global Financial Reporting," *Accounting Perspectives,* September 2015, pp. 154–167.

Investors, creditors, and other interested parties demand financial statements because the information is useful. But what governs the supply of financial information?

- Mandatory reporting is a partial answer. Most companies in the United States and other developed countries are required to compile and distribute financial statements to shareholders and to file a copy with a government agency (in the United States, that agency is the SEC). This requirement allows all interested parties to view the statements.
- The advantages of voluntary disclosure are the rest of the answer. Financial information that goes beyond the minimum requirements can benefit the company, its managers, and its owners. For example, voluntary financial disclosures can help the company obtain capital more cheaply or negotiate better terms from suppliers. But benefits like these come with potential costs: information collection, processing, and dissemination costs; competitive disadvantage costs; litigation costs; and political costs. This means that two companies with different financial reporting benefits and costs are likely to choose different accounting policies and reporting strategies.

Different companies choose different accounting policies and reporting strategies because financial reporting standards are often imprecise and open to interpretation. This imprecision gives managers an opportunity to shape financial statements in ways that allow them to achieve specific reporting goals.

- Most managers use their accounting flexibility to paint a truthful economic picture of the company.
- Other managers mold the financial statements to mask weaknesses and to hide problems.
- Analysts who understand financial reporting, managers' incentives, and the accounting flexibility available to managers will maintain a healthy skepticism about the numbers and recognize that financial statements sometimes conceal more than they reveal.

The accountant's and analyst's job is made more difficult when financial reporting measurement and disclosure rules differ across national boundaries. Reporting rules in some countries such as Canada, the United Kingdom, and the United States evolved to reflect firms' underlying economic performance. But reporting rules in many other countries—France, Germany, and Japan, for example—merely complied with taxation or other statutory requirements.

- Globalization forced many firms in countries using a commercial or tax law approach to seek foreign capital. In turn, this has led countries around the world to move to IFRS, making it easier for firms in their countries to raise capital in domestic and foreign financial markets.
- The FASB and IASB have worked to converge the guidance for numerous accounting issues. However, in many cases, the boards have issued substantially different standards after having worked together originally.

APPENDIX 1A

GAAP IN THE UNITED STATES

This is a brief, historical overview of the public and private sector organizations that have influenced the development of financial accounting practices in the United States. As you shall see, some organizations have explicit legal authority to decide what constitutes U.S. GAAP. Other organizations lack that authority but remain influential.[33]

[33] We gratefully acknowledge the substantial contributions of Professor Stephen A. Zeff to the material in this appendix.

Early Developments

Corporate financial reporting practices in the United States prior to 1900 were primarily intended to provide accounting information for management's use. Financial statements were made available to shareholders, creditors, or other interested external parties on a limited basis. The **New York Stock Exchange (NYSE),** established in 1792, was the primary mechanism for trading ownership in corporations. As such, it could establish specific requirements for the disclosure of financial information and thereby dictate accounting standards for corporations whose shares it listed. Beginning in 1869, the NYSE attempted to persuade listed companies to make their financial statements public. Few companies complied. The prevailing view of corporate management was that financial information was a private concern of the company and that public disclosure would harm the company's competitive advantage.

The library archive at the University of California at Berkeley contains examples of public company annual reports dating back to the 1850s. The archive includes General Electric (1892), National Biscuit Company (Nabisco, 1898), and Procter & Gamble (1891).

Passage of the Sixteenth Amendment to the U.S. Constitution in 1913 and subsequent legislation allowing the federal government to tax corporate profits set the stage for expanded corporate financial disclosure. This legislation required companies to maintain accurate financial recordkeeping systems; the goal of this legislation was to ensure proper tax accounting and to facilitate collection. However, corporate financial disclosures to outsiders were still limited.

The stock market crash of 1929 and the Great Depression that followed provoked widespread concern about financial disclosure. Some observers alleged that the collapse of the stock market was due largely to the lack of meaningful requirements for reporting corporate financial information to investors and creditors.[34] Many also believed that economic conditions would not improve until investors regained confidence in the financial markets.

When Franklin D. Roosevelt was sworn in as president in March 1933, the economy was still paralyzed, unemployment was rampant, and the nation's banking system was on the verge of collapse. In the Senate, public hearings exposed a pattern of financial abuse by such distinguished banking institutions as J.P. Morgan, National City Bank, and Chase National Bank that included insider trading, market manipulation, reckless speculation, and special favors to influential friends.

In an effort to bolster public confidence and restore order to the securities market, Congress enacted the Securities Act of 1933, which required companies selling capital stock or debt in interstate commerce to provide financial information pertinent to establishing the value and risk associated with those securities. One year later, the act was amended to establish the SEC as an independent agency of the government, an agency whose function was to regulate both the securities sold to the public and the exchanges where those securities were traded. Companies issuing stock or debt listed on organized exchanges were required to file annual audited reports with the SEC.[35] The SEC was also empowered to establish and enforce the accounting policies and practices followed by registered companies.

In January 1933, the NYSE began requiring all companies seeking exchange listing to submit independently audited financial statements and to agree to audits of all future reports.

These powers are given to the SEC in Section 19(a) of the Securities Act of 1933 as amended:

> . . . the Commission shall have authority, for the purposes of this title, to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earning statement, and the methods to be followed in the preparation of

[34] See E. R. Willet, *Fundamentals of Securities Markets* (New York: Appleton-Century-Crofts, 1968), pp. 208–14.

[35] Security registration statements and other reports filed under the 1934 amendments to the Securities Act are public information and are available for inspection at the SEC and at the securities exchange where the company's securities are listed.

> accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer. The rules and regulations of the Commission shall be effective upon publication in the manner which the Commission shall prescribe.

In addition to its primary pronouncement—*Regulation S-X,* which describes the principal formal financial disclosure requirements for companies—the SEC issues *Financial Reporting Releases, Staff Accounting Bulletins,* and other publications stating positions on accounting and auditing matters.

The SEC's Division of Corporation Finance (DCF) reviews the financial statements in both periodic filings and prospectuses to ensure compliance with SEC requirements. The DCF writes deficiency letters to companies when it has questions about their accounting and disclosure practices. If a company cannot satisfy the DCF's concerns, it must revise and reissue its financial statements accordingly. Companies that fail to do so risk an SEC-imposed trading suspension or offering curtailment. No other securities commission in the world has such extensive authority to regulate financial reporting practices.

Accounting Series Release No. 4, issued in April 1938, first expressed the SEC's position that generally accepted accounting principles for which there is "substantial authoritative support" constitute the SEC standard for financial reporting and disclosure. The release further indicated that a company filing financial statements reflecting an accounting principle that had been formally disapproved by the SEC or for which there was no substantial authoritative support would be presumed to be filing misleading financial statements even though there was full disclosure of the accounting principles applied. However, the release did not provide guidance as to what the SEC meant by *substantial authoritative support.* This void was later filled.

Emergence of GAAP

The Securities Exchange Act of 1934 required the financial statements of all publicly traded firms to be audited by independent accountants but only if so stipulated by the SEC, which soon did so. This requirement elevated the role of the independent accountants' professional organizations. These organizations were active in influencing accounting policy prior to the 1930s, but the securities acts accentuated the need for more formal accounting standards and for systematic public announcement of those standards.

> In 1938 and 1939, Congress permitted companies to use a new inventory method—LIFO or last-in, first-out described in Chapter 9—for income tax purposes, but only if LIFO is also used in corporate annual reports to shareholders. This is one of the very few instances in which tax policy has influenced GAAP.

During the years immediately following passage of the 1933 and 1934 securities acts, the SEC relied primarily on the American Institute of Certified Public Accountants (AICPA), the national professional organization of certified public accountants, to develop and enforce accounting standards.[36] In response to the SEC and to the growing need to report reliable financial information, the AICPA created the Committee on Accounting Procedure in 1939 to establish, review, and evaluate accepted accounting procedures. This committee began the practice of developing U.S. financial accounting and reporting standards in the private sector. The SEC, by a narrow vote, expressed its support for this private-sector approach to

[36]The American Association of Public Accountants was established in 1887 and represented the core of the accounting profession in the United States. The name of the organization was changed to the American Institute of Accountants in 1917, and it became the AICPA in 1957.

establishing U.S. accounting standards. The SEC did not delegate its standards-setting authority to the committee—by law, it cannot delegate that authority.

Until its demise in 1959, the AICPA's Committee on Accounting Procedure was responsible for narrowing the differences and inconsistencies in accounting practice. The committee issued 51 Accounting Research Bulletins (ARBs) and four Accounting Terminology Bulletins that set forth what the committee believed GAAP should be. These pronouncements were not binding on companies or their auditors.

In 1959, the AICPA established the Accounting Principles Board (APB) to replace the Committee on Accounting Procedure. The APB's basic charge was to develop a statement of accounting concepts—that is, a conceptual foundation for accounting—and to issue pronouncements resolving current accounting controversies. During its existence from 1959 to 1973, the APB issued 31 Opinions and four Statements designed to improve financial accounting and disclosure. (Opinions were mandatory accounting standards, Statements were not.) At the outset, the force of these pronouncements, as with earlier ARBs, depended on general acceptance and persuasion. The APB sought compliance with financial reporting standards by attempting to persuade corporations and independent auditors that the standards improved the quality of financial reporting. By 1964, many accounting professionals and business leaders were convinced that persuasion alone could neither reduce the tremendous latitude available under then-existing accounting and reporting practices nor eliminate inconsistencies in the application of those practices. Critics cited instances in which identical transactions could be accounted for by any one of several different methods and net income could be manipulated by selecting a particular accounting approach from among several considered to be "generally accepted."

A turning point in the development of corporate financial reporting standards occurred in October 1964 when the Council (or governing body) of the AICPA adopted a requirement that was later incorporated into the rules of ethics for independent CPAs:

> **Rule 203—Accounting Principles:**
> A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement. [As amended.][37]

This requirement provided further impetus to corporations and their auditors to implement the accounting standards prescribed in APB opinions and in earlier pronouncements not superseded by these opinions. (Of course, the SEC's DCF is responsible for ensuring GAAP compliance.) This in turn caused greater attention to be focused on the APB's activities.

Complaints about the process used to develop financial reporting and accounting standards surfaced in the 1960s and early 1970s. Corporate management, government regulators, and other interested external parties voiced concern about the lack of participation by organizations other than the AICPA, the quality of the opinions issued, the failure of the APB to

[37] The Special Bulletin approved by the Council in 1964 referred to departures from APB Opinions, not GAAP, and did not mention the term *misleading*. In 1973, the Council approved the inclusion of language from the Special Bulletin as Rule 203. The GAAP "override" provision described in the last sentence of Rule 203 is rarely seen these days in the financial statements of companies subject to SEC oversight, and most observers believe the SEC will not accept departures from GAAP.

develop a coherent conceptual foundation for external financial reporting, the insufficient output by the APB, and the APB's failure to act promptly to correct alleged accounting and reporting abuses.

The APB was not immune to criticism from politicians, government regulators, and the business community. One example occurred in the early 1960s when the APB attempted to resolve the question of accounting for the **investment tax credit.** The APB initially required the tax credit to be treated as a balance sheet item, a reduction in the asset's purchase cost, rather than as an immediate increase to earnings. This decision met with strong resistance from government, business, and several major accounting firms who argued that the APB's approach would impede economic growth. After the SEC said it would allow both methods in filings with the Commission, the APB had no alternative but to rescind its earlier pronouncement (*Opinion No. 2*) and to permit the earnings increase (*Opinion No. 4*).[38] This change in the accounting standard enabled firms to use the accounting methods they preferred for the investment tax credit. This disagreement over the accounting treatment for the investment tax credit epitomized the political interference inherent in the establishment of GAAP.

During the transition period between the APB and FASB, the SEC took a more active and aggressive role in policy making. During its last nine months of operation (October 1972 through June 1973), the APB issued seven opinions in an attempt to complete its agenda of in-process accounting policy considerations. The SEC issued eight releases on accounting matters during this same period and another nine during the first year of the FASB.

The 1971 Study Group on Establishment of Accounting Principles (or "Wheat Committee") was formed by the AICPA to review and evaluate the private-sector standard-setting process as well as to recommend improvements where possible. This committee was created because of growing concern among accounting professionals over the APB's ability to withstand pressure from the business community. The committee recommended that a new and independent, full-time standards-setting organization be established in the private sector to replace the APB. This recommendation, which the AICPA approved and which became effective in July 1973, created the FASB. The FASB was the first full-time accounting standards-setting body in the world.

The FASB differed from its predecessors in several ways:

1. Board membership consisted of 7 voting members, in contrast to the 18 members on the APB.
2. Autonomy and independence were enhanced by requiring members to sever all ties with their prior employers and by dictating that the FASB directly pay member salaries.
3. Broader representation was achieved by not requiring board members to hold a CPA license.
4. Staff and advisory support was increased substantially.

Accounting Series Release No. 150, issued by the SEC in December 1973, formally acknowledged that financial accounting pronouncements of the FASB (and its predecessor organizations) are ordinarily considered by the SEC as having "substantial authoritative support" and thus are the SEC standards for financial reporting and disclosure. Accounting practices that are contrary to FASB pronouncements are considered to not have such support. This release also reaffirmed the SEC's private-sector approach to standards setting. It said,

> the Commission intends to continue its policy of looking to the private sector for leadership in establishing and improving accounting principles and standards through the FASB with the expectation that the body's conclusions will promote the interests of investors.

[38] In fact, Congress passed legislation in December 1971 permitting the investment tax credit to "flow through" to reported earnings in the year the credit was taken against the company's federal tax obligation. This situation illustrates the ultimate power of the Congress over the establishment of financial reporting and accounting standards in the United States. See "Accounting for the Investment Credit," *APB Opinion No. 2* (New York: AICPA, 1962); "Accounting for the Investment Credit," *APB Opinion No. 4* (New York: AICPA, 1964).

Current Institutional Structure in the United States

The SEC still retains broad statutory powers to define accounting terms, prescribe the methods to be followed in preparing financial reports, specify the details to be presented in financial statements, and enforce financial accounting and reporting rules. Under the Securities Act of 1933, companies wanting to issue securities interstate must file a **prospectus** with the SEC. The prospectus is a public document prepared for each new security offering containing information about the company, its officers, and its financial affairs. The financial section of the prospectus must be audited by an independent CPA who is registered to practice before the SEC. Once securities have been sold to the public, the company is required to file publicly accessible, audited financial statements with the SEC each year. These annual statements are known as the *10-K filing*. In addition, unaudited quarterly financial reports (called *10-Q filings*) are required. The annual 10-K disclosure requirements closely overlap the information in the company's published financial statements but are more extensive.[39]

Although the SEC has wide statutory authority to impose financial reporting rules, it continues to rely on private sector organizations (currently the FASB) to set accounting standards. The SEC has occasionally forced these organizations to tackle critical problems, and it once rejected an accounting standard issued by the FASB.[40] Such situations occur rarely.

Since July 1973, the FASB has been responsible for establishing accounting standards in the United States. As of May 2016, the FASB has issued 125 Accounting Standards Updates (ASUs), 168 Statements of Financial Accounting Standards, eight Statements of Financial Accounting Concepts, and numerous interpretations. FASB Technical Bulletins, Staff Implementation Guides, Staff Announcements, and Staff Positions provide clarification and interpretation guidance, but they represent the views of staff, not the Board. In 2009, the FASB distilled this voluminous GAAP literature into a single authoritative database called the Accounting Standards Codification (ASC).

Prior to 2013, publicly traded and private companies followed the same GAAP. To address potential differences in number of users and cost-benefit trade-offs, the FASB and the **Private Company Council** (a FASB advisory group formed in 2012) issued *Private Company Decision-Making Framework* in 2013.[41] The framework identified circumstances where it would be appropriate to provide separate guidance for private companies. The separate guidance may relate to effective date, transition method, recognition and measurement, disclosure, or presentation. For example, the new leasing standard reduces transition costs for private

[39] The financial reporting and accounting requirements pertaining to SEC registrants are described in the following publications: Regulation S-X, the original and comprehensive document issued by the commission that prescribes financial reporting rules and the forms to be filed with the SEC; Accounting Series Releases, which are amendments, extensions, and additions to Regulation S-X; Special SEC Releases that relate to current issues as they arise; Accounting and Auditing Enforcement Releases (AAERs), which document the SEC response to accounting and auditing irregularities; and Financial Reporting Releases (FRRs). The FRRs and AAERs are the successors to Accounting Series Releases. Staff Accounting Bulletins are issued by Office of the Chief Accountant and DCF and serve as interpretations of Regulation S-X and its amendments, extensions,and additions; they do not carry the legal weight of SEC releases.

[40] "Financial Accounting and Reporting by Oil and Gas Producing Companies," *Statement of Financial Accounting Standards (SFAS) No. 19* (Stamford, CT: FASB, 1977). This statement was issued after protracted deliberation, and it identified a single method of accounting that was to be followed by all affected companies. In August 1978, the SEC ruled that a new method of accounting for oil and gas reserves needed to be developed and that in the meantime, companies could use any method that had been generally accepted prior to *SFAS No. 19*. This directly contradicted the FASB and required the issuance of both a statement suspending *SFAS No. 19* and a second FASB statement finally bringing the SEC and FASB into conformity with one another. SEC involvement was, in part, due to enactment of a public law requiring an investigation into and action on the state of oil and gas accounting rules by December 25, 1977. Such legal deadlines in connection with the accounting standards-setting process are rare.

[41] FASB and Private Company Council, *Private Company Decision-Making Framework,* (Norwalk, CT: FASB, 2013).

companies by allowing them to use a risk-free rate (instead of the implicit rate in the specific lease) to compute the present value of operating lease commitments existing at the transition date (see ASC 842-20-30-3).

A key question relates to which firms qualify as a private company. Paragraph 12 of the document identifies characteristics of **public business entities,** which would not be considered private companies. For example, companies are public business entities if they are required to file with the SEC or another regulatory agency under the Securities Exchange Act of 1934. We emphasize the accounting required for public business entities in subsequent chapters.

The FASB has neither the authority nor the responsibility to enforce compliance with GAAP. That responsibility rests with company management, the accounting profession, the SEC, and the courts. Some observers believe that compliance is the weak link in the private-sector standards-setting chain. These critics point to frequent litigation on financial reporting matters in the courts, the escalating cost of liability insurance premiums paid by audit firms, and criticism by the SEC's chief accountant regarding the independence of external auditors.[42]

The FASB follows a "due process" procedure in developing Accounting Standards Updates. This process is designed to ensure public input in the decision process. Most updates issued by the FASB go through three steps:

1. *Discussion-memorandum stage:* After the Board and its staff have considered a topic on its agenda and perhaps consulted with experts and other interested parties, it issues a discussion memorandum. This memorandum outlines the key issues involved and the Board's preliminary views on those issues. The public is invited to comment in writing on the memorandum, and public hearings are sometimes held to permit interested individuals to express their views in person.
2. *Exposure-draft stage:* After further deliberation and modification by the Board and its staff, an exposure draft of the proposed update is issued. During this stage, a period of not less than 30 days, further public comment is requested and evaluated.
3. *Voting stage:* Finally, the Board votes on whether to issue an ASU describing amendments to the Accounting Standards Codification or to revise the proposed update and reissue a new exposure draft. For a proposed update to become official and a part of GAAP, a majority of Board members must approve it.

Influential groups and organizations use the FASB's due process to plead for alternative solutions. The arguments often include cost-benefit considerations, claims that the proposed accounting treatment is not theoretically sound or will not be understood by users, implementation issues, and concerns that the proposed update will be economically harmful to specific companies, industries, or the country.[43] Government agencies, preparer organizations such as the Business Roundtable, and industry trade organizations such as Financial Executives International create substantial pressures on the Board. Some contend that the interests of investors, creditors, and other financial statement users are not always well represented in this political forum. Others disagree.

What does the future hold? According to one keen observer of the process by which accounting principles are established in the United States, history is destined to repeat itself:

> When a highly prescriptive standards setter is coupled with a rigorous enforcement process used by a government regulator to secure compliance with accounting standards, especially in a

[42] W. P. Schuetze, "A Mountain or a Molehill?" *Accounting Horizons,* March 1994, pp. 69–75.

[43] For example, SEC reversal of *SFAS No. 19* was justified on the grounds that implementation of the proposed accounting standard would sharply inhibit petroleum exploration and development activities.

confrontational society such as the United States, companies and even branches of government will lobby the standards setter not to approve standards that interfere with their business plans and strategies. This is what has happened increasingly in the United States since the 1970s, and there is no sign that, on sensitive and controversial issues, it will diminish in intensity or frequency.[44]

Public Company Accounting Oversight Board When Congress gave the task of setting accounting standards to the newly created SEC in 1934, it left the job of overseeing auditing standards and individual audit firms to the accounting profession. For nearly seven decades, the AICPA and its predecessor organization have performed the job. In the late 1970s, the AICPA formed the Public Oversight Board to monitor the conduct of auditors. The Board was funded by the dues paid by members of the AICPA's SEC Practice Section, but it had little power to enforce auditing standards or discipline wayward audit firms.

The Public Company Accounting Oversight Board (PCAOB), the successor to the old Board, is funded by mandatory fees from public companies and operates under the SEC's oversight. The new Board was created by the Sarbanes-Oxley Act (SOX) of 2002. The PCAOB is empowered to establish auditing standards, including standards for independence and ethics, and to conduct periodic quality reviews ("inspections") of auditors' work. It can also investigate alleged audit failures and impose penalties on auditors and their firms. The PCAOB can fine, censure, suspend, or bar from practice auditors and audit firms for wrongdoing.

SOX Compliance The groundbreaking SOX was enacted to rein in earlier accounting abuses by strengthening auditor independence and improving financial reporting transparency. In addition to establishing the PCAOB, SOX requires company compliance in a number of areas. For most companies, Sections 302 and 404 represent the bulk of SOX compliance work. The following is a brief overview of each section.

Section 302: Corporate Responsibility for Financial Reports. This section requires CEOs and CFOs to personally certify the accuracy of financial statements and related disclosures in the annual and quarterly reports. CEOs and CFOs must certify that those statements fairly present in all material aspects the results of operations and financial condition of the company.

Section 404: Management Assessment of Internal Controls. This section requires an annual evaluation of internal controls and procedures for financial reporting. CEOs and CFOs must periodically assess and certify the effectiveness of internal controls and procedures. Companies are obliged to include an internal control report in their annual report. Among other things, this report:

- Acknowledges management's responsibility for establishing and maintaining internal control over financial reporting.
- Contains an assessment of the effectiveness of the company's internal control over financial reporting as of the end of the most recent fiscal year.
- Discloses any material weaknesses uncovered in the company's internal controls.

Section 404 also requires a company's external auditor to examine and report on management's assessment of internal controls as well as the effectiveness of the controls themselves.

In addition to these provisions, SOX **Section 906** requires CEOs and CFOs to sign and certify that the company's financial statements comply with SEC reporting requirements and

[44]S. A. Zeff, "The Evolution of U.S. GAAP: The Political Forces Behind Professional Standards," *The CPA Journal,* February 2005.

fairly represent the company's financial condition and results. Willful failure to comply with this requirement can result in fines of up to $5 million and imprisonment for up to 20 years.

The accounting profession and SEC have long recognized that sound internal controls are essential to ensure financial statement credibility. For example, in December 1977, after hundreds of public companies disclosed bribes, kickbacks, and political payoffs, Congress amended the Securities Exchange Act of 1934 to require issuers to have reasonable internal controls. In 1981, the U.S. Senate attempted to delete this section of the law but failed. Over the years, several professional groups have urged the SEC to require management reporting to shareholders on the effectiveness of internal control. Among these are the *Report of the National Commission on Fraudulent Financial Reporting* (the Treadway Commission) in 1987, the Public Accounting Oversight Board in 1993, and the General Accounting Office in 1996. In the end, a crisis of confidence and congressional action rather than a proactive SEC resulted in legislation requiring that corporations have adequate internal controls to ensure complete and accurate financial reporting.

PROBLEMS / DISCUSSION QUESTIONS

P1-1

Demand for accounting information **(LO 1-1)**

Required:

1. Explain why each of the following groups might want financial accounting information. What type of financial information would each group find most useful?
   a. The company's existing shareholders.
   b. Prospective investors.
   c. Financial analysts who follow the company.
   d. Company managers.
   e. Current employees.
   f. Commercial lenders who have loaned money to the company.
   g. Current suppliers.
   h. Debt-rating agencies such as Moody's or Standard and Poor's.
   i. Regulatory agencies such as the Federal Trade Commission.
2. Identify at least one other group that might want financial accounting information about the company, and describe how it would use the information.

P1-2

Incentives for voluntary disclosure **(LO 1-3)**

Required:

1. Describe how the following market forces influence the supply of financial accounting information:
   a. Debt and equity financial markets.
   b. Managerial labor markets.
   c. The market for corporate control (for example, mergers, takeovers, and divestitures).
2. What other forces might cause managers to voluntarily release financial information about the company?
3. Identify five ways managers can voluntarily provide information about the company to outsiders. What advantages do these voluntary approaches have over the required financial disclosures contained in annual and quarterly reports to shareholders?

P1-3

Costs of disclosure **(LO 1-3)**

Required:

1. Define each of the following disclosure costs associated with financial accounting information, and provide an example of each cost:
   a. Information collection, processing, dissemination costs.
   b. Competitive disadvantage costs.
   c. Litigation costs.
   d. Political costs.
2. Identify at least one other potential disclosure cost.

P1-4

Determining why financial reporting rules differ **(LO 1-5)**

Allocating resources in the most efficient manner maximizes the wealth of any country. It is generally acknowledged that financial information plays an important role in efficient resource allocation.

Required:

Given that both of the preceding statements are correct, why are the financial reporting rules in some countries (e.g., Canada and the United States) designed to be very helpful to external investors whereas in other countries (e.g., Germany and Japan) they are intended to be less helpful?

P1-5

Generally accepted accounting principles (GAAP) **(LO 1-4)**

A friend of yours sent an e-mail asking about generally accepted accounting principles (GAAP). It seems your friend was browsing through Whirlpool Corporation's recent annual report and she spotted the following statement:

> The financial statements have been audited by Ernst & Young LLP, an independent registered public accounting firm, whose report, based upon their audits, expresses the opinion that these financial statements present fairly the consolidated financial position, statements of income and cash flows of Whirlpool and its subsidiaries in accordance with accounting principles generally accepted in the United States.

She asks you what generally accepted accounting principles are, in what ways they are important to independent auditors and external users (investors or creditors), and where they come from.

Required:

1. What are generally accepted accounting principles (GAAP)?
2. Why is GAAP important to independent auditors and to external users?
3. Describe the FASB organization and how it establishes new accounting rules.
4. Describe the IASB organization and its role in establishing new accounting standards.
5. How does the Securities and Exchange Commission (SEC) influence the financial reporting practices of U.S. companies?

P1-6

Relevance versus faithful representation **(LO 1-1)**

You have decided to buy a new automobile and have been gathering information about the purchase price. The manufacturer's website shows a "list price" of $24,500, which includes your preferred options: leather trim and digital audio player. You have also consulted the "Blue Book" guide to car prices and found that the average price paid for a similar new vehicle is $19,500. However, the guide also indicates that recent selling prices have ranged from $18,000 up to $22,000.

Required:

1. Which price quote, the "list price" or the "Blue Book" average price, is the more relevant for your decision? Why?
2. Which price quote is more representationally faithful? Why?

P1-7

Accounting information characteristics **(LO 1-1)**

Farmers State Bank is considering a $500,000 loan to Willard Manufacturing. Three items appearing on Willard's balance sheet are:

a. Cash on hand and in the bank, $20,000.
b. Accounts receivable of $60,000, less an allowance for uncollectibles of $15,000.
c. Accumulated depreciation of $36,000.

Required:

1. Which of the balance sheet items—cash, net accounts receivable, or accumulated depreciation—is the most relevant for the bank's loan decision? Why?
2. Which of the balance sheet items is the most representationally faithful? Why?

P1-8

Accounting conservatism **(LO 1-1)**

Suppose your company purchased land and a warehouse for $5 million. The price was steep, but you were told that a new interstate highway was going to be built nearby. Two months later, the highway project is canceled and your property is now worth only $3 million.

Required:

1. How does the concept of accounting conservatism apply to this situation?
2. Suppose instead that you paid $3 million and later learned that the property is worth $5 million because a new highway is going to be built nearby. How does the conservatism concept apply to this new situation? Why?

P1-9

Factors affecting financial reporting **(LO 1-2, LO 1-3, LO 1-4)**

Required:

Provide a two- or three-sentence response that argues for or against (indicate which) each of these statements:

1. Accounting is an exact science.
2. Managers choose accounting procedures that produce the most accurate picture of the company's operating performance and financial condition.
3. U.S. accounting standards are influenced more by politics than by science or economics.
4. If the FASB and SEC were not around to require and enforce minimum levels of financial disclosure, most companies would provide little (if any) information to outsiders.
5. When managers possess good news about the company (that is, information that will increase the stock price), they have an incentive to disclose the information as soon as possible.
6. When managers possess bad news about the company (that is, information that will decrease the stock price), they have an incentive to delay disclosure as long as possible.
7. Managers who disclose only the minimum information required to meet FASB and SEC requirements may be doing a disservice to shareholders.

P1-10

Economic consequences of accounting standards **(LO 1-3)**

In the early 1990s, the FASB issued new rules that dramatically altered the way in which many companies recorded their obligations for postretirement health care benefits. The Board found that most companies used "cash basis" accounting and waited until expenditures for benefits were actually made before recording any expense. This meant that no liability to pay

future benefits appeared on the companies' balance sheets even though an obligation to pay future health care benefits clearly existed. The FASB concluded that this approach was inappropriate and instead required companies to record the cost of future health care benefits as incurred.

The affected companies and their trade organizations argued that having to record a liability and an expense equal to the extremely large dollar amounts of these health care benefit commitments would cause employers to substantially reduce their promised benefits to employees and perhaps curtail the benefits entirely.

Required:

1. Why were companies concerned about suddenly reporting a large liability (and corresponding expense) for postretirement health care benefits? What economic consequences might this accounting change have on the affected companies?
2. Some affected companies said they would reduce or eliminate promised benefits to avoid recording the liability and expense. This action harms employees who will then have to bear the burden of future health care costs. Should the FASB consider economic consequences of this sort when updating accounting standards? Why or why not?

P1-11

Two sets of books **(LO 1-1)**

"It's time for the government to stop enabling accounting fraud. The Internal Revenue Service and the SEC let companies keep two sets of books, one for tax reporting and the other for financial reporting. There should be no difference in the figures corporations report to the IRS and the SEC. The combined surveillance and enforcement by these agencies of one set of books and identical tax and financial reports should give the investing public a clearer picture of corporate performance." Letter to the Editor, *BusinessWeek,* August 12, 2002.

Required:

1. Why do companies keep two sets of accounting books, one for tax reporting and the other for shareholder financial reports?
2. Why might it *not* be a good idea to force companies to issue the same financial statements for both IRS and SEC purposes?

P1-12

Accounting quality and the audit committee **(LO 1-4)**

Source: Audit Committee Update 2000, PricewaterhouseCoopers LLP.

The New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) require that listed firms have audit committees of independent (that is, outside) company directors. Audit committees review the firm's audited financial statements with management and with the outside auditor and recommend to the full board of directors that the statements be included in the company's annual report. As a committee member, you might ask management about the following:

1. What are the key business and financial risks the company has to deal with in its financial reporting?
2. What financial reporting areas involved subjective judgments or estimates, and how are those judgments made and estimates determined?
3. Are there significant areas where the company's accounting policies were difficult to determine?
4. How do the company's accounting practices compare with those of others in the industry?
5. Are the financial statements and underlying accounting methods consistent with those used last year?
6. Are alternative accounting practices being proposed or considered that should be brought to the committee's attention?

7. Were there serious problems in preparing the financial statements?
8. Have outside parties including the SEC, major investors, analysts, and the news media voiced concern about the company's accounting practices?
9. Were there disagreements between management and the auditor regarding accounting practices and, if so, how were they resolved?

Source: Audit Committee Update 2000, PricewaterhouseCoopers LLP.

Required:
Explain for each question why the audit committee and investors might be interested in the answer.

P1-13

Worldwide convergence of accounting standards **(LO 1-6)**

The IASB and its predecessor organization have as a stated objective to narrow worldwide differences in accounting practices and the presentation of financial information. In February 2006 at a ceremony in Beijing, People's Republic of China, the Chinese Ministry of Finance announced the adoption of new Chinese accounting standards that bring about substantial convergence between them and the IASB's IFRS. These are excerpts from a statement made during the ceremony by Sir David Tweedie, chairman of the IASB:

> I am honoured to be here today to mark what I believe is an important step for the development of the Chinese economy and its place in the world's increasingly integrated capital markets. The adoption of the new Chinese accounting standards system brings about substantial convergence between Chinese standards and International Financial Reporting Standards (IFRSs), as set by the International Accounting Standards Board (IASB). Like the United States and Japan, China is committed to convergence with IFRS. . . .
>
> The benefits of these accounting reforms for China are clear. The new Chinese standards that incorporate accounting principles familiar to investors worldwide will encourage investor confidence in China's capital markets and financial reporting and will be an additional spur for investment from both domestic and foreign sources of capital. For Chinese companies that are increasingly playing a global role, the acceptance of the new standards should also reduce the cost of complying with the accounting regimes of the different jurisdictions in which they operate. . . .

Required:
1. Why might it be beneficial to narrow worldwide differences in accounting practices? Are there any disadvantages associated with convergence?
2. Explain how the convergence of Chinese accounting standards and IFRS can benefit the Chinese investor who invests only in Chinese companies.
3. Explain how the convergence of Chinese accounting standards and IFRS can benefit the U.S. investor who sometimes invests in Chinese companies.

P1-14

Debt covenants and aggressive accounting practices **(LO 1-4)**

Friedman's Inc. is a leading fine jewelry retailer. In November 2004, the company said that it might default on certain of the financial covenants contained in one of the company loan agreements. Here is an excerpt from the company's press release:

> In particular, Friedman's expects that it will fail to meet cumulative EBITDA requirements for the period ending October 30, 2004, constituting a default under its term loan, and it will fail to meet a minimum ratio of Accounts Payable to Inventory as of October 30, 2004, constituting a default under both its term loan and its revolving loan. Friedman's is currently in discussions with its senior lenders under the credit facility regarding the amendment of its covenants to eliminate the default.

EBITDA stands for earnings before interest, taxes, depreciation, and amortization. Apparently, Friedman's term loan contained a provision that required the company to

maintain a minimum level of profitability (measured using EBITDA) over several periods (hence, the use of "cumulative," meaning summed over the periods in question).

Required:

1. What will happen to the company if it violates these two covenants and is unsuccessful in obtaining a waiver or amendment from senior lenders?
2. Explain how the EBITDA covenant creates an incentive for Friedman's to engage in aggressive accounting practices. Provide one or more examples of aggressive accounting that Friedman's might use to avoid violating the EBITDA covenant.
3. Explain how the accounts payable to inventory covenant also creates an incentive for Friedman's to engage in aggressive accounting practices.

P1-15

Toshiba Corporation **(LO 1-6)**

Locate the most recent annual report of Toshiba Corporation, the large Japanese electronics company, on the company's website: www.toshiba.co.jp. You will find an electronic copy of the annual report in the "Investor Relations" section of the website.

Required:

1. Besides the financial statements and related notes, what other types of information are contained in the annual report?
2. What types of financial statements are included in the annual report?
3. What country's GAAP rules does Toshiba follow in preparing its annual report?
4. Toshiba's common stock is traded on the New York Stock Exchange. How can you determine if there are differences between Toshiba's reported net income and the net income that would have been reported under U.S. GAAP?

P1-16

Carrefour Group **(LO 1-5)**

Locate the most recent annual report of Carrefour Group, the French retail company and the second largest retailer in the world, on the company's website: www.carrefour.com. You will find an electronic copy of the annual report in the "Finance: Publications and Presentations" section of the website. The report is in two parts: a summary "annual" report, and the more detailed "financial" report.

Required:

1. What types of financial information are contained in the "annual" report?
2. Besides the financial statements and related notes, what other types of information are contained in the "financial" report?
3. What types of financial statements are included in the "financial" report?
4. What country's GAAP rules does Carrefour's follow in preparing its financial statements?
5. How does the Carrefour's statement of financial position (balance sheet) differ from those of U.S. companies?

CASES

C1-1

Novartis AG: Form 20-F Reconciliation **(LO 1-6)**

Novartis AG is a Swiss company that develops, manufactures, and markets pharmaceuticals and vaccines. As of January 2005, European firms, including Novartis, were required to compile their financial reports in accordance with International Financial Reporting Standards (IFRS). In 2006, Novartis filed with the U.S. Securities and Exchange Commission a Form

20-F that, among other things, included a reconciliation of "net income from continuing operations under IFRS" to "net income under U.S. GAAP." A copy of that reconciliation follows.

	2006 ($ millions)	2005 ($ millions)	2004 ($ millions)
Net income from continuing operations under IFRS	**7,019**	**6,072**	**5,365**
US GAAP adjustments:			
Available-for-sale securities	(114)	278	(183)
Inventory	103	20	(43)
Associated companies		(6)	179
Intangible assets	(1,743)	(1,238)	(590)
Property, plant and equipment	58	53	77
Pensions and other post-employment benefits	(198)	(181)	(82)
Deferred taxes	125	178	423
Share-based compensation	(5)	(44)	(61)
Currency translation			(301)
Minority interests	(27)	(11)	(15)
Others	(68)		9
Net income from continuing operations under US GAAP	**5,150**	**5,121**	**4,778**
Net income from discontinuing operations under US GAAP	114	69	15
Net income under US GAAP	**5,264**	**5,190**	**4,793**

Required:

1. What is the magnitude (in $ millions) of the difference between IFRS net income and U.S. GAAP net income?
2. Which net income number would Novartis managers prefer to report to stakeholders? Why?
3. As an investor who is considering buying shares of a pharmaceutical company, how would your decision be influenced if a candidate company reported $7,019 million of net income rather than $5,264 million?
4. Why are Form 20-F reconciliations helpful to investors who plan to buy or sell shares of a foreign company traded on a U.S. stock exchange?
5. Why might Form 20-F reconciliations also be helpful to investors who plan to buy or sell shares of a foreign company traded on a foreign stock exchange?

C1-2

Henley Manufacturing Inc.: Announcing sales and earnings goals **(LO 1-3)**

As your first week at Henley Manufacturing Inc. draws to a close, you find a memorandum on your desk from the company's CEO. The memo outlines sales and earnings goals for next year: Sales are expected to increase 15% with net income growing by 20%.

The memo says that these goals are ambitious in light of the company's performance over the past two years—ambitious but attainable if "everyone remains focused and committed to our business strategy."

As you finish the memo, your boss, the vice president of finance, steps into your office. She asks you what you think about the memo. You reply that it is important to have clear financial goals but that you would need to know more before making any comments on whether the goals will be easy or difficult to achieve. As she leaves your office, you ask if the CEO will be announcing these goals at next week's annual shareholders' meeting. Your boss answers, "We've never disclosed our sales and earning goals in the past." When you ask why, she says, "We aren't required to under U.S. securities regulations."

Two days later, your boss stops by again and tells you that she raised the issue of disclosing to shareholders the firm's net income and sales goals at this morning's executive committee meeting. The CEO was intrigued but requested that someone identify the costs and benefits of

doing so. As she leaves your office, your boss asks you to prepare a briefing document for presentation at the next executive committee meeting.

Required A:

1. What are the potential costs and benefits to Henley Manufacturing of announcing its sales and earnings goals at the shareholders' meeting?
2. Would you recommend that the CEO announce both, one, or neither goal? Why?
3. If the company's sales and earnings goals covered three years rather than just next year, would your recommendation change? Why or why not?

Required B:

Suppose the memo was more detailed and described the following financial goals for next year: annual sales growth of 15%; annual earnings growth of 20%; a return on net tangible assets of 16%; a return on common equity of 20%; a minimum current ratio of 2.4; a minimum interest coverage ratio of 7.0; a minimum profit margin of 5%; a dividend payout ratio (dividends/net income) of 35% to 40%; a maximum long-term debt to common equity ratio of 40% to 45%; a minimum increase of 15% in annual capital expenditures; and a minimum inventory turnover ratio of 4.5.

Would you recommend that the CEO disclose all, some, or none of these goals at the shareholders' meeting? Which ones and why?

C1-3

Fortress International: Disclosing major customers **(LO 1-2)**

The following excerpt is from Fortress International Group's 2012 10-K report filed with the SEC and is a required disclosure:

> [W]e earned approximately 46% of our total revenue from two customers for the year ended December 31, 2012, and 43% from three customers for the year ended December 31, 2011.

Required:

1. Why does the SEC require companies like Fortress International to alert financial statement readers to the existence of major customers?
2. How might this information be of use to a financial analyst?
3. Why might these two substantial customers want to monitor the financial performance and health of Fortress? What specific information about Fortress would be of most interest to the customers?
4. Why might Fortress want to monitor the financial performance and health of these two customers? What information about the customers would be of most interest to Fortress?

C1-4

The gap in GAAP **(LO 1-4)**

It is often alleged that the value of financial statement information is compromised by the latitude that GAAP gives to management. Companies can use different accounting methods to summarize and report the outcome of otherwise similar transactions. Inventory valuation and depreciation are examples in which GAAP allows several alternative accounting methods.

At one extreme, the FASB and the SEC could limit accounting flexibility by establishing a single set of accounting methods and procedures that all companies would apply. At the other extreme, the FASB and the SEC could simply require companies to provide relevant and reliable financial information to outsiders without placing any restrictions on the accounting methods used.

Required:

1. Why should managers be allowed some flexibility in their financial accounting and reporting choices?

2. Of the two approaches to accounting standards setting that are mentioned, which better describes the current financial reporting environment in the United States?
3. Describe the advantages and disadvantages of these two approaches to accounting standards setting, and tell how these advantages and disadvantages vary across different groups of financial statement users.

COLLABORATIVE LEARNING CASE

C1-1

Landfil's accounting change **(LO 1-4)**

You have been asked to attend a hastily called meeting of Landfil's senior executives. The meeting was called to formulate a strategy for responding to questions from shareholders, analysts, and the media about Landfil's accounting for site development costs. A major competitor, Chambers Development, announced yesterday that it would no longer capitalize site development costs but instead would expense those costs as they were incurred. Stock market reaction to the Chambers announcement was swift and negative, with the stock down 57% at this morning's opening of the NYSE.

Landfil Inc. acquires, operates, and develops nonhazardous solid waste disposal facilities. Landfil is the third largest waste management company of its type in the United States with 37 disposal sites. Sales have been growing at the rate of 30% annually for the last five years, and the company has established a solid record of earnings and operating cash flow performance.

Accounting Policy

Landfil capitalizes site development costs in much the same way that Chambers Development did prior to its announcement yesterday. Under the old accounting method at Chambers Development, when the firm spent $20 million on landfill site development, it would book the entire amount as a deferred asset. Then Chambers would spread the cost over 10 years by charging $2 million to earnings each year. Under the new accounting method, all $20 million is expensed in the first year.

Landfil has included the following description of its site development accounting in all annual reports issued during the last five years:

> The Company capitalizes landfill acquisition costs, including out-of-pocket incremental expenses incurred in connection with the preacquisition phase of a specific project (for example, engineering, legal, and accounting due-diligence fees); the acquisition purchase price, including future guaranteed payments to sellers; and commissions. If an acquisition is not consummated, or a development project is abandoned, all of such costs are expensed. Salaries, office expenses, and similar administrative costs are not capitalized. Landfill development and permitting costs, including the cost of property, engineering, legal, and other professional fees, and interest are capitalized and amortized over the estimated useful life of the property upon commencement of operations.

The Meeting

Discussion at the meeting became rather heated as several different points of view emerged. Some members of the executive team argued that Landfil should do nothing but reaffirm its capitalization policy, informing shareholders and others who contacted the company that this policy was consistent with GAAP and disclosed fully in the annual report. Other members of the team argued for a more proactive response involving both direct communication with shareholders and analysts as well as press releases to the media. These communications would also reaffirm the company's capitalization policy but in a more strident manner. Still other members of the executive team argued that Landfil should immediately announce that

it too was discontinuing capitalization in favor of immediate expensing. No clear consensus emerged as the meeting progressed, and the group decided to take a 10-minute break before resuming discussion.

As the meeting was about to reconvene, the CEO stopped by your chair and said, "I've been handed a phone message indicating that our largest shareholder has just called. She wants to know our reaction to the events at Chambers Development. I have to call her back in 15 minutes with an answer. When the meeting starts, I'd like you to summarize the major issues we face and to state how you think we should proceed."

Required:

Prepare your summary.

Additional study material is available in Connect.

Accrual Accounting and Income Determination

2

This chapter describes the key concepts and practices that govern the measurement of annual or quarterly income.[1] The cornerstone of income measurement is **accrual accounting.** Under accrual accounting, ***revenues are recorded (recognized)* when the seller has performed a service or conveyed an asset to a buyer,** which entitles the seller to the benefits represented by the revenues, and the value to be received for that service or asset is reasonably assured and can be measured with a high degree of reliability. ***Expenses are the expired costs or assets that are used up in producing those revenues. Expense recognition is tied to revenue recognition. That is, expenses are recorded in the same accounting period in which the related revenues are recognized. The approach of tying expense recognition to revenue recognition is commonly referred to as the "matching principle."*** Revenues less expenses, together with gains and losses, constitute income.

A natural consequence of accrual accounting is the decoupling of measured earnings from operating cash inflows and outflows. Except in the case of cash sales, such as for a meal at a restaurant, revenues under accrual accounting generally do not correspond to cash received during the period. Similarly, accrual-based expenses generally do not correspond to cash outlays during the period. In fact, ***there are often large differences between the firm's reported profit performance and the amount of cash generated from operations. Frequently, however, accrual accounting earnings provide a more accurate measure of the economic value added during the period than do operating cash flows.***[2]

The following section uses an example to illustrate the distinction between cash and accrual accounting measures of performance.

CASH FLOW VERSUS ACCRUAL INCOME MEASUREMENT

In January 2017, Canterbury Publishing sells three-year subscriptions to its quarterly publication, *Windy City Living,* to 1,000 subscribers. The subscription plan requires prepayment by the customers, so Canterbury receives the full subscription price of

[1] In this text, we use the terms *profit, earnings,* and *income* interchangeably.

[2] *Economic value added* represents the increase in the value of a product or service as a consequence of operating activities. To illustrate, the value of an assembled automobile far exceeds the value of its separate steel, glass, plastic, rubber, and electronics components. The difference between the aggregate cost of the various parts utilized in manufacturing the automobile and the price at which the car is sold to the dealer represents economic value added (or lost) by production.

LEARNING OBJECTIVES

After studying this chapter, you will understand:

- LO 2-1 The distinction between cash-basis versus accrual income and why accrual-basis income generally is a better measure of operating performance.
- LO 2-2 The general concept behind revenue recognition under accrual accounting.
- LO 2-3 The matching principle and how it is applied to recognize expenses under accrual accounting.
- LO 2-4 The difference between traceable and period costs.
- LO 2-5 The format and classifications for a multiple-step income statement and how the statement format is designed to differentiate earnings components that are more sustainable from those that are more transitory.
- LO 2-6 The presentation of discontinued operations and unusual or infrequently occurring items.
- LO 2-7 How to report a change in accounting principle, accounting estimate, and accounting entity.
- LO 2-8 How error corrections and restatements are reported.
- LO 2-9 The distinction between basic and diluted earnings per share (EPS) and required EPS disclosures.
- LO 2-10 What composes comprehensive income and how it is displayed in financial statements.
- LO 2-11 Other comprehensive income differences between IFRS and U.S. GAAP.
- LO 2-12 How the flexibility in GAAP invites "earnings management."
- LO 2-13 The procedures for preparing financial statements and how to analyze T-accounts.

$300 (12 issues × $25 per issue) from each of the subscribers ($300 × 1,000 = $300,000) at the beginning of 2017. Canterbury issues common stock for $50,000 cash and takes out a $100,000 three-year loan from a local bank on January 1, 2017. The loan calls for interest of 10% per year, but the interest is not payable until the loan matures on December 31, 2019. The cost of publishing and distributing the magazine amounts to $60,000 each year, which is paid in cash at the time of publication.

A schedule of operating cash inflows and outflows would be:

Operating Cash Inflows and Outflows

($000 omitted)	2017	2018	2019
Cash inflows	$300.0	$ —	$ —
Cash outflows:			
Production and distribution	(60.0)	(60.0)	(60.0)
Interest on loan	—	—	(33.1)*
Operating cash flow	$240.0	$(60.0)	$(93.1)

*With 10% interest compounded annually, the payment on December 31, 2019, would be $100,000 × 1.10^3 = $133,100, of which $33,100 would be interest.

Publishing the magazine and servicing the subscriptions require economic effort in each of the years 2017 through 2019, as indicated by the $60,000 of cash outflows for production and distribution each year. However, if income were measured on a cash basis, the entire $300,000 of cash inflow from subscription receipts would be treated as revenue in 2017, the year in which the subscriptions are sold and cash is collected, with no revenue recognized in the remaining two years of the subscription period. Likewise, the $33,100 of interest paid on December 31, 2019, would be reported as an expense in 2019 under the cash basis of accounting, with no interest expense recognized in the first two years. Consequently, on a cash basis, Canterbury Publishing would report a relatively high "profit" of $240,000 in 2017 when the subscriptions are sold and collected, followed by "losses" of $60,000 in 2018 and $93,100 in 2019 when the costs associated with publishing the remaining issues and financing the operations are paid.

Clearly, cash-basis accounting distorts our view of Canterbury's operating performance on a year-by-year basis. Moreover, none of the annual cash-basis profit figures provide a reliable benchmark for predicting future operating results. This distortion is due to differences in the timing of when cash inflows and outflows occur. Recognizing cash inflows as revenue and cash outflows as expenses would result in a cash-basis income number that failed to match effort and accomplishment properly.

Revenues arise from economic activities that span a three-year period. Canterbury's obligation to subscribers is fulfilled gradually over these three years as each issue is delivered, not just in 2017 when cash is collected.

The principles that govern revenue and expense recognition under accrual accounting are designed to alleviate the mismatching that exists under cash-basis accounting, making accrual earnings a more useful measure of a firm's performance. Accrual accounting allocates $100,000 of subscription revenue to each of the years 2017, 2018, and 2019 as the magazine is delivered to subscribers and Canterbury's obligation to provide the publication is satisfied. Likewise, accrual accounting recognizes interest expense in each year the bank loan is outstanding, not just in 2019 when the interest is paid. The information required to determine accrual earnings and to prepare all the financial statements is compiled by means of **journal entries,** which are made to record each transaction as it occurs and at the end of each year to adjust for the passage of time.

Throughout this book, **DR** represents the debit side and **CR** represents the credit side of the accounting entry to record the transaction being discussed. See the appendix to this chapter for a review of how these transactions are recorded.

Transactions for 2017

DR	Cash	$ 50,000	
CR	Common stock		$ 50,000

To record the issuance of common stock.

DR	Cash	$100,000	
CR	Loan payable		$100,000

To record the borrowing.

DR	Cash	$300,000	
CR	Deferred subscription revenue		$300,000

To record collection of 1,000 three-year subscriptions at $300 each for *Windy City Living*. Deferred subscription revenue is a liability account reflecting Canterbury's obligation to provide subscribers with future issues of *Windy City Living*

DR	Publishing and distribution expense	$ 60,000	
CR	Cash		$ 60,000

To record publishing and distribution expenses paid in cash.

Adjusting entries on December 31, 2017

DR	Deferred subscription revenue	$100,000	
CR	Subscription revenue		$100,000

To record subscription revenue for magazines delivered in 2017.

DR	Interest expense	$ 10,000	
CR	Accrued interest payable		$ 10,000

To accrue interest expense incurred but not yet paid, and to set up a liability for interest accrued during the period.

Transactions for 2018

DR	Publishing and distribution expense	$ 60,000	
CR	Cash		$ 60,000

To record publishing and distribution expenses paid in cash.

Adjusting entries on December 31, 2018

DR	Deferred subscription revenue	$100,000	
CR	Subscription revenue		$100,000

To record subscription revenue for magazines delivered in 2018.

DR	Interest expense	$ 11,000	
CR	Accrued interest payable		$ 11,000

To accrue interest expense incurred but not yet paid, and to set up a liability for interest accrued during the period. Interest is $110,000 (the balance due after the 2017 interest accrual) times 10%.

Transactions for 2019

DR	Publishing and distribution expense	$ 60,000	
CR	Cash		$ 60,000

To record publishing and distribution expenses paid in cash.

Adjusting entries on December 31, 2019

DR	Deferred subscription revenue	$100,000	
CR	Subscription revenue		$100,000

To record subscription revenue for magazines delivered in 2019.

DR	Interest expense	$ 12,100	
CR	Accrued interest payable		$ 12,100

To accrue interest expense incurred during the year. Interest expense is $121,000 (the balance due after the 2017 and 2018 interest accruals) times 10%. After this adjusting entry, the Accrued interest payable account will have a balance of $33,100.

Additional Transaction at December 31, 2019

DR	Loan payable	$100,000	
DR	Accrued interest payable	33,100	
CR	Cash		$133,100

To record repayment of the loan and accrued interest.

Canterbury's accrual-basis income statements for each of the three years are as follows:

Canterbury Publishing Income Statements (ignores income taxes)

($000 omitted)	2017	2018	2019
Subscription revenue	$100.0	$100.0	$100.0
Publishing and distribution expense	(60.0)	(60.0)	(60.0)
Interest expense	(10.0)	(11.0)	(12.1)
Net income	$ 30.0	$ 29.0	$ 27.9

From this example, it is clear that accrual accounting revenue for a period does not correspond to cash receipts for the same period. Likewise, accrual-basis expenses in a period do not correspond to cash outflows in that period. ***Accrual accounting decouples earnings measurement from operating cash flows.*** Indeed, accrual accounting can result in large differences between the firm's reported accrual-basis earnings and the amount of cash generated from operations (cash-basis earnings) year by year, as shown in Figure 2.1.

As this example illustrates, ***accrual accounting better matches economic benefit*** (revenue from subscriptions) ***with economic effort*** (magazine publication and distribution expenses and interest costs), ***thereby producing a measure of operating performance—accrual earnings—that provides a more realistic picture of past economic activities.*** Note that in this example, publication and distribution expenses match the corresponding cash outflow amounts. But the expense amount is based on the consumption of resources, not the timing of cash flows. The two just happen to be the same in this particular case. Many believe that accrual accounting numbers also provide a better basis for predicting future performance of an enterprise.

The view that accrual accounting dominates simple cash flow measures of performance was reasserted in *Statement of Financial Accounting Concepts No. 8* issued by the Financial Accounting Standards Board (FASB) in 2010. It stated:

> Accrual accounting depicts the effects of transactions, and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is important because information about a reporting entity's economic resources and claims and changes in its economic resources and claims during a period provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period.[3]

[3] "Conceptual Framework for Financial Reporting: Chapter 1, The Objective of General Purpose Financial Reporting," *Statement of Financial Accounting Concepts No. 8* (Stamford, CT: FASB, 2010), para. OB17.

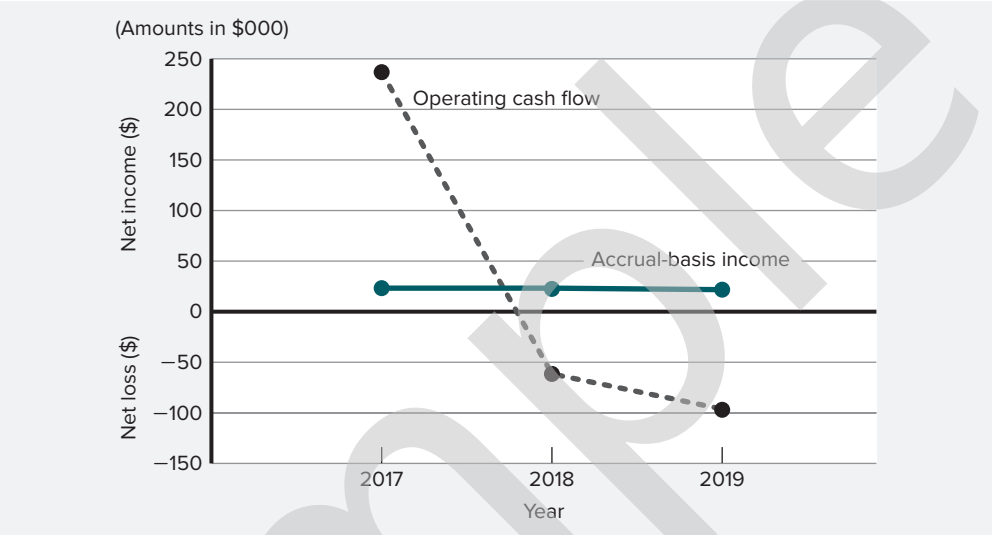

Figure 2.1

CANTERBURY PUBLISHING

Comparison of Accrual-Based Earnings and Operating Cash Flow

Still, it is important to recognize that reported accrual accounting income for a given period may not always provide an accurate picture of underlying economic performance for that period. One of our objectives is to help you, as a user of accounting information, understand not only the benefits of accrual accounting numbers but also their limitations. Throughout the book, we contrast accounting measurements and their earnings impact with the underlying economic circumstances, highlighting those situations in which the two may diverge.

Articulation of Income Statement and Balance Sheet

An important feature of the accrual accounting model is the interrelationship between the income statement and the balance sheet. In particular, whenever income or loss is recognized, there is a corresponding increase or decrease in net assets (assets minus liabilities) that did not arise due to a transaction with an owner of the business. As a result, when income (loss) is recognized, retained earnings is increased (decreased) and the balance sheet equation (Assets = Liabilities + Owners' Equity) is preserved. Retained earnings, a component of owners' equity, represents the accumulation of all the company's earnings since its inception, net of dividends.

Exhibit 2.1 examines how each of Canterbury's transactions affected assets, liabilities, and owners' equity. Note that any transaction that changed the balance in owners' equity was either a transaction with an owner or involved recognition of an amount on the income statement. In other words, net income is the change in owners' equity not due to transactions with owners.[4] Thus, there are two equivalent ways to think about the financial statement effects of income recognition. One perspective is that when income is recognized, the net income number (and thus, owners' equity) increases. The other perspective is that when net income is recognized, net assets increase. These two approaches to thinking about income recognition focus on different aspects of the same transaction. They remind us that net income recognition triggers an increase in the book value (carrying value) of net assets; ***that is, net asset valuation and net income determination are inextricably intertwined.***

Book value or **carrying value** refers to the amount at which an account (or set of related accounts) is reported on a company's financial statements. For example, the cost of property, plant, and equipment may be reported at $1,000,000 with accumulated depreciation of $300,000. The net book value or carrying value of property, plant, and equipment is the cost minus accumulated depreciation, or $700,000.

[4] This statement ignores the possibility of other comprehensive income, which we address later in the chapter.

EXHIBIT 2.1 **Summary of Canterbury Publishing Transaction Effects on Balance Sheet**

	Assets	Liabilities	Owners' equity	
Issuance of common stock	$ 50,000		$ 50,000	OWN
Issuance of debt	100,000	$100,000		
Sale of three-year subscription	300,000	300,000		
Publishing and distribution expenses	(60,000)		(60,000)	NI
Recognition of subscription revenue		(100,000)	100,000	NI
Accrual of interest expense		10,000	(10,000)	NI
Balance, December 31, 2017	390,000	310,000	80,000	
Publishing and distribution expenses	(60,000)		(60,000)	NI
Recognition of subscription revenue		(100,000)	100,000	NI
Accrual of interest expense		11,000	(11,000)	NI
Balance, December 31, 2018	330,000	221,000	109,000	
Publishing and distribution expenses	(60,000)		(60,000)	NI
Recognition of subscription revenue		(100,000)	100,000	NI
Accrual of interest expense		12,100	(12,100)	NI
Repayment of debt and accrued interest	(121,100)	(121,100)		
Balance, December 31, 2019	$148,900	$ 12,000	$136,900	

OWN - Transaction with owner. Change in owners' equity not recognized in net income.
NI - Change in owners' equity recognized in net income.

Revenue Recognition—General Concepts

A critical accounting question is: At what point in the operating cycle is it appropriate to recognize that a firm's net assets have increased in value and thus recognize income? Recently, the FASB and IASB issued a joint pronouncement that revamped the standards for revenue recognition. The new standard replaced a patchwork of rules, many of which were industry-specific, with a single framework for when revenue is to be recognized. We explore this standard in detail in Chapter 3. For now, think of the point at which revenue is to be recognized as the point at which the entity has satisfied its obligation to provide goods or services to a customer. In the case of a transaction at a department store, for example, it is when the exchange of goods for cash or a receivable (e.g., from a credit card) is made.

Expense Recognition

Once revenue for a period has been determined, the next step in determining income is to accumulate and record the costs associated with generating the revenue. Some costs are easily traced to the revenue earned. They are called **traceable costs.** Other costs are also clearly important in generating revenue, but their contribution to a specific sale is difficult, if not impossible, to quantify. Such costs are called **period costs.** Let's see how the matching principle is applied to traceable costs and period costs.

Traceable Costs

Traceable costs are recognized in expense in the same period as the corresponding revenue is recognized. This process is often called **matching.** In the case of Canterbury Publishing, the cost of physically producing each copy of the magazine is traceable to the revenue for that copy. Costs of physically producing a good, such as these costs, are

called **product costs,** and they often constitute a large portion of the traceable costs. Product costs also include manufacturing overhead, such as factory maintenance, insurance, and depreciation. Although it is difficult to associate overhead costs with specific units of production, they are generally allocated to inventory costs (and thus expensed as part of cost of goods sold) on some rational basis.

Canterbury's distribution costs, the cost of delivering the magazines, are assumed also to be traceable. That is, it is possible to identify the delivery costs with the physical delivery of the magazines, say through the U.S. mail. These are not product costs, but they are still recognized as expense in the same period as the revenue to which they are traced.

Period Costs Canterbury Publishing also incurred interest expense. Although interest is a necessary cost, it is not possible to associate interest with specific copies of the magazine. Thus, it is a period cost and it is expensed in the period the benefit was derived. Note that period costs are not expensed on a cash basis. The interest was all paid in 2019, but it was still expensed over the years the loan was outstanding, which is the period of time Canterbury benefited from the use of the borrowed funds.

RECAP

Revenue is recognized when an entity satisfies its contractual obligation to provide goods and services to a customer. The matching principle associates expired costs (expenses) with the revenues recognized in a period. Costs directly associated with specific revenues are called *traceable costs,* and these costs are expensed in the same period as the associated revenue. Period costs, those costs that cannot be associated with specific units of production, are expensed in the period benefited.

INCOME STATEMENT FORMAT AND CLASSIFICATION

Virtually all decision models in modern corporate finance are based on expected future cash flows. Recognizing this, the FASB stated:

> Thus, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.[5]

One way to provide users with information about prospective future cash flows would be to present them with cash flow forecasts prepared by *management.* However, financial reporting focuses on historical information, not forecasts, because forecasts of such numbers are considered to be too "soft"—that is, too speculative or manipulable.

Instead, financial reporting seeks to satisfy users' needs for assessing future cash flows by providing financial information based on past and current events in a format that gives financial statement users reliable and representative baseline numbers for generating *their own* forecasts of future cash flows. To accomplish this, an income statement format that segregates components of income has evolved. The purpose of this format is to classify separately income components that are "transitory" and to clearly differentiate them from income components believed to be "sustainable" or likely to be repeated in future reporting periods.

Valuation

As we examine the income statement format and classification rules, you will see that multiple-step income statements are intended to subdivide income in a manner that facilitates forecasting. Broadly speaking, the income statement separates earnings into two components: continuing operations and discontinued operations. Income from continuing operations comprises the earnings of any portion of an entity's business that does not qualify as a discontinued operation.

[5] *Statement of Financial Accounting Concepts No. 1,* op. cit., para. 37.

EXHIBIT 2.2 **Mythical Corporation**

Income Statements for the Years Ended December 31,

($ in millions)	2017	2016	2015
Net sales	$3,957	$3,478	$3,241
Costs of goods sold	(1,364)	(1,189)	(1,096)
Gross profit	2,593	2,289	2,145
Selling, general and administrative expenses	(1,093)	(949)	(922)
① **Unusual or infrequently occurring items (Note 1)**	(251)	—	—
Income from continuing operations before income taxes	1,249	1,340	1,223
Income tax expense	(406)	(436)	(411)
② **Income from continuing operations**	843	904	812
③ **Discontinued operations (Note 2)**			
Income from discontinued operations, net of tax	203	393	528
Gain on disposal of discontinued business segment, net of tax of $53	98	—	—
Net income	$1,144	$1,297	$1,340

Note 1: Unusual or infrequently occurring items—A strike closed operations in the Pleasant Grove manufacturing facility for five months in mid-2017. The fixed costs incurred at the idle plant totaled $251 million.

Note 2: Discontinued operations—The Company discontinued a business segment in 2017. The income from discontinued operations amounts reported in the income statement are net of tax of $105, $210, and $285 in 2017, 2016, and 2015, respectively.

Our discussion is based on the comparative income statements of Mythical Corporation for 2015–2017, presented in Exhibit 2.2.

Income from Continuing Operations

Mythical's income statement begins with the two components of Gross profit: Net sales, representing the revenue generated from sales of products during the period, and Cost of goods sold, representing the costs of producing the goods or services that were sold during the period. Gross profit is a key number for assessing the performance of an enterprise and for predicting future profitability. Analysts often focus on it as a percentage of Net sales, a quantity referred to as gross margin or gross margin percentage. Gross margin is useful for understanding how competitive pressures affect profit margins. For example, more price competition in an industry generally leads to "thinner margins."

Selling, general, and administrative expenses include marketing costs like advertising and sales commissions, accounting and legal costs, depreciation on corporate offices, and salaries of corporate management. These are essentially all the costs of operating the business other than manufacturing costs, which are included in Cost of goods sold, and interest expense.

Unusual or infrequently occurring items (item ① in Exhibit 2.2) are gains and losses (usually losses) that arise from a firm's continuing operations, but that are not typical, recurring costs. These amounts are reported as separate line items in the continuing operations section of the income statement.

Note that Income from continuing operations (item ② in Exhibit 2.2) is after deducting income tax expense. The income tax expense amount that is subtracted to arrive at Income from continuing operations is only the income tax expense related to continuing operations.

That is, any income tax expense or benefit that arises due to discontinued operations is not included in the line item Income tax expense. Rather, it is incorporated into the amounts presented for discontinued operations.

Unusual or Infrequently Occurring Items Material events that arise from a firm's ongoing, continuing activities but that are unusual in nature or infrequent in occurrence are reported as a separate line item within continuing operations. The Mythical Corporation income statement presented in Exhibit 2.2 includes a charge for losses incurred in conjunction with a labor strike. The charge is shown as a separate line item and described in a financial statement note (see item ① and Note 1 in Exhibit 2.2). The costs associated with the strike are highlighted because although they relate to continuing operations, they are not regular, recurring costs. Other examples of unusual or infrequently occurring items include:

1. Write-downs or write-offs of receivables, inventories, equipment leased to others, and intangibles.
2. Gains or losses from the exchange or translation of foreign currencies.
3. Gains or losses from the sale or abandonment of property, plant, or equipment.
4. Special one-time charges resulting from corporate restructurings.
5. Gains or losses from the sale of investments.
6. Losses from floods, fires, or other disasters.

Including unusual or infrequently occurring items as a component of Income from continuing operations complicates financial forecasting and analysis. Given its name, Income from continuing operations would seem to include only *the normal, recurring,* (*presumably*) *more sustainable, ongoing operating activities* of the organization. And, some unusual or infrequently occurring items do recur. For example, some firms are continually selling or disposing of obsolete manufacturing assets as well as taking write-downs on inventory or selling investment securities. Still, even though these items might recur for a given company, the amounts are not likely to be similar from one period to the next. So, while projecting sales from prior period sales and an estimated growth rate might be reasonable, projecting unusual or infrequently occurring items in the same way would not be. In addition, some unusual or infrequently occurring items do not recur at all. For example, Mythical's charge due to a strike would not be expected to recur in 2018. Consequently, the persistence of unusual or infrequently occurring items is likely to vary from period to period and from item to item. As a result, separate disclosure is provided for these items to assist users in forecasting future results. And, it is important for an analyst to understand the nature of each unusual or infrequently occurring item in order to make reasonable earnings forecasts.

Discontinued Operations

Because a primary objective of financial reporting is to assist users in generating estimates of future cash flows, transactions related to certain operations the firm intends to discontinue or has already discontinued are separated from other income statement items.[6] The reason is straightforward because, by definition, discontinued operations will not generate *future* operating cash flows.

[6] FASB ASC Paragraph 205-20-45-3: Presentation of Financial Statements—Discontinued Operations—Other Presentation Matters—Reporting Discontinued Operations.

Mythical Corporation discontinued a component of its business in 2017 (Exhibit 2.2, item ③). The operating results of this recently discontinued operation are excluded from continuing operations in the current period (2017) when the decision to discontinue was made. In addition, they are excluded from continuing operations in any prior years (2016 and 2015 for Mythical) for which comparative data are provided.[7] This makes the Income from continuing operations number of $843 million in 2017 comparable with the corresponding amounts of $904 million and $812 million in 2016 and 2015, respectively. While restating the 2016 and 2015 results makes continuing operations comparable to the 2017 results, it means that all the numbers from the Net sales line through the Income from continuing operations line reported in the 2016 and 2015 columns of the 2017 annual report will be different from the amounts originally reported in the 2016 and 2015 financial statements. However, net income for 2016 and 2015 are the same as originally reported because the amounts removed from continuing operations are reclassified to discontinued operations for those years.

An asset group represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities within the entity.

How is a disposition evaluated to determine if it will receive discontinued operations treatment? First, under U.S. GAAP, a **component of an entity**[8] comprises operations and cash flows that can be clearly distinguished, both operationally and for financial reporting purposes, from the rest of the entity. It may be a reportable segment, an operating segment, a reporting unit, a subsidiary, or an asset group.

If the component has been disposed of, it is treated as a discontinued operation if ". . . the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results."[9] If the component has not yet been disposed of, it must first be determined whether it is classified as held for sale. A disposal group is considered **held for sale** if the following six conditions are met:[10]

- Management has committed to a plan to sell the component.
- The component is available for immediate sale in its present condition subject only to terms that are usual and customary for such sales.
- An active program to locate a buyer has been initiated, as have all other necessary actions.
- The sale is probable, and is expected to be completed within one year (subject to certain exceptions).
- The component is being actively marketed at a reasonable price.
- It is unlikely that significant changes will be made to the disposal plan or that it will be withdrawn.

If the component is deemed to be held for sale, then it also must meet the strategic shift criterion to be given discontinued operations treatment. The strategic shift criterion is a relatively new requirement for discontinued operations treatment. In 2014, the FASB narrowed the definition of a discontinued operation by adding this requirement. As a result, some dispositions that previously would have been considered discontinued operations no longer are. The new guidelines became effective for calendar year firms in 2015.

[7] Securities and Exchange Commission (SEC) rules (Regulation S-X, Article 3) require that comparative income statement data for at least three years and comparative balance sheet data for two years be provided in filings with the Commission. For this reason, most publicly held corporations provide these comparative income statement and balance sheet data in their annual report to shareholders.

[8] FASB ASC Section 360-10-20 - Property, Plant, and Equipment - Overall - Glossary.

[9] FASB ASC Paragraph 205-20-45-1B: Presentation of Financial Statements - Discontinued Operations—Other Presentation Matters

[10] For the exact wording of these criteria, see FASB ASC Paragraph 205-20-45-1E: Presentation of Financial Statements - Discontinued Operations - Other Presentation Matters.

Amounts Reported When Disposal Group Has Been Sold When the discontinued component is sold before the end of the reporting period, companies must report two elements as part of discontinued operations:

1. Operating income or loss (that is, revenue minus expenses) from operating the component from the beginning of the reporting period to the disposal date, net of related tax effects.
2. Gain or loss on disposal computed as the net sale price minus book value of net assets disposed of, net of related tax effects.

In Exhibit 2.2, we see that in 2017 Mythical reported a $203 million profit from operating the discontinued operations through the date of sale. This amount is net of tax, and Note 1 indicates the tax effect was $105 million, implying the pretax profit was $308 million. Mythical also reported a $98 million gain on the sale, after considering a $53 million tax effect. Therefore, the pretax gain was $151 million, representing the excess of the selling price over the book value of the net assets sold.

We also see in Exhibit 2.2 that prior years have been restated to reflect the discontinued operations separately, even though these operations were not considered discontinued in the prior years. This is done to enhance comparability across years. Exhibit 2.3 shows the relationship between the 2016 and 2015 numbers as reported in the 2017 annual report and the numbers as originally reported. The adjustment column represents a "deconsolidation," or the removal of the discontinued operations from the consolidated amounts originally reported. Note that the individual line item amounts for the discontinued operations are assumed, but in such a way that they are consistent with the information (pretax and aftertax profit of the discontinued operations) already provided in Exhibit 2.2.

In 2016, the operations that were sold in 2017 had Net sales of $1,600 million, Cost of goods sold of $565 million, Selling, general, and administrative expenses of $465 million and income tax expense of $177 million. To derive the restated 2016 income statement to be presented in Mythical's 2017 annual report, these amounts were removed from the respective line

EXHIBIT 2.3 **Mythical Corporation - Retroactive Restatement of Discontinued Operations**

	2016			2015		
($in millions)	As Originally Reported	Adjustments	As a Discontinued Operation	As Originally Reported	Adjustments	As a Discontinued Operation
Net sales	$ 5,078	($1,600)	$ 3,478	$ 5,348	($2,107)	$3,241
Cost of goods sold	(1,754)	565	(1,189)	(1,853)	757	(1,096)
Gross profit	3,324		2,289	3,495		2,145
Selling, general and adminitstrative expenses	(1,414)	465	(949)	(1,553)	631	(922)
Unusual or infrequently occurring items						
Income from continuing operations before taxes	1,910		1,340	1,942		1,223
Income tax expense	(613)	177	(436)	(602)	191	(411)
Income from continuing operations	1,297		904	1,340		812
Discontinued operations:						
Income from operation of discontinued operations, net of tax		393	393		528	528
Gain on disposal, net of tax						
Net income	$ 1,297	$ 0	$ 1,297	$ 1,340	$ 0	$1,340

EXHIBIT 2.4 **Typical Disclosure for Discontinued Operations When Asset Group Is Held For Sale**

Partial Income Statement

Income from continuing operations	$800,000
Income tax expense	(280,000)
Income from continuing operations after tax	520,000
Discontinued operations	
Operating income (net of taxes of $42,000) from January 1, 2017, through December 31, 2017	78,000
Impairment loss (net of $17,500 tax benefit) on assets held for sale	(32,500)
Net income	$565,500

items in the income statement and the net income they compose, $393 million, was added in as a single line item—Income from discontinued operations, net of tax. The result is a restated income statement with the same net income amount of $1,297 million, but with every line item different from the original presentation. A similar exercise is presented for 2015.

Amounts Reported When Disposal Group Is Considered "Held for Sale" If a component becomes a discontinued operation in a reporting period but has not been sold by the end of the period, the income effects of the discontinued operations are reported in two elements:

1. Operating income or loss (that is, revenue minus expenses) from operating the component, net of tax effects.
2. An impairment loss[11] (net of tax effects) if the book value of the net assets in the disposal group is more than the net assets' fair value minus cost to sell.

Exhibit 2.4 illustrates a typical income statement disclosure for this situation with an after-tax impairment loss on assets "held for sale" of $32,500.

Note that both the income (loss) from operating the discontinued component and any gain (loss) from disposal or impairment are reported net of tax effects. This "net of tax" treatment is called **intraperiod income tax allocation.** The reason for this treatment is to match the income tax burden or benefit with the item giving rise to it. The allocation of the tax burden or benefit across components of income makes the income figures more informative.

Here's why: If income tax were not matched with the item giving rise to it, the reported income tax expense would combine taxes arising from both continuing and discontinued operations, which would make it difficult for financial statement users to forecast future tax outflows. Under intraperiod income tax allocation, the income tax associated with discontinued operations ③ is not included in Mythical's $406 million income tax expense figure for 2017 (Exhibit 2.2), thus facilitating forecasts of expected future flows after tax.

RECAP

Unusual or infrequently occurring items that are considered material must be disclosed separately as part of pre-tax income from continuing operations. Discontinued operations are reported separately after income from continuing operations and on an after-tax basis.

[11] See Chapter 10 for further details on determining whether an asset has become impaired and, if so, the amount of the loss.

Frequency and Magnitude of Various Categories of Transitory Income Statement Items

As Figure 2.2 illustrates, financial reporting rules for presenting operating results isolate transitory components of earnings to assist users in predicting future earnings and cash flows. Research evidence confirms that the GAAP income statement classification framework we have discussed is useful to financial statement users. Specifically, subdividing earnings into three transitory components—unusual or infrequent items, discontinued operations, and **extraordinary items** (when they existed)—and disclosing these amounts separately so that they are distinguished from the income that comes from continuing operations improves forecasts of future earnings.[12]

Another category of transitory items reported separately on the income statement that existed under U.S. GAAP until recently is extraordinary items. To be treated as an extraordinary item, the event or transaction must have been *both* unusual and infrequently occurring. Effective in 2016 for calendar-year firms, U.S. GAAP no longer permits extraordinary item treatment. Instead, such gains and losses are reported in the continuing operations section of the income statement on a pretax basis, with the tax effect included in income tax expense. Extraordinary items were never permitted under IFRS.

Figure 2.2 shows the proportion of firms reporting (1) Unusual or infrequent items, (2) Discontinued operations, or (3) Extraordinary items in their income statements from 2002–2014. The most common category of separately disclosed earnings components is unusual or infrequently occurring items reported as part of income from continuing operations. About 62% of the sample firms reported such items in 2014, with the proportion having grown from about 50% in 2002. Discontinued operations is the next most common separately disclosed item, appearing in approximately 13% of the earnings statements of firms in 2014. That proportion has fluctuated between 12% and 17% during the period examined. The proportion of firms disclosing extraordinary items decreased from 15% in 2002 to less than 2% in 2014. The dramatic decline in the first two years of the data is because originally gains and losses on early extinguishment of debt were automatically classified as extraordinary items. Once the automatic classification was eliminated for those transactions, extraordinary items were far less common.

Exhibit 2.5 shows that over the 2002–2014 period, the majority of unusual or infrequently occurring items were losses. The preponderance of losses for unusual or infrequently occurring items reflects two things:

1. The conservative bias of accrual accounting rules encourages early recognition of declines in asset values below cost or book value but tends to delay recognition of increases in value until the asset is sold.

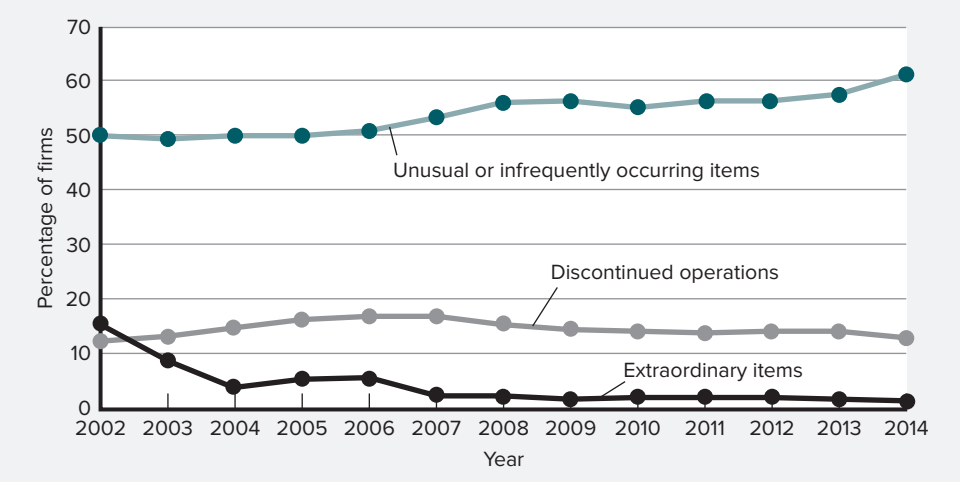

Figure 2.2

PROPORTION OF FIRMS REPORTING NONRECURRING ITEMS (2002–2014)

Source: Standard and Poor's Compustat® Annual Industrial File as data source; methodology not verified or controlled by *Standard & Poor's.*

[12] For evidence that predictive ability is improved when transitory components of earnings are identified, see P.M. Fairfield, R.J. Sweeney, and T.L. Yohn, "Accounting Classification and the Predictive Content of Earnings," *The Accounting Review,* July 1996, pp. 337–55.

EXHIBIT 2.5 **Percentage of Nonrecurring Items That Are Losses (2002–2014)**

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Unusual or infrequently occurreing items	76.3%	71.2%	72.1%	72.3%	69.2%	72.5%	77.5%	73.4%	74.3%	75.8%	78.3%	77.3%	78.1%
Discontinued operations	53.2	46.6	43.9	40.9	40.5	40.8	48.8	53.9	48.9	46.6	48.6	46.5	49.9
Extraordinary items	75.3	57.2	40.2	52.4	27.6	27.0	32.1	41.1	35.4	28.8	29.6	25.2	29.3

Source: Compustat Annual Industrial File.

2. Firms have a stronger incentive to disclose separately and clearly label losses than they do gains. To include (undisclosed) nonrecurring losses as part of the income from continuing operations line would cause financial statement users to underestimate future income. To avoid this understatement firms opt for separate line-item disclosure of losses.

REPORTING ACCOUNTING CHANGES

Consistency, as that term is used in accounting, means using the same accounting methods to describe similar economic events from period to period. Consistency enhances accounting's decision usefulness by allowing users to identify trends or turning points in a company's performance over time. However, because we live in a dynamic and ever-changing business environment, consistency in application of accounting standards over time is not always possible. Firms sometimes voluntarily switch accounting methods or revise estimates used to compute net income because they believe the alternative method or estimate better reflects the firm's underlying economics. Also, accounting standards-setting bodies, such as the FASB and the IASB, frequently issue new standards in response to changes in the business environment, requiring companies to change accounting methods.

When firms change accounting methods, it raises questions about **transition methods.** That is, how do you actually effect a change from one accounting method to another? Below we describe how accounting method changes are disclosed under U.S. GAAP.[13] These disclosures are designed to enhance the comparability and consistency of the numbers over time and to inform financial statement users about the effects of the change on the current period results.

As shown in Exhibit 2.6, accounting changes fall into one of three categories: change in accounting principle, change in accounting estimate, or change in reporting entity.

Change in Accounting Principle

A change in an accounting principle occurs when (1) a firm *voluntarily* changes from one generally accepted accounting principle to another generally accepted accounting principle or (2) the accounting standards-setting body revises accounting standards, requiring firms to follow a new method *(mandatory* change). An example of a voluntary change is a firm switching from the last-in, first-out (LIFO) to first-in, first out (FIFO) method for valuing inventories. A mandatory accounting change is illustrated by the GAAP change that required firms to expense employee stock option grants in the income statement rather than just disclosing the value of such grants in financial statement notes, as was previously allowed.[14]

In general, U.S. GAAP requires firms to use the **retrospective approach** to account for changes in accounting principles unless it is impracticable to do so or a new standard specifies

[13] FASB ASC Topic 250: Accounting Changes and Error Corrections.

[14] FASB ASC Topic 718: Compensation—Stock Compensation.

EXHIBIT 2.6 Types of Accounting Changes

Type of Change	Description	Examples
Change in accounting principle	Change from one generally accepted accounting principle to another. This change can be voluntary (initiated by the firm) or mandatory (required by a standards-setting body such as the FASB).	Voluntary • Change in methods of inventory costing Mandatory • Adoption of a new FASB standard
Change in accounting estimate	Revision of an estimate because of new information or new experience.	• Change in estimated percentage of uncollectible accounts (bad debts) • Change in depreciation method (e.g., straight line to accelerated method)* • Change in estimated service life or salvage value of depreciable assets
Change in accounting entity	Change in the economic units that compose the reporting entity.	• Reporting consolidated financial statements in place of financial statements for individual entities • Adding a subsidiary not previously included in prior years' consolidated financial statements

* Under U.S. GAAP, a change in depreciation methods is treated as a change in estimate that is achieved by a change in accounting principle.

some other transition method.[15] Under the retrospective approach, prior years' financial statements (balance sheet, income statement, cash flow statement, and statement of stockholders' equity) are revised to reflect the impact of the accounting principle change. The revised prior-year financial statements are as if the new principle had been used since the company's inception.

In addition to revised amounts appearing in the comparative prior-year financial statements, a journal entry is made to adjust all balance sheet accounts as of the beginning of the current year (i.e., the change year) to what their balances would have been had the new method always been used. In addition to adjusting existing asset or liability accounts, the entry to record the accounting principle change typically requires an adjustment to the firm's beginning Retained earnings balance to reflect the **cumulative effect** of the accounting principle change on all prior periods' reported income. This cumulative effect is the difference between what reported cumulative earnings would have been in all prior years if the new method had always been used versus the cumulative earnings previously reported under the old method.[16]

Like many retailers, Abercrombie & Fitch's fiscal year-end is the end of January. So the 2012 fiscal year ends on February 2, 2013. Abercrombie & Fitch's 2012 10-K report was filed with the SEC on April 4, 2013, which is after the effective date of this accounting change.

Exhibit 2.7 illustrates how apparel retailer Abercrombie & Fitch Co. used the retrospective approach for its change from the lower of cost or market (LCM) utilizing the retail method to the weighted average cost method to

[15] Changes in principles that are deemed to be impracticable to apply retrospectively occur when information needed to do so is not available or would require assumptions about management's intent in a prior period that cannot be independently verified [FASB ASC Paragraph 250-10-45-9: Accounting Changes—Overall—Other Presentation Matters—Impracticability].

[16] The cumulative effect on beginning retained earnings reflects only the direct effects on earnings, which includes related tax effects. Indirect effects (e.g., profit sharing or royalty payments based on reported income) are not included under the retrospective application [FASB ASC Paragraph 250-10-45-8: Accounting Changes—Overall—Other Presentation Matters—Change in Accounting Principle].