Ninth Edition

Financial Accounting in an Economic Context

JAMIE PRATT

WILEY

FINANCIAL ACCOUNTING
In an Economic Context

Ninth Edition

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WILEY

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Preface

Financial Accounting in an Economic Context continues to be a trendsetting textbook in the area of introductory financial reporting and analysis. Since the publication of the first edition in 1989, this text has become an important part of the curriculum at a large and impressive group of forward-thinking schools. The ninth edition continues to build on the strengths of previous editions, while it introduces new ideas and refinements that better communicate the book's economic decision-making theme.

KEEPING STUDENTS UP TO DATE

The ninth edition has retained and improved upon the popular features developed in prior editions. In addition to updating virtually all of the hundreds of real-world references, we briefly discuss below some of the key and very recent features. For the most part, however, this ninth edition maintains the same style and content of the eighth edition, which was very well received by a wide variety of universities, colleges, and other institutions.

Globalization of Business and Financial Reporting Standards Business is becoming more global with each passing day, and International Financial Reporting Standards (IFRS) are used throughout the world, including in the United States. While the ninth edition still is based on U.S. GAAP, IFRS standards and concepts are woven throughout the entire text. Starting with Chapter 1, IFRS is included in our definition of generally accepted accounting principles, and the ongoing process of converging toward a single global system is described and discussed. Chapter 2 features a complete set of IFRS-based financial statements, published by Unilever, a Dutch-based consumer-goods company, and discusses the conceptual differences between U.S. GAAP and IFRS. Throughout the remainder of the text, conceptual and mechanical differences between U.S. GAAP and IFRS are highlighted via international boxed-in items that do not interrupt the flow of the text, but allow interested readers to see where differences between the two systems reside. In addition, many end-of-chapter exercises, problems, and issues for discussion deal directly with IFRS-based financial statements, and in a number of places complete IFRS-based financial statements are illustrated and discussed. Note as well that IFRS is not the only evidence of globalization featured in this edition. Differences in business practices and cultures, differences in financial disclosure and format practices, and environmental differences across national borders are all highlighted. Indeed, we live in a global business world, and the ninth edition reflects what future business leaders need to know to operate effectively within it.

Statement of Cash Flows The ninth edition discusses the statement of cash flows from the very first chapter, and demonstrates how to prepare the statement directly from the activity in the cash T-account in Chapter 4. Mechanical differences between accruals and cash flows are introduced and illustrated in Appendix 4A through the process of reverse T-account analysis, and the actual preparation of the statement of cash flows, using the indirect form of presentation, occurs in Chapter 14.

Appendix 4A includes not only reverse T-account analysis but also the preparation of a relatively simple statement of cash flows under both the direct and indirect forms of presentation. Throughout the remaining chapters we have worked in special boxed-in items, where appropriate, that invite the reader to consider differences between accruals and cash flows, normally in terms of the adjustments to net income in the operating section of the statement of cash flows prepared under the indirect method. This feature constantly reminds the reader of the reconciliation between net income and net cash from operations, a very important part of understanding financial statements, and it better prepares the students for Chapter 14, which covers the statement as a whole. Readers who understand Appendix 4A and make note of the boxed-in items will find that Chapter 14 is no more than a helpful review.

Fair Market Value Accounting Students in today's business environment should understand the basics of fair market value accounting, and how it differs from the traditional matching model. U.S. GAAP is showing signs of moving toward a fair market value–based system (e.g., the fair value option for financial instruments), and IFRS relies more heavily on fair values than does U.S. GAAP. To address this development, fair market value accounting is weaved throughout the ninth edition. In addition to frequent references to market and firm valuation, the text also discusses difficulties in the financial markets and security valuation issues related to the collapse of major financial institutions. Appendix A covers valuation and the time value of money. Other prominent examples appear in:

Chapter 2—Differences between U.S. GAAP and IFRS in their reliance on fair market value accounting.

Chapter 3—Measurement fundamentals of financial reporting, including a discussion of asset valuation in terms of fair market value vs. historical cost.

Chapter 5—Discussion of financial statement analysis and firm valuation.

Chapter 8—Illustrations and discussions of fair market value applications to asset valuation and the fair value option for financial instruments under U.S. GAAP. This chapter also introduces acquisitions and the valuation of goodwill.

Chapter 9—Special section dealing with accounting for long-lived assets using the matching model vs. the fair market value option available under IFRS.

Chapter 11—Discussion of the fair market value of long-term debt vs. long-term debt accounting under the effective interest method.

Chapter 12—Discussion of market value vs. book value of common stock.

Complete Financial Statement Analysis Package Chapter 5 is devoted to financial statement analysis, and Appendix 5A covers shareholder value creation, how it relates to the return on equity model, and cash flow analysis. Chapter 5 also includes a section devoted to business segment analysis, which introduces real-world disclosures and links these disclosures to overall financial statement analysis, and Appendix 5A includes a section on the mechanics of projecting financial statements. End-of-chapter items are devoted to both business segment analysis and projection of financial statements. Finally, at the end of Chapters 6–13 is a special section that discusses ROE analysis in terms of the chapter topic, and directs students to a website where they are asked to analyze real company data with an ROE spreadsheet model.

CONTINUING THE APPROACH

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

Economic Factors

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

Measurement Issues

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

Mechanics

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

Decision-Making Perspective

This text presents financial accounting in a way that helps managers make decisions—a decision-making perspective. At a fundamental level, managers make two kinds of decisions:

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

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

FIGURE P–1

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

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

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

SUCCESSFUL FEATURES RETAINED FROM PREVIOUS EDITIONS

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

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

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

Reverse T-Account Analysis An important user-oriented, analytical skill, called *reverse T-account analysis*, is covered in detail in Appendix 4A. This material shows students how to derive transactions from the financial statements, and many exercises and problems throughout the text require students to use it.

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

International Coverage At the end of each chapter, we discuss timely, relevant, and important international issues. These sections encourage students to think more broadly about global business issues and how they relate to accounting.

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

Excerpts from Business Publications and Professional Journals Over 10,000 references from various business publications (*Wall Street Journal*, *Forbes*, and other professional and academic journals) are integrated throughout the text. Updated to reflect the most recent developments, these references document and clarify important chapter concepts and introduce students to information sources that will be useful to them in their business careers.

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

SUPPLEMENTS FOR THE INSTRUCTOR

Instructor's Manual This instructor's resource includes a synopsis that highlights general chapter topics, a text/lecture outline that summarizes the chapter in detail, lecture tips for areas in which students commonly have difficulty, answers to chapter questions, and an assignment classification table.

Test Bank More than 1,700 questions are included in both the printed and microcomputer versions of the Test Bank. Learning outcomes are provided for each question.

Solutions Manual This supplement provides complete solutions to all exercises and problems in the text.

Powerpoint Presentation Slides Lecture slides highlight the major concepts of each chapter. The slides may be printed out for use on an overhead projector.

Financial Accounting Website (http://www.wiley.com/college/pratt) This password-protected instructor resource provides the Solutions Manual, Instructor's Manual, Test Bank, and PowerPoint Presentation Slides in an easily downloadable format.

For more information on these or other supplemental materials, please contact your local Wiley sales representative or visit us online at www.wiley.com/college/pratt.

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Finally, heartfelt and sincere thanks go to my wife, Kathy, and children, Jason, Ryan, and Dylan. Their consistent support and understanding over the past 25 years has certainly enabled and motivated me to push forward toward the completion of now the ninth successful edition of this text.

Jamie Pratt

About the Author

Jamie Pratt holds the A. L. Prickett Chair of Accounting at Indiana University in Bloomington, Indiana. He received his undergraduate degree from Purdue University in 1973 and his doctoral degree from Indiana in 1977. Prior to joining the Indiana faculty in 1990, Jamie served on the faculties at the University of Washington in Seattle, Northwestern University, the University of Zurich (Switzerland), and INSEAD, an MBA program in Fontainebleau, France. Jamie teaches in executive programs throughout the world and has won numerous teaching awards and honors. He served as the Associate Editor of *The Accounting Review*, is very active in the American Accounting Association, and continues to publish in the top academic journals in accounting. In addition to this text, Jamie has authored a variety of educational products, including a case book, a spreadsheet-based financial analysis simulation, and state-of-the-art interactive financial reporting cases. His newest text, co-authored with Professor Eric Hirst, focuses on the link between shareholder value creation and financial reporting.

An Overview of Financial Accounting

PART 1

International Business Machines (IBM), the largest technology services company in the world, had surpassed the expectations of those analysts following the company and its industry every quarter since 2005. In April 2013, however, the company released a report, indicating earnings of $3.00 per share of outstanding stock, which was below the $3.05 amount expected by the analysts. The response of the stock market was swift, with IBM share prices dropping by almost 6 percent. Perhaps indicative of the economic climate at the time, the company also reported that computer system hardware sales and consulting services generated revenues below prior forecasts.

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

CHAPTER 1

Financial Accounting and Its Economic Context

Key Points

The following key points are emphasized in this chapter:

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

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

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

1.1 Financial Reporting and Investment Decisions

Financial reporting plays an important role in investment decisions.

1. *Profit-seeking companies*—Managers of profit-seeking companies prepare reports containing financial information for the owners of these companies. In addition to other information, these reports contain four financial statements: the balance sheet, the income statement, the statement of shareholders' equity, and the statement of cash flows.
2. *Owners and other interested parties (users)*—Although prepared primarily for the owners, these financial reports are available to the public and are read by other interested parties who use them to assess the financial condition and performance of the company as well as

the performance of its managers. Such interested parties, called users in this text, include potential investors, bankers, government agencies, and the company's customers and suppliers.

3. *User decisions*—Users obtain information from the financial reports that helps assess the company's past performance, predict its future performance, and control the activities of its managers. Thus financial reports, help users to make better decisions. Investors, for example, use financial reports to choose companies in which to invest their funds; bankers use them to decide where to loan their funds and what interest rates to charge.
4. *Effects of user decisions*—User decisions affect the financial condition and performance of the company and the economic well-being of its managers. For example, a banker may use the information contained in a financial report to decide not to loan a certain company much-needed funds. Such a decision may cause the company to struggle and may cost managers their jobs and owners their investments.

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

1. Economic consequences
2. User orientation

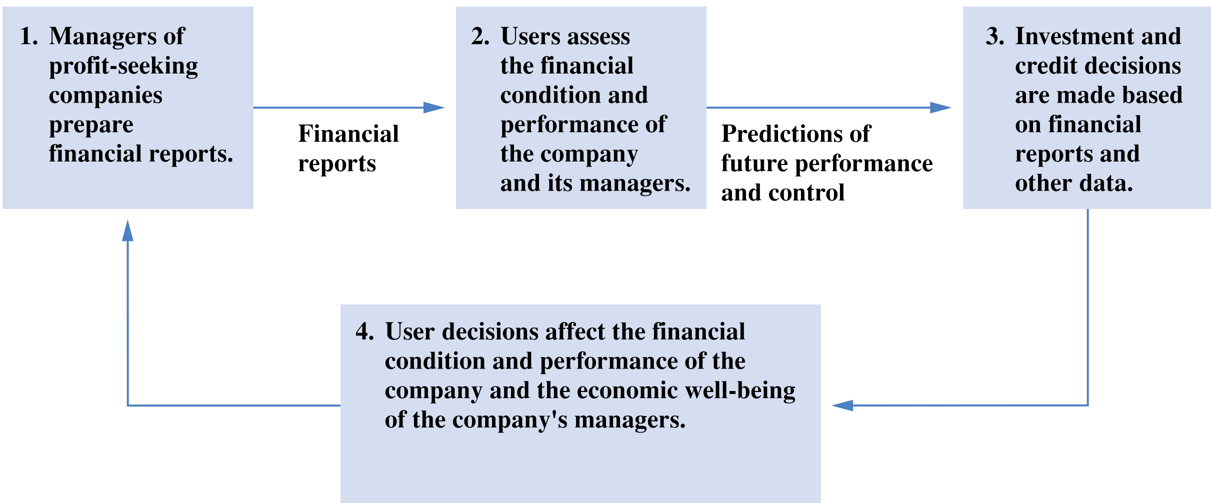

FIGURE 1–1 Financial reporting and investment decisions

1.1.1 Economic Consequences

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

1.1.2 User Orientation

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

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

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

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

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

1.2 The Demand for Financial Information: A User's Orientation

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

1.2.1 Consumption and Investment

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

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

1.2.2 Where to Invest?

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

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

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

1.2.3 The Demand for Documentation

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

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

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

1.2.4 The Demand for an Independent Audit

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

1.2.5 Martin and the CPA: Different Incentives

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

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

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

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

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

The Auditor's Report

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

Overall, you are reassured by the auditor's report. It indicates that the auditor reviewed Microline's records thoroughly and concluded that the statements (1) were prepared in conformity with generally accepted accounting principles, (2) present fairly Microline's financial condition and operations, and (3) resulted from an effective internal control system. You suspect that the auditor could have rendered a much less favorable report, such as that the statements were not prepared in conformance with generally accepted accounting principles, or that

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF MICROLINE:

We have audited the accompanying balance sheet of Microline as of December 31, 2013 and 2012, and the related statements of income, shareholders' equity, and cash flows for the years then ended. We have also audited management's assessment of the effectiveness of its internal control over financial reporting. These financial statements and the effectiveness of the internal controls are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and management's assessment of the internal controls based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Microline as of December 31, 2013, and 2012, and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles. Also, in our opinion management maintained effective internal control over financial reporting as of December 31, 2013.

Arthur Price

Arthur Price, Certified Public Accountant
March 12, 2014

FIGURE 1–2
The standard audit report

no opinion could be reached because Microline's accounting system and internal controls were so poorly designed, or that Microline was in danger of failure. You also realize, however, that you know very little about internal control systems, auditing standards, and generally accepted accounting principles, and that Microline's management made a number of significant estimates when preparing the statements. This discovery is somewhat troubling because, even with the audit, it seems that Microline's management may have had some subjective influence on the financial statements.

The Management Letter

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

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

MANAGEMENT'S RESPONSIBILITIES:

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

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

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

Martin Wagner

Martin Wagner, Chief Executive Officer
March 12, 2014

FIGURE 1–3
Management's letter

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

The Financial Statements

You briefly review the four financial statements (see Figure 1–4) and note first that dollar amounts are listed for both 2013 and 2012. This discovery is somewhat discouraging because only information about the past is included on the statements and is subject to the auditor's report and management letter. Nothing about Microline's future prospects is included in the financial statements—but the future is what interests you most. Whether Microline is able to provide an acceptable return on your $1 million investment depends primarily on what happens in the future. The past is often a poor indicator of the future.

You also observe that each statement emphasizes a different aspect of Microline's financial condition and performance. The balance sheet, for example, lists the company's assets, liabilities, and shareholders' equity. On the income statement, expenses are subtracted from revenues to produce a number called net income. The statement of shareholders' equity includes (1) the beginning and ending common stock and retained earnings balance, which can be found on the 2012 and 2013 balance sheets; (2) net income, which is the bottom line on the income statement; and (3) dividends. The statement of cash flows includes the beginning and ending balance of cash, which can be found on the 2012 and 2013 balance sheets, and net cash flows from operating, investing, and financing activities. It becomes clear quite quickly that you do not understand these terms and that you know very little about the information conveyed by these statements and, therefore, cannot begin to assess whether Microline would be a good company in which to invest.

Microline
Financial Statements
As of December 31, 2013 and 2012

	2013	2012
BALANCE SHEET		
ASSETS		
Cash	$ 100,000	$ 60,000
Accounts receivable	80,000	90,000
Equipment	330,000	300,000
Land	500,000	500,000
Total assets	$1,010,000	$ 950,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Short-term payables	$ 50,000	$ 30,000
Long-term payables	420,000	450,000
Common stock	400,000	400,000
Retained earnings	140,000	70,000
Total liabilities and shareholders' equity	$1,010,000	$ 950,000
INCOME STATEMENT		
Revenues	$1,650,000	$1,500,000
Expenses	1,450,000	1,350,000
Net income	$ 200,000	$ 150,000
STATEMENT OF SHAREHOLDERS' EQUITY		
Beginning balance in common stock and retained earnings	$ 470,000	$ 400,000
Plus: Net income	200,000	150,000
Less: Dividends	130,000	80,000
Ending balance in common stock and retained earnings	$ 540,000	$ 470,000
STATEMENT OF CASH FLOWS		
Net cash flow from operating activities	$ 250,000	$ 120,000
Net cash flow from investing activities	(50,000)	(340,000)
Net cash flow from financing activities	(160,000)	280,000
Net increase (decrease) in cash	$ 40,000	$ 60,000
Beginning cash balance	60,000	0
Ending cash balance	$ 100,000	$ 60,000

FIGURE 1–4
Financial statements for Microline

The Footnotes

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