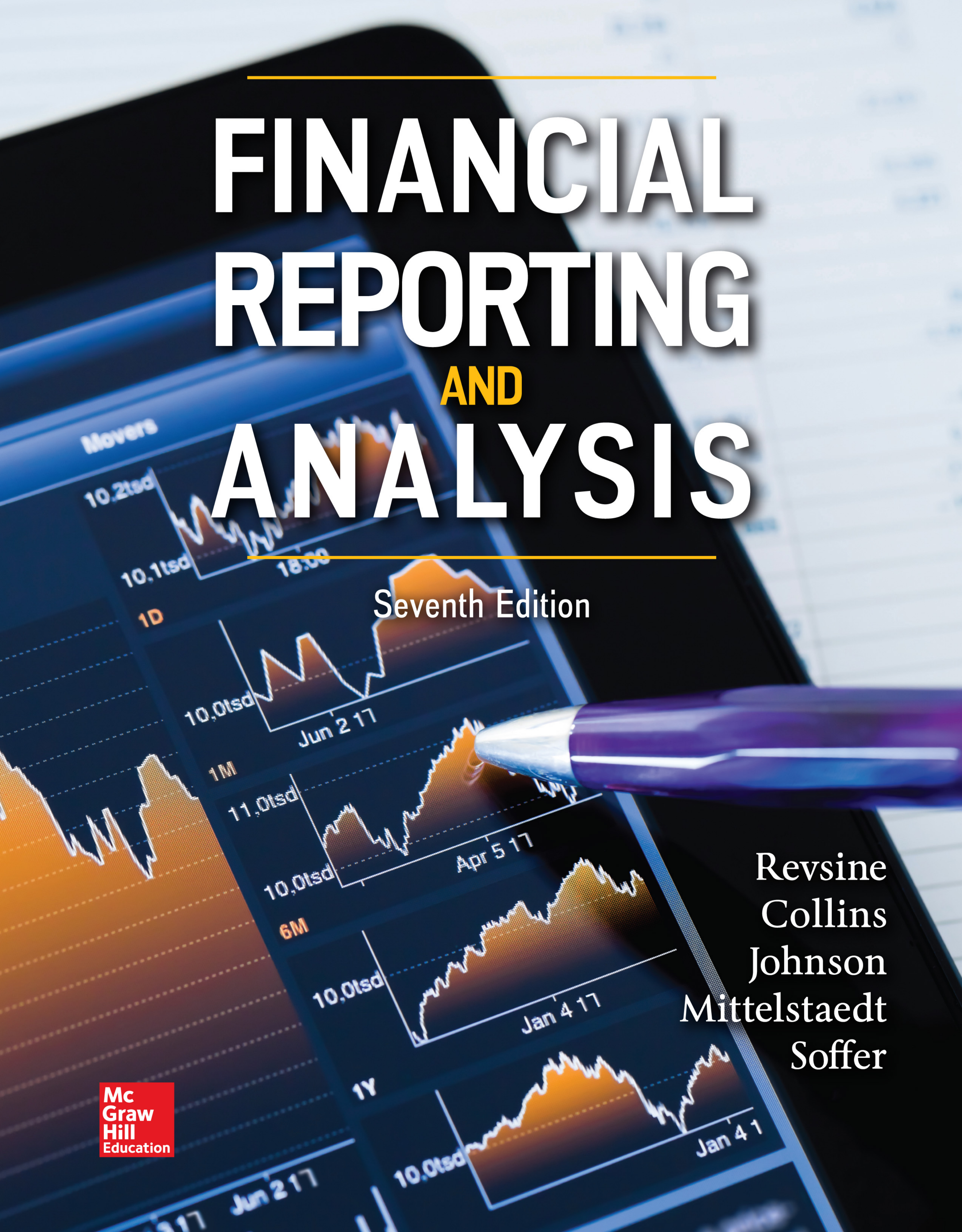


FINANCIAL REPORTING AND ANALYSIS

Seventh Edition

Revsine
Collins
Johnson
Mittelstaedt
Soffer

McGraw Hill Education

FINANCIAL REPORTING & ANALYSIS

7th EDITION

Lawrence Revsine
Late of Northwestern University

Daniel W. Collins
Henry B. Tippie Research Chair in Accounting
Tippie College of Business
The University of Iowa

W. Bruce Johnson
Sidney G. Winter Professor of Accounting
Tippie College of Business
The University of Iowa

H. Fred Mittelstaedt
Deloitte Foundation Professor of Accountancy
Mendoza College of Business
University of Notre Dame

Leonard C. Soffer
Clinical Professor of Accounting
Booth School of Business
University of Chicago

Mc Graw Hill Education

FINANCIAL REPORTING AND ANALYSIS, SEVENTH EDITION

Published by McGraw-Hill Education, 2 Penn Plaza, New York, NY 10121.

This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 DOW 21 20 19 18 17

ISBN 978-1-259-72265-3
MHID 1-259-72265-1

Chief Product Officer, SVP Products & Markets: *G. Scott Virkler*
Vice President, General Manager, Products & Markets: *Marty Lange*
Managing Director: *Tim Vertovec*
Marketing Director: *Natalie King*
Executive Brand Manager: *Rebecca Olson*
Director, Product Development: *Rose Koos*
Associate Director of Digital Content: *Kevin Moran*
Lead Product Developer: *Kris Tibbetts*
Senior Product Developers: *Rebecca Mann, Danielle Andries*
Marketing Manager: *Zachary Rudin*
Market Development Manager: *Julie Wolfe*
Digital Product Analyst: *Xin Lin*
Director, Content Design & Delivery: *Linda Avenarius*
Program Manager: *Daryl Horrocks*
Senior Content Project Manager: *Dana M. Pauley*
Buyer: *Jennifer Pickel*
Design: *Jessica Serd*
Content Licensing Specialists: *Melissa Homer/Melisa Seegmiller*
Cover Image: ©Mlenny Photography/Getty Images
Compositor: *SPi Global*
Printer: *R. R. Donnelley*

Library of Congress Cataloging-in-Publication Data

Names: Revsine, Lawrence, author. | Mittelstaedt, Fred.
Title: Financial reporting and analysis/Lawrence Revsine, Late of Northwestern University, H. Fred Mittelstaedt, Deloitte Foundation, professor of Accountancy, Mendoza College of Business, University of Notre Dame, Leonard C. Soffer, Clinical Professor of Accounting Booth School of Business, University of Chicago.
Other titles: Financial reporting & analysis
Description: Seventh edition. | Dubuque : McGraw-Hill Education, 2017. | Revised edition of Financial reporting & analysis, [2015]
Identifiers: LCCN 2016047075 | ISBN 9781259722653 (hardback)
Subjects: LCSH: Financial statements. | Financial statements--Case studies. | Corporations—Accounting. | BISAC: BUSINESS & ECONOMICS/Accounting/Financial.
Classification: LCC HF5681.B2 R398 2017 | DDC 657/.3—dc23 LC record available at https://lccn.loc.gov/2016047075

mheducation.com/highered

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 1*6 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.

Acknowledgments

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.

We wish to thank the following professors who assisted in the text's development:

Lester Barenbaum, *La Salle University*
Gerhard Barone, *Gonzaga University*
John Bildersee, *New York University*
Stephen Brown, *University of Maryland-College Park*
Sharon Borowicz, *Benedictine University*
John Brennan, *Georgia State University*
Philip Brown, *Harding University*
Shelly L. Canterbury, *George Mason University*
Jeffrey Decker, *University of Illinois—Springfield*
Doug De Vidal, *University of Texas at Austin*
Ilia Dichev, *Emory University*
Timothy P. Dimond, *Northern Illinois University*
Joseph M. Donato, *Thomas College*
Michael T. Dugan, *University of Alabama*
Barbara Durham, *University of Central Florida-Orlando*
David O. Fricke, *University of North Carolina—Pembroke*
Michael J. Gallagher, *Defiance College*
Lisa Gillespie, *Loyola University—Chicago*
Alan Glazer, *Franklin and Marshall College*
Cristi Gleason, *University of Iowa—Iowa City*
Patrick J. Griffin, *Lewis University*
Paul Griffin, *University of California—Davis*
Coby Harmon, *University of California-Santa Barbara*
Donald Henschel, *Benedictine University*
Richard Houston, *University of Alabama-Tuscaloosa*
James Irving, *College of William & Mary*
Kurt Jesswein, *Sam Houston State University*
Gun Joh, *San Diego State University—San Diego*
J. William Kamas, *University of Texas at Austin*
Frimette Kass-Schraibman, *Brooklyn College*
Jocelyn Kauffunger, *University of Pittsburgh*
Robert Kemp, *University of Virginia*
Adam Koch, *University of Virginia*
Michael Kubik, *Johns Hopkins University*
Bradley Lail, *NC State University-Raleigh*
Steve C. Lim, *Texas Christian University*
Chao-Shin Liu, *University of Notre Dame*
Don Loster, *University of California—Santa Barbara*
Troy Luh, *Webster University*
David Marcinko, *Skidmore College*
Kathryn Maxwell (Cordova), *University of Arizona*
P. Michael McLain, *Hampton University*
Kevin Melendrez, *New Mexico State University-Las Cruces*
Krish Menon, *Boston University*
Kyle S. Meyer, *Florida State University*
Stephen R. Moehrle, *University of Missouri—St. Louis*
Brian Nagle, *Duquesne University*
Ramesh Narasimhan, *Montclair State University*
Sia Nassiripour, *William Paterson University*
Bruce Oliver, *Rochester Institute of Technology*
Keith Patterson, *Brigham Young University-Idaho*
Erik Paulson, *Dowling College*
Bonita Peterson-Kramer, *Montana State University-Bozeman*
Maryann Prater, *Clemson University*
Chris Prestigiacomo, *University of Missouri—Columbia*
Richard Price, *Rice University*

Atul Rai, *Wichita State University*
Vernon Richardson, *University of Arkansas—Fayetteville*
Tom Rosengarth, *Bridgewater College*
Eric Rothenburg, *Kingsborough Community College*
Mike Sandretto, *University of Illinois—Champaign*
Lynn Saubert, *Radford University*
Paul Simko, *University of Virginia—Charlottesville*
Praveen Sinha, *California State University at Long Beach*
Mike Slaugbaugh, *Indiana University/Purdue University-Ft Wayne*
Sheldon Smith, *Utah Valley University Orem*
Greg Sommers, *Southern Methodist University*
Carolyn Spencer, *Dowling College*
Victor Stanton, *University of California—Berkeley*
Jack Stecher, *Carnegie Mellon University*
Thomas L. Stober, *University of Notre Dame*
Phillip Stocken, *Dartmouth College*
Ron Stunda, *Birmingham Southern College*
Kanaiyalal Sugandh, *La Sierra University*
Eric Sussman, *University of California—Los Angeles*
Nicole Thibodeau, *Willamette University*
Robin Thomas, *NC State University-Raleigh*
Terry Tranter, *University of Minnesota-Minneapolis*
Robert Trezevant, *University of Southern California*
Mark Trombley, *University of Arizona*
Suneel Udpa, *University of California—Berkeley*
Marcia R. Veit, *University of Central Florida-Orlando*
Kenton Walker, *University of Wyoming—Laramie*
Clark Wheatley, *Florida International University—Miami*
Mike Wilkins, *Texas A & M University*
Michael Wilson, *Metropolitan State University*
Jennifer Winchel, *University of South Carolina*
Colbrin Wright, *Central Michigan University*
Christian Wurst, *Temple University—Philadelphia*
Paul Zarowin, *New York University*

We are particularly grateful to Ilene Persoff, Long Island University/CW Post Campus, for her careful technical and editorial review of the manuscript, Solutions Manual, and Test Bank for the Seventh edition. Her insightful comments challenged our thinking and contributed to a much improved new edition.

We are grateful to our supplements contributors for the seventh edition: Peter Theuri, Northern Kentucky University, who prepared the Instructor's Manual; and Jeannie Folk, College of DuPage, who prepared the PowerPoints®.

We gratefully acknowledge the McGraw-Hill Higher Education editorial and marketing teams for their encouragement and support throughout the development of the seventh edition of this book.

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.

Chapter

47

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.

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.

> 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.

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 **Analysis** **Valuation** **Contracting**

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

S T R E T C H **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 profitablity (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

C2-1

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

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.

INSTRUCTOR LIBRARY

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

- Presentation slides
- Solutions manual
- Test bank available in Connect and TestGen
  - 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

AACSB Statement

McGraw-Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *Financial Reporting & Analysis* recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the Test Bank to the eight general knowledge and skill guidelines in the AACSB standards.

The statements contained in *Financial Reporting & Analysis* are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. While *Financial Reporting & Analysis* and the teaching package make no claim of any specific AACSB qualification or evaluation, we have within *Financial Reporting & Analysis* labeled selected questions according to the eight general knowledge and skills areas.

Assurance of Learning Ready

Many educational institutions today are focused on the notion of *assurance of learning,* an important element of some accreditation standards. *Financial Reporting & Analysis* is designed specifically to support your assurance of learning initiatives with a simple, yet powerful solution. Each test bank question for *Financial Reporting & Analysis* maps to a specific chapter learning objective listed in the text. You can use Connect to easily query for learning objectives that directly relate to the learning objectives for your course. You can then use the reporting features of Connect to aggregate student results in similar fashion, making the collection and presentation of assurance of learning data simple and easy.

connect®

Required=Results

©Getty Images/iStockphoto

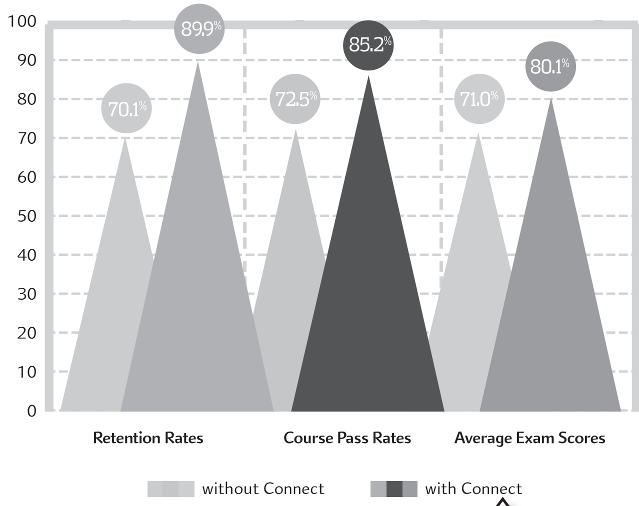
McGraw-Hill Connect®
Learn Without Limits

Connect is a teaching and learning platform that is proven to deliver better results for students and instructors.

Connect empowers students by continually adapting to deliver precisely what they need, when they need it, and how they need it, so your class time is more engaging and effective.

73% of instructors who use **Connect** require it; instructor satisfaction **increases** by 28% when **Connect** is required.

Connect's Impact on Retention Rates, Pass Rates, and Average Exam Scores



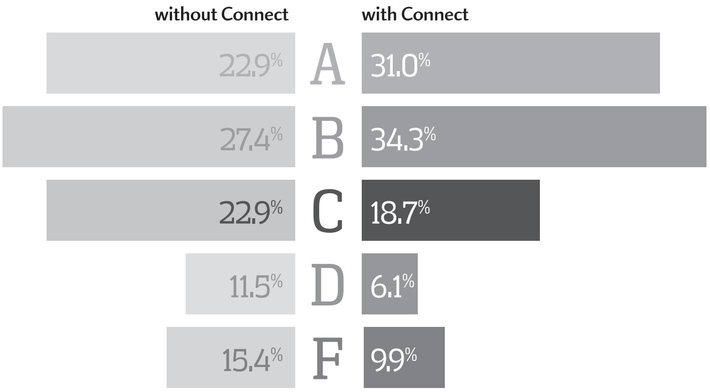
Using **Connect** improves retention rates by **19.8%**, passing rates by **12.7%**, and exam scores by **9.1%.**

Analytics

Connect Insight®

Connect Insight is Connect's new one-of-a-kind visual analytics dashboard that provides at-a-glance information regarding student performance, which is immediately actionable. By presenting assignment, assessment, and topical performance results together with a time metric that is easily visible for aggregate or individual results, Connect Insight gives the user the ability to take a just-in-time approach to teaching and learning, which was never before available. Connect Insight presents data that helps instructors improve class performance in a way that is efficient and effective.

Impact on Final Course Grade Distribution



Adaptive

THE **ADAPTIVE READING EXPERIENCE** DESIGNED TO TRANSFORM THE WAY STUDENTS READ

More students earn **A's** and **B's** when they use McGraw-Hill Education **Adaptive** products.

SmartBook®

Proven to help students improve grades and study more efficiently, SmartBook contains the same content within the print book, but actively tailors that content to the needs of the individual. SmartBook's adaptive technology provides precise, personalized instruction on what the student should do next, guiding the student to master and remember key concepts, targeting gaps in knowledge and offering customized feedback, and driving the student toward comprehension and retention of the subject matter. Available on tablets, SmartBook puts learning at the student's fingertips—anywhere, anytime.

Over **8 billion questions** have been answered, making McGraw-Hill Education products more intelligent, reliable, and precise.

www.mheducation.com

STUDENTS WANT

SMARTBOOK®

95% of students reported **SmartBook** to be a more effective way of reading material.

100% of students want to use the Practice Quiz feature available within **SmartBook** to help them study.

100% of students reported having reliable access to off-campus wifi.

90% of students say they would purchase **SmartBook** over print alone.

95% of students reported that **SmartBook** would impact their study skills in a positive way.

Mc Graw Hill Education

*Findings based on 2015 focus group results administered by McGraw-Hill Education

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.

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.

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

[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.

Chapter

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

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.

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.

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.