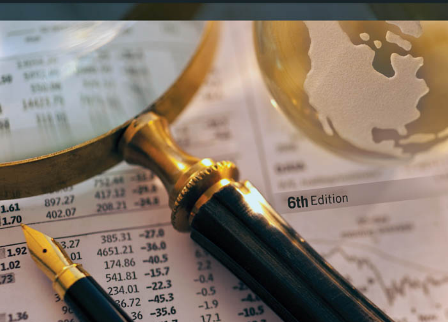
Financial Reporting & Analysis



Revsine | Collins | Johnson | Mittelstaedt | Soffer

FINANCIAL REPORTING & ANALYSIS

6th EDITION

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Late of Northwestern University

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FINANCIAL REPORTING & ANALYSIS

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The authors dedicate this work to:

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

W. Bruce Johnson—Diane and Cory

H. Fred Mittelstaedt—Laura and Grace

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

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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

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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. 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.

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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

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 and 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 May 1980 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). Adding to this challenge is the fact that the Financial Accounting Standards Board (FASB) and its global counterpart—the International Accounting Standards Board (IASB)—have issued in the past few years an unprecedented number of proposed new standards intended to improve financial reporting practices worldwide and to achieve convergence of U.S. GAAP and IFRS. These proposed new standards will change in fundamental ways when revenue is recognized, how certain assets and liabilities are measured, and how information is presented in financial statements. We believe it is essential for students not only to comprehend the key similarities and differences between current U.S. GAAP and IFRS, but also to grasp the significant changes to those standards that are on the horizon.

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—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 intermediate 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,* Sixth 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 reporting alternatives and subjective accounting estimates give managers discretion in the timing of earnings and in reporting the components of financial position. We believe this approach—which focuses on the fundamental measurement and reporting issues that arise from both simple and complex business transactions, and how financial statements are used for decision making—better prepares students to adapt as business transactions and accounting standards continue to evolve.

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 aimed not only at those charged with the responsibility for preparing financial statements, but also those who will 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, Sixth 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, 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 Sixth Edition

The first five 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 five 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:

- 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 as part of their convergence project.
- Incorporation of all FASB and IASB standards, exposure drafts, and discussion papers released through July 2013.
- New Chapter 5 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 Points or to proposed new FASB and IASB standards.

Chapter Revision Highlights

Chapter 1: The Economic and Institutional Setting for Financial Reporting

- Streamlined discussion of how and why international accounting standards are developed.
- Explanation of the FASB Accounting Standards Codification™ project.
- Expanded description of the FASB Conceptual Framework.

Chapter 2: Accrual Accounting and Income Determination

- Revised discussion of alternative formats for presenting comprehensive income.
- Revised Global Vantage section that highlights key differences between other comprehensive income (OCI) components under IFRS versus U.S. GAAP.
- Updated exhibits from company reports throughout the chapter.
- Updated data displays on transitory earnings components (special or unusual items, discontinued operations, and extraordinary items).

Chapter 3: Additional Topics in Income Determination

- Revised Global Vantage Point section that discusses key differences between IFRS and U.S. GAAP on revenue recognition with examples.
- New discussion of FASB/IASB recent proposals on revenue recognition.
- Updated exhibits from company reports throughout the chapter.

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

- Revised Global Vantage section that highlights key differences in where certain transactions are reported on the cash flow statement under IFRS versus U.S. GAAP.
- New problem material on IFRS versus U.S. GAAP cash flow statement items.
- Updated exhibits from company reports throughout the chapter.

Chapter 5: Essentials of Financial Statement Analysis

- Added new discussion of cause-of-change analysis.
- Updated exhibits from company reports throughout the chapter.
- Moved discussion of bankruptcy prediction models from appendix to chapter itself.
- Added new appendix on Segment Reporting.

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

- Updated existing exhibits from company reports throughout the chapter.

Chapter 7: The Role of Financial Information in Contracting

- Updated examples throughout the chapter.

Chapter 8: Receivables

- Updated the Global Vantage Point section on IFRS similarities and differences, and the implications of the FASB Exposure Draft on Financial Instruments.
- Revised discussion on bad debt expense to be consistent with proposed ASU on Revenue Recognition.
- Introduced a new allowance for doubtful accounts analysis using Krispy Kreme.
- Updated the troubled debt restructuring discussion regarding what constitutes financial difficulties and concession under ASU 2011-02.
- Updated existing company examples throughout the chapter.

Chapter 9: Inventories

- Updated Global Vantage Point section on the differences between U.S. GAAP and IFRS and added new case materials.
- Updated inventory method and LIFO reserve statistics.
- Provided new examples of inventory write-offs and fraud.
- Added Whole Foods inventory disclosures to tie to Chapter 5 discussions.

Chapter 10: Long-Lived Assets

- Updated and expanded Global Vantage Point section on the differences between U.S. GAAP and IFRS.
- Expanded discussion of conceptual underpinnings of accounting for long-lived assets.
- New impairment example using Krispy Kreme.
- Streamlined discussion of difficulties associated with analyzing historical cost financial statements.
- New Whole Foods example to tie to Chapter 5 examples.
- Added and updated new problems and cases.
- Updated web appendix on current value accounting for IFRS issues; available on www.mhhe.com/revsine6e.

Chapter 11: Financial Instruments as Liabilities

- Updated Global Vantage Point sections on IFRS guidance for liability presentation, long-term debt, hedge accounting, and contingent liabilities.
- New section on loan guarantees and ASC 460.

Chapter 12: Financial Reporting for Leases

- Updated Global Vantage Point section on the differences between U.S. GAAP and IFRS and the Exposure Drafts jointly developed by the FASB and the IASB.
- Updated comparison of operating and capital lease obligations by industry.
- New Whole Foods example for illustrating constructive capitalization to tie to Chapter 5 examples.
- Added and updated problems and cases tied to FASB/IASB Exposure Draft and existing IFRS.

Chapter 13: Income Tax Reporting

- Added discussion of how the Patient Protection and Affordable Care Act affected many companies' deferred tax assets and resulted in earnings charges when the law was enacted.
- Added explanation of why deferred tax positions for a company never reverse even though individual items do reverse.
- Added discussion of deferred taxes and the cash flow statement.
- 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.
- Added new diagram of pension relationships.
- Updated and redesigned presention of statistics on plan assets by plan type, assumptions, and funded status.
- Revised analysis for GE by using 2012 information.
- Added discussion of immediate recognition of actuarial gains.
- Added new problems and cases.

Chapter 15: Financial Reporting for Owners' Equity

- New section on convertible debt that may be settled in cash.
- Added new examples and updated existing examples of company disclosures.
- Additional problem material on distinguishing equity from debt transactions.

Chapter 16: Intercorporate Equity Investments

- Reorganized material on debt investments so that it all appears together in the appendix.
- Reorganized material on purchase and pooling of interests methods so they appear together in the chapter itself.
- Updated exhibits from company reports throughout the chapter.

Chapter 17: Statement of Cash Flows

- Added appendix showing a simple way to use Excel to derive cash flow statements.
- Updated exhibits from company reports throughout the chapter.

Appendix: Time Value of Money

- Added discussion of Excel.

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

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We gratefully acknowledge the McGraw-Hill/Higher Education editorial and marketing teams for their encouragement and support throughout the development of the Sixth 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 (or earnings) for financial reporting purposes. Income is the difference between **revenues** and **expenses.**[1] The cornerstone of income measurement is **accrual accounting.** Under accrual accounting, ***revenues are recorded (recognized) in the period when they are "earned" and become "realized or realizable"***—that is, 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.[2] Revenues are considered realizable when the related assets received or held are readily convertible to known amounts of cash or claims to cash.[3] ***Expenses are the expired costs or assets that are used up in producing those revenues. Expense recognition is tied to revenue recognition. Therefore, expenses are recorded in the same accounting period in which the revenues are recognized. The approach of tying expense recognition to revenue recognition is commonly referred to as the "matching principle."***

A natural consequence of accrual accounting is the decoupling of measured earnings from operating cash inflows and outflows. Reported revenues under accrual accounting generally do not correspond to cash receipts for the period; also, reported expenses generally do not correspond to cash outlays of the period. In fact, ***accrual accounting can produce 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.***[4]

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

[2] In "Elements of Financial Statements," *Statement of Financial Accounting Concepts (SFAC) No. 6,* the Financial Accounting Standards Board (FASB) defines revenues as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations" (para. 78). Expenses are defined as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations" (para. 80).

[3] "Recognition and Measurement in Financial Statements of Business Enterprises," *Statement of Financial Accounting Concepts No. 5* (Stamford, CT: FASB, 1984), para. 83. Assets that are readily convertible to cash have both the following characteristics: (a) interchangeable (fungible) units, and (b) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

[4] *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,

LEARNING OBJECTIVES

After studying this chapter, you will understand:

1. The distinction between cash-basis versus accrual income and why accrual-basis income generally is a better measure of operating performance.
2. The criteria for revenue recognition under accrual accounting and how they are used in selected industries.
3. The matching principle and how it is applied to recognize expenses under accrual accounting.
4. The difference between product and period costs.
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.
6. The distinction between special and unusual items, discontinued operations, and extraordinary items.
7. How to report a change in accounting principle, accounting estimate, and accounting entity.
8. The distinction between basic and diluted earnings per share (EPS) and required EPS disclosures.
9. What comprises comprehensive income and how it is displayed in financial statements.
10. Other comprehensive income differences between IFRS and U.S. GAAP.
11. The procedures for preparing

Chapter

Boxed Readings

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

188 CHAPTER 4 Structure of the Balance Sheet and Statement of Cash Flows

defaulting on required interest and principal payments (see Chapter 5 for further discussion of capital structure ratios).

In addition to assessing the mix of debt versus equity financing, the balance sheet and related notes to the financial statements provide information for evaluating the **maturity structure** of the various obligations within the liability section. This information is critical to assessing the **liquidity** of an entity. Liquidity measures how readily assets can be converted to cash relative to how soon liabilities will have to be paid in cash. The balance sheet is the source of information for a variety of liquidity measures (detailed in Chapter 5) used by analysts and commercial loan officers to assess an entity's creditworthiness.

Maturity structure refers to how far into the future the obligations will come due.

In addition to the liquidity measures that focus on short-term cash inflows and cash needs, balance sheets provide information for assessing long-term **solvency**—a company's ability to generate sufficient cash flows to maintain its productive capacity and still meet interest and principal payments on long-term debt. A company that cannot make debt payments when due is technically insolvent and may be forced to reorganize or liquidate.

Operating and financial flexibility refers to an entity's ability to adjust to unexpected downturns in the economic environment in which it operates or to take advantage of profitable investment opportunities as they arise. Balance assessments. A firm that has most of its assets i (for example, a foundry) has limited ability to limited operating flexibility. Similarly, a firm v of high interest debt will have limited ability t

As part of a joint effort with the IASB, the FASB recently worked on a project on financial statement presentation that would require

Why Financial Statements Are Important 5

NEWS CLIP

ACCOUNTING'S PERFECT STORM

WorldCom's revelation in June 2002 that it improperly hid $3.8 billion in expenses during the previous five quarters, or longer, set a low-water mark in a tide of accounting scandals among many firms. One of every 10 companies listed on the U.S. stock exchanges (or 845 companies in total) found flaws in past financial statements and restated earnings between 1997 and June 2002. Investors in those companies lost more than $100 billion when the restatements were announced. By comparison, only three companies restated earnings in 1981.

According to some observers, a confluence of events during the late 1990s created a climate in which accounting fraud wasn't just possible but was likely! This was accounting's perfect storm: the conjunction of unprecedented economic growth with inordinate incentive compensation, an extremely aggressive management culture, investors preoccupied with quarterly profits, and lax auditors. At companies that didn't make the Wall Street earnings number by even as little as a penny, the stock price tanked and put top management jobs at risk. Individually, some of these forces may have been good news. But when they all came together, it was a disaster waiting to happen.

Congress responded to the almost daily onslaught of accounting scandals by passing the **Sarbanes-Oxley Act** (SOX) in late July 2002. This legislation was hailed as the most groundbreaking corporate reform since the 1934 Securities Act that, among other things, had established the Securities and Exchange Commission. Key provisions of SOX are intended to strengthen auditor independence and improve financial statement transparency by:

- Requiring the CEO and CFO to certify in writing that the numbers in their company's financial reports are correct. Executives face potential civil charges of fraud or criminal charges of lying to the government if their company's numbers turn out to be bogus.
- Requiring each annual report of a public company to include a report by management on the company's internal control over financial reporting. Among other things, this report must disclose any material internal control weaknesses (i.e., deficiencies that result in more than a remote likelihood that a material accounting misstatement will not be prevented or detected).
- Banning outside auditors from providing certain nonaudit services—bookkeeping, financial system work, appraisals, actuarial work, internal audits, management and human resource consulting, investment-advisory work, and the auditors' other advocacy-related services—to their audit clients so that independence is not compromised. Fees paid to auditors for services must now be disclosed in the client's annual report.
- Requiring public companies to disclose whether the audit committee—comprising outside directors and charged with oversight of the annual audit—has a financial expert and if not, why not. Companies must also now reveal their off-balance-sheet arrangements (see Chapters 8 and 11) and reconcile reported "pro forma" earnings (see Chapter 5) with the audited earnings number.

In the words of one observer, "Our free market system does not depend on executives being saintly or altruistic. But markets do rely on institutional mechanisms, such as auditing and independent boards, to offset opportunistic, not to mention il-

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

Comprehensive income measures a company's change in equity (net assets) that results from all nonowner transactions and events. It is composed of both bottom-line accrual income that is reported on the income statement and other comprehensive income components. Other comprehensive income comprises selected unrealized gains and losses on incomplete (or open) transactions that bypass the income statement and that are reported as direct increases or decreases to stockholders' equity. Firms are required to report comprehensive income in a statement that is displayed with the same promi-

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 the text website for materials such as Excel Templates.

International

Analysis

Valuation

Contracting

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

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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

E2-1

Determining accrual- and cash-basis revenue **(LO 1)**

AICPA ADAPTED

In November and December 2014, Gee Company, a newly organized magazine publisher, received $36,000 for 1,000 three-year subscriptions at $12 per year, starting with the January 2015 issue of the magazine.

Required:

How much should Gee report in its 2014 income statement for subscriptions revenue on an accrual basis? How much revenue would be reported in 2014 on a cash basis?

Summary

SUMMARY

- This chapter highlights the key differences between cash and accrual income measurement.
- In most instances, accrual-basis revenues do not equal cash receipts and accrual expenses do not equal cash disbursements.
- The principles that govern revenue and expense recognition under accrual accounting are designed to alleviate the mismatching of effort and accomplishment that occurs under

Problems/Discussion Questions

PROBLEMS / DISCUSSION QUESTIONS

P2-1

Determining royalty revenue **(LO 2)**

AICPA ADAPTED

Foremost Company owns a royalty interest in an oil well. The contract stipulates that Foremost will receive royalty payments semiannually on January 31 and July 31. The January 31 payment will be for 30% of the oil sold to jobbers between the previous June 1 and November 30, and the July 31 payment will be for oil sold between the previous December 1 and May 31. Royalty receipts for 2014 amounted to $150,000 and $240,000 on January 31 and July 31, respectively. On December 31, 2013, accrued royalty revenue receivable amounted to

Cases

CASES

C2-1

Conducting financial reporting research: Discontinued operations **(LO 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.

Student Center

The text Online Learning Center at www.mhhe.com/revsine6e contains a variety of student study materials including:

- Online interactive quizzes include multiple-choice questions so students can quiz themselves. Grading occurs on the spot!
- Spreadsheet transparencies prepared by the authors are templates that provide students text data in Excel format.
- PowerPoint slides are included for students to review key lecture points.

Instructor Resource Center

The Instructor's Resource Center contains all of the instructor materials for your course in one convenient location at www.mhhe.com/revsine6e.

- Additional problem and case material for most chapters is provided for instructors in PDF form.
- The Solutions Manual prepared by the text authors is an extensive ancillary that provides detailed solutions for every end-of-chapter assignment.
- The Instructor's Resource Manual contains chapter overviews, outlines, and questions and answers. It also includes teaching tips and suggested readings to enhance your lectures and discussion groups.
- The new Test Bank includes a variety of examination questions to test students' grasp of chapter-by-chapter concepts and applications.
- The EZ Test Computerized Test Bank is the computerized version of the Test Bank that enables you to create your own exams.
- Powerpoint Lecture Slides include key lecture points as well as a variety of exhibits from the text.
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The Economic and Institutional Setting for Financial Reporting | 1

"No one ever said accounting was an exact science."

LEARNING OBJECTIVES

After studying this chapter, you will understand:

1. Why financial statements are valuable sources of information about companies.
2. How the demand for financial information stems from its ability to improve decision making and monitor managers' activities.
3. How the supply of financial information is influenced by the costs of producing and disseminating it and by the benefits it provides.
4. How accounting rules are established, and why management can shape the financial information communicated to outsiders and still be within those rules.
5. Why financial reporting philosophies and detailed accounting practices sometimes differ across countries.
6. Why International Financial Reporting Standards (IFRS) influence the accounting practices of U.S. companies.

In late June 2002, WorldCom stunned investors by announcing that it intended to restate its financial statements for 2001 and the first quarter of 2002.[1] According to the company's press release, an internal audit of capital expenditures had uncovered $3.8 billion in improper bookkeeping transfers from line cost expense—an income statement item—to the balance sheet. Without those transfers, the company would have reported a loss for 2001 and the first quarter of 2002. The company's chief financial officer was fired, and its controller resigned. Trading in the company's stock was immediately halted. When trading resumed a few days later, the stock was worth only 6 cents per share, having lost more than 90% of its value.

The accounting scandal at WorldCom, along with those involving many other highly visible companies during the late 1990s and early 2000s, were watershed events. Investors, regulators, and politicians worldwide lost confidence in the soundness of U.S. accounting standards, the transparency of corporate financial reports, the expertise and independence of auditors, and the integrity of U.S. financial markets. Congress responded by passing the Sarbanes-Oxley Act, which contained sweeping reforms intended to restore public confidence. To understand why the reforms were needed, and how they have shaped today's financial reporting environment, let's step back in time to May 2002 and take a close look at the WorldCom scandal. After all, as the philosopher George Santayana has said: "Those who cannot learn from history are doomed to repeat it!"

WorldCom's Curious Accounting

According to a report on the company from a highly regarded Wall Street analyst, WorldCom is doing surprisingly well despite tough times throughout the industry. The company is a global leader in the telecommunications industry, providing a complete package of communications services (voice, data, and Internet) to businesses and

Chapter

[1] 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.

consumers. WorldCom grew very fast—an average of 58% each year from 1996 through 2000—as a result of a nearly insatiable demand for wireless communications and high-speed Internet access. Then, in March 2001, the dot-com bubble burst and Internet spending came to a screeching halt. Telecommunications companies suddenly faced excess capacity and shrinking demand for their services.

Despite the industry downturn, WorldCom reported better-than-expected 2002 first quarter results: sales of $8,120 million and pretax profits of $240 million. That's a 16% decline in sales and a 40% decline in profits, but other firms in the industry, including giants such as AT&T, are reporting even steeper sales and earnings decreases. WorldCom shares look incredibly cheap at the current price of $2 per share. As one stock analyst points out, "The company has $2.3 billion in cash, which translates into a $20.50 book value per share. And you have to pay only $2 a share for this gem! You cannot find a more attractive investment opportunity in the market." Perhaps investors have overreacted to the slump in wireless and Internet spending by penalizing WorldCom's stock too much. If so, now may be the ideal time to buy.

A closer look at WorldCom's financial statements confirms what the analyst is saying. Sales and earnings outpace the competition by a wide margin. Operating cash flows are positive and exceed the cash being spent for capacity expansion, and the balance sheet remains healthy. Overall, the company seems to be on a solid footing.

But what's this? An article in this morning's newspaper raises a new concern. The article says that WorldCom's "line costs," the rent WorldCom pays other companies for the use of their telecommunications networks, are holding steady at about 42% of sales. That's odd because line costs as a percentage of sales are rising at AT&T and other companies in the industry. WorldCom decided several years ago to lease large amounts of network capacity instead of building its own global communications network. These leases call for fixed rental payments each month without regard to message volume ("traffic"). This means that WorldCom must still pay the same amount of rent even though its customers are not sending much traffic through the network these days. What seems odd to the news reporter is that the same rental payment each month combined with lower traffic revenue should produce an increase in line costs as a percent of sales. Higher line costs per dollar of revenue should translate into lower profits. That is what's happening at other companies, but at WorldCom, line costs haven't increased.

You call your broker, who confirms that WorldCom's stock is available at $1.75 per share in early trading. Should you take advantage of this investment opportunity and buy 10,000 shares? Should you avoid the stock because WorldCom's income statement may contain a line cost accounting torpedo that could potentially sink the share price? Should you take a closer look at company fundamentals—traffic volume, line costs, and other business aspects—before deciding whether to buy or avoid WorldCom shares? The unusual trend in line costs could indicate that WorldCom is successfully managing its excess capacity problems during a period of slack demand, or it could be a cautionary yellow flag warning of problems at the company.

What do you do?

WHY FINANCIAL STATEMENTS ARE IMPORTANT

This dilemma illustrates a fundamental point: 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. 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 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.***

As our prospective WorldCom stockholder knows, 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.[2] ***For this reason, financial statements are indispensable for developing an accurate profile of ongoing performance and prospects.***

WorldCom stockholders learned an even more important lesson: Financial statements sometimes conceal more than they reveal.

Untangling the Web at WorldCom

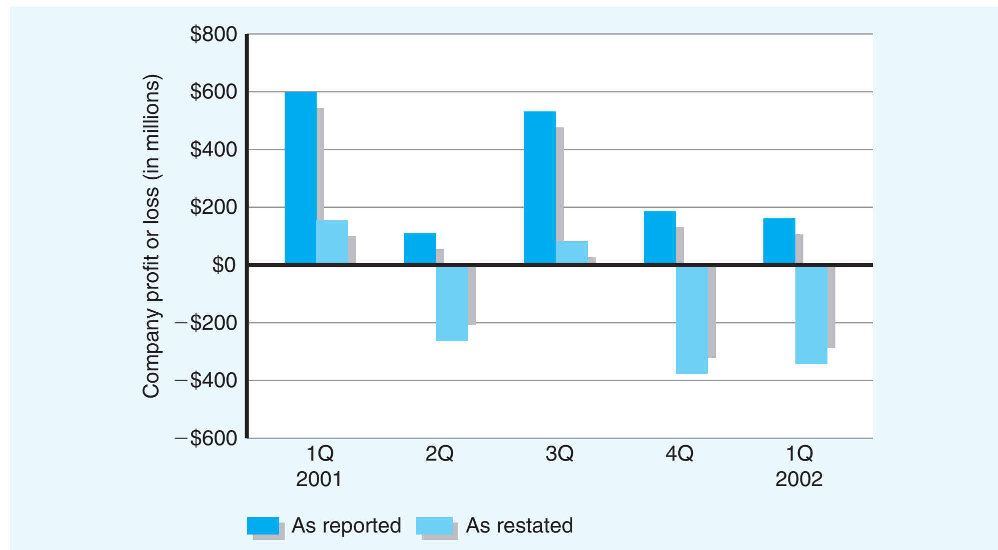
In late May 2002, Cynthia Cooper, WorldCom's vice president of internal audit, and two of her employees discovered a series of questionable accounting entries made during 2001 and the first quarter of 2002. To Cooper's dismay, she realized that $3.8 billion of line cost expense had been shifted from the income statement to the balance sheet, a deceptive practice that made WorldCom look far more profitable than it actually was. In early June, she

[2] 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.

Figure 1.1

WORLDCOM'S DISAPPEARING PROFITS

WorldCom improperly transferred a total of $3.8 billion in line cost expenses from the income statement to the balance sheet. This chart shows the company's profits (in millions) by quarter as reported originally and as later restated.



and a coworker discussed the line cost transfers with a WorldCom board member who chaired the audit committee. The committee then launched its own investigation. Based on its report, WorldCom's board decided in late June to restate the company's financial statements and to terminate the employment of two top executives. Figure 1.1 shows how WorldCom's profit picture for 2001 and early 2002 changed after the reported numbers were corrected.

The accounting rule that WorldCom violated is easy to understand. It says that when expenditures (think "money spent") provide a future benefit to the company, then and only then can the expenditures be recorded as balance sheet assets (Chapters 2 and 10 provide the details). This means that if the company spends a dollar today buying equipment that will be used for the next five years (the "future benefit"), the dollar spent should be shown as a balance sheet asset. But what if the dollar spent doesn't buy a *future* benefit? Then it cannot be shown as a balance sheet asset but instead must be shown on the income statement as a current period expense. That's the rule!

What did this accounting rule mean for the money WorldCom spent on line costs? Recall that these line costs were just the monthly rent WorldCom paid to other companies for the use of their communications networks and systems. Because the rent had to be paid each month, the money WorldCom spent wasn't buying a *future* benefit. So, all line costs should have been shown on the income statement as a current expense. Instead, WorldCom improperly "transferred" $3.8 billion of these costs from the income statement to the balance sheet where they were shown as an asset. This transfer violated the accounting rule for asset recognition and allowed WorldCom to appear more profitable than it actually was. The improper transfer also inflated WorldCom's operating cash flows.

Over the next few weeks, the situation at WorldCom grew far worse:

- Shareholder class action lawsuits were filed against the company and its management.
- The Securities and Exchange Commission (SEC) sued the company for accounting fraud and launched its own investigation.
- Five company executives were indicted on criminal charges, and four pleaded guilty.
- The company defaulted on a $4.25 billion credit line and was negotiating new payment terms with more than 30 banks.

NEWS CLIP

ACCOUNTING'S PERFECT STORM

WorldCom's revelation in June 2002 that it improperly hid $3.8 billion in expenses during the previous five quarters, or longer, set a low-water mark in a tide of accounting scandals among many firms. One of every 10 companies listed on the U.S. stock exchanges (or 845 companies in total) found flaws in past financial statements and restated earnings between 1997 and June 2002. Investors in those companies lost more than $100 billion when the restatements were announced. By comparison, only three companies restated earnings in 1981.

According to some observers, a confluence of events during the late 1990s created a climate in which accounting fraud wasn't just possible but was likely! This was accounting's perfect storm: the conjunction of unprecedented economic growth with inordinate incentive compensation, an extremely aggressive management culture, investors preoccupied with quarterly profits, and lax auditors. At companies that didn't make the Wall Street earnings number by even as little as a penny, the stock price tanked and put top management jobs at risk. Individually, some of these forces may have been good news. But when they all came together, it was a disaster waiting to happen.

Congress responded to the almost daily onslaught of accounting scandals by passing the **Sarbanes-Oxley Act** (SOX) in late July 2002. This legislation was hailed as the most groundbreaking corporate reform since the 1934 Securities Act that, among other things, had established the Securities and Exchange Commission. Key provisions of SOX are intended to strengthen auditor independence and improve financial statement transparency by:

- Creating the Public Companies Accounting Oversight Board (PCAOB) charged with establishing audit, independence, and ethical standards for auditors; investigating auditor conduct; and imposing penalties.
- Requiring the CEO and CFO to certify in writing that the numbers in their company's financial reports are correct. Executives face potential civil charges of fraud or criminal charges of lying to the government if their company's numbers turn out to be bogus.
- Requiring each annual report of a public company to include a report by management on the company's internal control over financial reporting. Among other things, this report must disclose any material internal control weaknesses (i.e., deficiencies that result in more than a remote likelihood that a material accounting misstatement will not be prevented or detected).
- Banning outside auditors from providing certain nonaudit services—bookkeeping, financial system work, appraisals, actuarial work, internal audits, management and human resource consulting, investment-advisory work, and the auditors' other advocacy-related services—to their audit clients so that independence is not compromised. Fees paid to auditors for services must now be disclosed in the client's annual report.
- Requiring public companies to disclose whether the audit committee—comprising outside directors and charged with oversight of the annual audit—has a financial expert and if not, why not. Companies must also now reveal their off-balance-sheet arrangements (see Chapters 8 and 11) and reconcile reported "pro forma" earnings (see Chapter 5) with the audited earnings number.

In the words of one observer, "Our free market system does not depend on executives being saintly or altruistic. But markets do rely on institutional mechanisms, such as auditing and independent boards, to offset opportunistic, not to mention illegal, behavior."* The Sarbanes-Oxley Act strengthens those important institutional mechanisms and, in so doing, calms the accounting storm.

* Robert Simmons as quoted in *CFO Magazine* (August 2002).

- In mid-July 2002, WorldCom filed for bankruptcy. The company was saddled with more than $40 billion in debt and had less than $10 billion in assets that could be readily converted into cash.
- In August of that year, the company acknowledged more than $7 billion in accounting errors over the previous several years.

The investigation would eventually uncover more than $11 billion in improper transfers and other accounting improprieties at the company. At least two dozen WorldCom employees were dismissed or resigned over the fraud. WorldCom—which now calls itself MCI and in 2006 became a subsidiary of Verizon—reached a settlement with the SEC to pay $750 million in penalties, then the largest fine ever levied against one company by the SEC. The company's

former chief executive officer (CEO) and chief financial officer (CFO) were both sentenced to lengthy prison terms. In March 2004, after correcting hundreds of thousands of accounting entries, WorldCom restated profits by $74.4 billion for revenues, expenses, asset write-downs, and adjustments to liabilities including the $11 billion of fraudulent transactions first uncovered in 2002. Most experts agree that WorldCom's accounting improprieties were designed to meet the financial targets of Wall Street analysts and to sustain a high stock price despite diminished economic prospects for the industry.

Financial statement fraud is rare.[3] Most managers are honest and responsible, and their financial statements are free from the type of distortions that occurred at WorldCom. However, this example underscores 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.

Company data used by investors and analysts come primarily from published financial statements and from the company's willingness to provide additional financial and operating data voluntarily. 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.

Statement readers must:

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

[3] See *2012 Report to the Nation on Occupational Fraud & Abuse* (Austin TX: Association of Certified Fraud Examiners Inc., 2012). To learn more about accounting's "perfect storm" and the unprecedented 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).

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.

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.

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.

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.

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.

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.

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

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

The focal point of the proxy contest often becomes the company performance as described in its recent financial statements. Management defends its record of past accomplishments while perhaps acknowledging a need for improvement in some areas of the business. Dissident shareholders point to management's past failures and the need to hire a new executive team. Of course, both sides are pointing to the same financial statements. Where one side sees success, the other sees only failure, and undecided shareholders must be capable of forming their own opinion on the matter.

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

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

Employees demand financial statement information for several reasons:

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

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

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

Customers Repeat purchases and product guarantees or warranties create continuing relationships between a company and its customers. A customer needs to know whether the seller has the financial strength to deliver a high-quality product on an agreed-upon schedule and whether the seller will be able to provide replacement parts and technical support after the sale. You wouldn't buy a personal computer from a door-to-door vendor without first checking out the product and the company that stands behind it. Financial statement information can help current and potential customers monitor a supplier's financial health and thus decide whether to purchase that supplier's goods and services.

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.

> 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.