



Understanding
Financial Statements

ELEVENTH EDITION

Lyn M. Fraser ■ Aileen Ormiston



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Aileen Ormiston

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**For Eleanor
—Lyn M. Fraser**

**For Katelyn
—Aileen Ormiston**

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Major changes have been incorporated into this eleventh edition of *Understanding Financial Statements* in order to continue improving the usefulness of the text for professors, students, and readers of the material. We have made many of the revisions in response to specific requests and comments from users of the text.

New to this Edition

- Learning objectives have been added to all chapters.
- Chapter 1 now includes a section on the characteristics, assumptions, principles and basis of accounting.
- Chapter 2 has an expanded section on types of long-term debt.
- Four new cases have been added to each chapter; spoiler alert: look for Facebook in Chapter 5.
- International accounting rules (IFRS) are discussed in relation to relevant topics in each chapter, and Chapters 2–5 include a comprehensive case of an international firm (Hydrogenics, a Canadian company).
- The test bank has been completely revised, and problems with solutions have been added to the website.

As always, our intent is to present the material in a way that helps readers make practical sense of complex financial information, leading to intelligent (and profitable!) decision-making.

Our preface to previous editions has included an update on our children, all of whom are now grown-up and leading interesting lives of their own, so our feature this year is of the new member of the team, Aileen’s granddaughter, Katelyn. While our children have all supported this work through its various iterations, Katelyn has responded to *Understanding Financial Statements* in a unique manner that should certainly encourage interest in our book.

Lyn M. Fraser



Chapter 1 provides an overview of financial statements and presents approaches to overcoming some of the challenges, obstacles, and blind alleys that may confront the user of financial statements: (1) the volume of information, with examples of specific problems encountered in such areas as the auditor's report and the management discussion and analysis section as well as material that is sometimes provided by management but is not useful for the analyst; (2) the complexity of the accounting rules that underlie the preparation and presentation of financial statements; (3) the variations in quality of financial reporting, including management discretion in some important areas that affect analysis; and (4) the importance of financial information that is omitted or difficult to find in conventional financial statement presentations.

Chapters 2, 3, 4, and 5 describe and analyze financial statements for a mythical but potentially real company, Sage Inc., which sells recreational products through retail outlets in the southwestern United States. The specifics of this particular firm should be helpful in illustrating how financial statement analysis can provide insight into a firm's strengths and weaknesses. But the principles and concepts covered throughout the book apply to any set of published financial statements (other than for specialized industries, such as financial institutions and public utilities).

Because one company cannot provide every account and problem the user will encounter in financial statements, additional company examples are introduced throughout the text where needed to illustrate important accounting and analytical issues.

Chapters 2 through 4 discuss in detail a basic set of financial statements: the balance sheet in Chapter 2, the income (earnings) statement and statement of stockholders' equity in Chapter 3, and the statement of cash flows in Chapter 4. The emphasis in each of these chapters is on what the financial statements convey about the condition and performance of a business firm as well as how the numbers have been derived. Appendix 3A discusses and illustrates issues that relate to the quality of earnings—and thus the usefulness—of financial reporting. The chapter contains a step-by-step checklist of key items to help the analyst assess the quality of reporting, and real-company examples of each step are provided.

With this material as background, Chapter 5 covers the interpretation and analysis of the financial statements discussed in Chapters 2 through 4. This process involves the calculation and interpretation of financial ratios, an examination of trends over time, a comparison of the firm's condition and performance with its competitors, and an assessment of the future potential of the company based on its historical record. Chapter 5 also reviews additional sources of information that can enhance the analytical process. Appendix 5A shows how to evaluate the

segmental accounting data reported by diversified companies that operate in several unrelated lines of business.

Self-tests at the ends of Chapters 1 through 5 provide an opportunity for the reader to assess comprehension (or its absence) of major topics; solutions to the self-tests are given in Appendix B. For more extensive student assignments, study questions and problems are placed at the end of the chapters. Cases drawn from actual company annual reports are used to highlight in a case-problem format many of the key issues discussed in the chapters.

Appendix A covers the computation and definition of the key financial ratios that are used in Chapter 5 to evaluate financial statements.

Appendix B contains solutions to self-tests for Chapters 1 through 5.

Appendix C presents a glossary of the key terms used throughout the book.

The ultimate goal of this book is to improve the reader's ability to translate financial statement numbers into a meaningful map for business decisions. It is hoped that the material covered in the chapters and the appendixes will enable each reader to approach financial statements with enhanced confidence and understanding of a firm's historical, current, and prospective financial condition and performance.

Understanding Financial Statements is designed to serve a wide range of readers and purposes, which include:

1. Text or supplementary text for financial statement analysis courses;
2. Supplementary text for accounting, finance, and business management classes that cover financial statement analysis;
3. Study material for short courses on financial statements in continuing education and executive development programs;
4. Self-study guide or course material for bank credit analysis training programs;
5. Reference book for investors and others who make decisions based on the analysis of financial statements.

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The list would be incomplete without mentioning the pets in our households who helped keep us in good humor throughout the revision of this edition: Toot, AddieMae, Escalante, Mooli, Teddy, Torin, and Tisha.

Lyn M. Fraser

Aileen Ormiston

Lyn M. Fraser has taught undergraduate and graduate classes in financial statement analysis at Texas A&M University and has conducted numerous seminars on the subject for executive development and continuing education courses. A Certified Public Accountant, she is the coauthor with Aileen Ormiston of *Understanding the Corporate Annual Report: Nuts, Bolts, and a Few Loose Screws* (Prentice Hall, 2003) and has published articles in the *Journal of Accountancy*, the *Journal of Commercial Bank Lending*, the *Magazine of Bank Administration*, and the *Journal of Business Strategies*. She has been recognized for Distinguished Achievement in Teaching by the Former Students Association at Texas A&M University and is a member of Phi Beta Kappa. Lyn's most recent publication is a new mystery novel, *Debits and Credits*, published by Mainly Murder Press in 2014.

Aileen Ormiston teaches in the Accounting Department in the W.P. Carey School of Business at Arizona State University and has taught in the MBA, honors, and online programs. She received her bachelor's degree in accounting from Michigan State University and a master's degree in finance from Texas A&M University. Prior to embarking on her teaching career, Aileen worked in cost accounting and also as an auditor in public accounting. She taught accounting and general business courses for 30 years at Mesa Community College, one of 13 universities and colleges that received a grant from the Accounting Education Change Commission. As a result of her pioneering work in changing accounting education, she was the recipient of the "Innovator of the Year" award from the League for Innovation in the Community College. For her service to honors students, Aileen has been named a Phi Theta Kappa mentor.

Financial Statements

An Overview

maze (māz), n. 1. An intricate, usually confusing network of passages, some blind and some leading to a goal. 2. Anything made up of many confused or conflicting elements. 3. A mental state of confusion or perplexity.¹

Learning Objectives

After studying this chapter, you should be able to:

- Explain why and how financial statements are useful for decision-making
- Describe the organizations that govern accounting rulemaking
- Describe the components of a Form 10-K
- Explain the challenges and complexities inherent in the accounting rules
- Understand management's impact on the quality of financial reporting

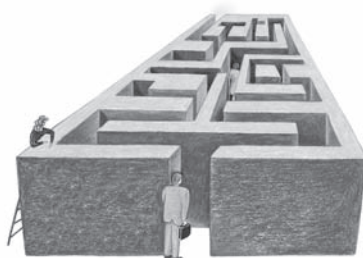
Map or Maze

A *map* helps its user reach a desired destination through clarity of representation. A *maze*, on the other hand, attempts to confuse its user by purposefully introducing conflicting elements and complexities that prevent reaching the desired goal. Business financial statements have the potential for being both map and maze.

¹ *The American Heritage Dictionary of the English Language*, New York: American Heritage Publishing Co., Inc. 1969.

As a map, financial statements form the basis for understanding the financial position of a business firm and for assessing its historical and prospective financial performance. Financial statements have the capability of presenting clear representations of a firm's financial health, leading to informed business decisions.

Unfortunately, there are mazelike interferences in financial statement data that hinder understanding the valuable information they contain. The sheer quantity of information contained in financial statements can be overwhelming and intimidating. Independent auditors attest to the fairness of financial statement presentations, but the auditors are hired by the companies they are auditing; many lawsuits have been filed and won against accounting firms for issuing "clean" auditors' reports on companies that subsequently failed or had major difficulties. The complexity of accounting policies underlying the preparation of financial statements can lead to confusion and variations in the quality of information presented. In addition, these rules are constantly evolving and changing. Management discretion in a number of areas influences financial statement content and presentation in ways that affect and even impede evaluation. Some key information needed to evaluate a company is not available in the financial statements, some is difficult to find, and much is impossible to measure.



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One of the main objectives of this book is to ensure that financial statements serve as a map, not a maze—that they lead to a determination of the financial health of a business enterprise that is as clear as possible for purposes of making sound business decisions about the firm.

Ongoing financial turmoil, major corporate failures, and the staggering collapse of financial markets underscore the need for financial analysts, financial advisors, creditors, investors, and individuals managing personal assets to have a basic understanding of financial statements. While this book focuses on firms operating primarily in nonfinancial industries, many of the underlying principles discussed in the book apply as well to the kinds of financial services and investment management firms—the Wall Street banks—that triggered the economic collapse of 2008, the most serious economic crisis in modern history.

One example of an essential "map-like" principle conveyed in this book over all its editions is the importance of **cash flow from operations** as a key performance measure. This concept is fully discussed and illustrated in Chapter 4. Many firms have gone bankrupt while presenting rosy net income figures because of their inability to generate cash from operations. Lehman Brothers is a classic case.

In the three years prior to its bankruptcy in 2008, the largest in U.S. history, Lehman Brothers reported steadily increasing and robust net income figures of \$3.3 billion in 2005, \$4.0 billion in 2006, and \$4.2 billion in 2007. Cash flow from operations, however, which should have provided at least a hint of the financial

disaster to come, was negative in those three years: \$12.2 billion in 2005, \$36.4 billion in 2006 and a whopping \$45.6 billion in 2007. As asset values tumbled, a company that already had staggering levels of debt had to borrow more and more to cover its failure to generate cash. The bankruptcies of the early 2000s such as Enron and WorldCom had similar map-like red flags. (See, for example, “I Told My Daughter Not to Invest in Enron” in *Understanding the Corporate Annual Report—Nuts, Bolts, and a Few Loose Screws*, Lyn M. Fraser and Aileen Ormiston, Prentice Hall, 2003).

The material in this book will convey information about how to read and evaluate business financial statements, and the authors will attempt to present the information in a straightforward manner, with relevant examples, that will be readily accessible to any reader, regardless of background or perspective. The book is intended for use by those who want to learn more about the content and interpretation of financial statements for such purposes as making sound investment and credit decisions about a company, evaluating a firm for current or prospective employment, surviving and advancing professionally in the current economic climate, and perhaps even passing an important examination or course. Throughout the book, the authors attempt to simplify and explain complex accounting and financial issues in a way that allows readers not only to understand the information presented in annual reports but to identify areas of potential strength and weakness—based on the reader’s interpretation rather than on the “spin” provided by company management.



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The reader can expect more than a dull exposition of financial data and accounting rules. Throughout these pages we will attempt—using timely examples, illustrations, and explanations—to get behind the numbers, accounting policies, and tax laws to assess how well companies are actually performing. The chapters and appendixes in the book show how to approach financial statements to obtain practical, useful information from their content. Although the examples in the book are based on corporate financial statements, the discussion also applies to the financial statements of small business firms that use generally accepted accounting principles.

The emphasis throughout the book is on analysis. In the first four chapters of the book, we will look at the contents of an annual report and break the financial statements into parts for individual study to better understand the whole of their content as a map to intelligent decision making. To fully analyze a firm, it is important to

assess the quality of the information supplied by management. This material will be covered in Appendix 3A, on the quality of earnings. The final chapter of the book combines all parts learned in prior chapters with analytical tools and techniques to illustrate a comprehensive financial statement analysis.

Usefulness

Financial statements and their accompanying notes contain a wealth of useful information regarding the financial position of a company, the success of its operations, the policies and strategies of management, and insight into its future performance. The objective of the financial statement user is to find and interpret this information to answer questions about the company, such as the following:

- Would an investment generate attractive returns?
- What is the degree of risk inherent in the investment?
- Should existing investment holdings be liquidated?
- Will cash flows be sufficient to service interest and principal payments to support the firm's borrowing needs?
- Does the company provide a good opportunity for employment, future advancement, and employee benefits?
- How well does this company compete in its operating environment?
- Is this firm a good prospect as a customer?

The financial statements and other data generated by corporate financial reporting can help the user develop answers to these questions as well as many others. The remainder of this chapter will provide an approach to using effectively the information contained in a corporate annual report. Annual reports in this book will refer to the information package published by U.S. companies primarily for shareholders and the general public. The Securities and Exchange Commission (SEC) requires large, publicly held companies to file annually a 10-K report, which is generally a more detailed document and is used by regulators, analysts, and researchers. The basic set of financial statements and supplementary data is the same for both documents, and it is this basic set of information—financial statements, notes, and required supplementary data—that is explained and interpreted throughout this book.

Volume of Information

The user of a firm's annual report can expect to encounter a great quantity of information that encompasses the required information—financial statements, notes to the financial statements, the auditor's report, a five-year summary of key financial data, high and low stock prices, management's discussion and analysis of operations—as well as material that is included in the report at the imagination and discretion of management. To understand how to navigate the vast amount of information available to financial statement users, background on the accounting rule-making environment is necessary. Financial statements are currently prepared according to generally accepted accounting principles (GAAP) that have been adopted in order to achieve a presentation of financial information that is understandable by users as well as relevant and reliable for decision making. The accounting rules that have been issued in order to achieve these objectives can be complicated and sometimes confusing.

The two authorities primarily responsible for establishing GAAP in the United States are the SEC, a public-sector organization, and the Financial Accounting Standards Board (FASB), a private-sector organization.

The SEC regulates U.S. companies that issue securities to the public and requires the issuance of a prospectus for any new security offering. The SEC also requires regular filing of

- Annual reports (10-K)
- Quarterly reports (10-Q)
- Other reports dependent on particular circumstances, such as a change in auditor, bankruptcy, financial restatements, or other important events (all filed as 8-K reports)

The SEC has congressional authority to set accounting policies and has issued rulings called Accounting Series Releases (ASRs) and Financial Reporting Rulings (FRRs). For the most part, however, accounting rule making has been delegated to the FASB.

Prior to September 15, 2009, FASB issued Statements of Financial Accounting Standards (SFASs) and interpretations. Effective September 15, 2009, the FASB Accounting Standards CodificationTM became the source of authoritative GAAP. The FASB's three primary goals in developing the Codification were (1) to simplify user access by codifying in one source all authoritative GAAP in the United States; (2) to ensure that the codified content accurately represented authoritative U.S. GAAP as of July 1, 2009; and (3) to create a codification research system that is up to date for the released results of standard-setting activity.²

After 50-plus years and more than 2,000 standards, the FASB recognized the need for a better system to research accounting standards. The Codification includes not only SFASs, but also standards from other accounting organizations and relevant rules written by the SEC. The FASB Accounting Standards CodificationTM Research System will be updated concurrently with the release of Accounting Standards Updates. Accounting Standards Updates will also be issued for amendments to the SEC content of the Codification. All updates and prior standards will be organized by related topics.³

The SEC and FASB have worked closely together in the development of accounting policy, with the SEC playing largely a supportive role. But at times the SEC has pressured the FASB to move on the issuance of accounting standards or to change its policies (inflation accounting, oil and gas accounting). Pressures on the FASB stem from the private sector and have been highly controversial at times.

² FASB Accounting Standards Codification: Notice to Constituents (v 4.1) About the Codification. Financial Accounting Foundation, 2010.

³ The five topic areas of the Codification include the following: (1) General Principles (Topic Codes 105–199). These topics relate to broad conceptual matters. Topics include generally accepted accounting principles. (2) Presentation (Topic Codes 205–299). These topics relate only to presentation matters and do not address recognition, measurement, or derecognition matters. Topics include income statement, balance sheet, earnings per share, and so forth. (3) Financial Statement Accounts (Topic Codes 305–799). The Codification organizes topics in a financial statement order, including assets, liabilities, equity, revenue, and expenses. Topics include receivables, revenue recognition, inventory, and so forth. (4) Broad Transactions (Topic Codes 805–899). These topics relate to multiple financial statement accounts and are generally transaction oriented. Topics include business combinations, derivatives, nonmonetary transactions, and so forth. (5) Industry (Topic Codes 905–999). These topics relate to accounting that is unique to an industry or type of activity. Topics include airlines, software, real estate, and so forth.

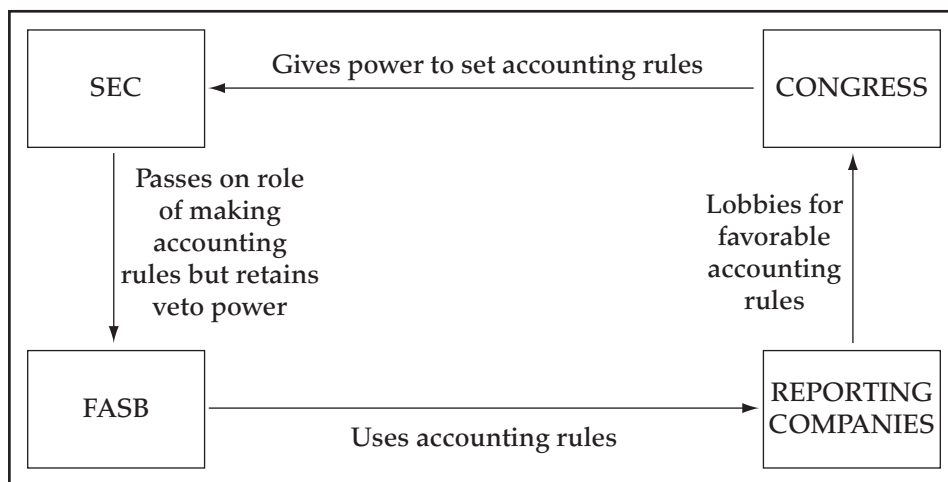
FIGURE 1.1 FASB/SEC Relationship

Figure 1.1 illustrates the relationship between the SEC and the FASB. An example of a measure that was vehemently opposed by the business sector was the FASB's proposal to require companies to deduct from profits compensation to executives in the form of stock options. The FASB first began exploring this issue in 1984, but it was not resolved until 1995 because of business and ultimately political intervention. Business lobbyists gained congressional support that effectively forced the FASB to compromise its stance on this issue.⁴ As a result of the opposition, FASB Statement No. 123, "Accounting for Stock-Based Compensation," only required that companies disclose in the notes to the financial statements the effects on profits of new employee stock options based on the fair value at the date of grant. The controversy that arose with regard to stock-based compensation caused the SEC to take a closer look at the FASB's standard-setting process. In 1996, the SEC made public its concern that the standard-setting process is too slow; however, the SEC rejected suggestions from business executives that the private sector should have more influence in the process. The SEC vowed to maintain the FASB's effectiveness and independence.⁵

Corporate scandals such as Enron and WorldCom brought to the forefront the challenges and pressures the FASB faces when creating accounting rules. The issue of stock-based compensation was reopened by the FASB in 2002. A new FASB proposal adopted in December 2002 to force the expensing of all employee stock compensation from profits once again resulted in congressional interference, delaying the new rule from taking effect until after June 15, 2005. The SEC and the FASB continue to examine potential rule changes or new rules in a variety of areas such as off-balance-sheet financing and overhauling the financial statements; however, these changes will most likely evolve as a result of joint projects between the U.S. rule-making bodies and the International Accounting Standards Board (IASB).

⁴ To learn more about this controversy see Stephen Barr, "FASB Under Siege," *CFO*, September 1994.

⁵ "SEC Calls for More Efficient FASB but Rejects Stronger Outside Influence," *Journal of Accountancy*, May 1996.

Global Economy

The globalization of business activity has resulted in the need for a uniform set of accounting rules in all countries. Investors and creditors in international markets would benefit from financial statements that are consistent and comparable regardless of the firm's location. To address this need, the IASB, formerly the International Accounting Standards Committee, was formed in 1973. The eventual goal of the IASB is the adoption of uniform international accounting standards. Accomplishing this objective would allow companies to list securities in any market without having to prepare more than one set of financial statements. The need for international accounting standards has been underscored by global corporate scandals. While Enron was the catalyst for rethinking accounting standards in the United States, Europe also had a comparable scandal when Italian dairy food giant Parmalat filed for bankruptcy after committing financial fraud. Today the FASB and the IASB are working on a convergence of standards. The concept of a convergence of standards was discussed as early as the 1950s, but the pace of convergence began moving at a much faster pace in the 2000s. The Norwalk Agreement in 2002 was a result of the FASB and IASB agreeing to work toward convergence between U. S. GAAP and IFRS (international financial reporting standards). The European Union began requiring publicly traded companies to use IFRS in 2005 and over 100 other countries had adopted IFRS or a version of IFRS by 2009. As of 2007 foreign firms registered with the SEC have been allowed to file annual reports based on IFRS with no reconciliation to U. S. GAAP; however, U.S. firms may not use IFRS for SEC reporting purposes.⁶

The SEC has supported convergence of standards and spent years on a work plan to determine if IFRS should be adopted in the U.S.; however, a final staff report released in July 2012 by the SEC did not make a recommendation. The SEC has expressed concern about items such as the expense of transitioning to IFRS, insufficient influence over IASB standards setting, and the reliance in the U.S. legal environment of contract language that refers to U. S. GAAP.⁷



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While the rest of the world moves toward acceptance of IFRS to reduce complexity in a global world, complexity for multinational firms in the U.S. will continue as a result of the SEC's lack of a recommendation to move toward IFRS adoption. Ford Motor Company, for example, has indicated a plan to adopt IFRS to save time and money, finding it easier to convert from IFRS, which will be used in 60 different international jurisdictions, to U. S. GAAP which is only used in one jurisdiction.⁸

⁶ See *International Convergence of Accounting Standards-A Brief History* (Norwalk CT: FASB, 2013).

⁷ *Final Staff Report: Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers* (Washington D.C.: SEC, July 2012).

⁸ "Will IFRS Be Mandated Under New SEC Chair White?" <http://ifrs.wordpress.com> April 10, 2013.

The focus throughout the textbook is on U. S. GAAP; however, the process illustrated for financial statement analysis can be used for annual reports based on IFRS. Differences that occur between U. S. GAAP and IFRS will be discussed where appropriate. A case has been added to each chapter in the book to illustrate analysis of an international firm.

Where to Find a Company's Financial Statements

Corporate financial statements are available from several sources. First, all publicly held companies must file a Form 10-K annually with the SEC. The information in this document is mandated by the SEC and contains uniform content, presented in the same order for all filing companies. Figure 1.2 shows a sample of required 10-K items. Documents filed with the SEC can usually be accessed through the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) database at the SEC's Web site, www.sec.gov. Some companies mail the firm's 10-K report to shareholders rather than producing a separate annual report. Other firms send a slickly prepared annual report that includes the financial statements as well as other public relations material to shareholders and prospective investors. Finally, most corporations now post their annual report (or provide a link to the EDGAR database) on their corporate Web site.

The Financial Statements

A corporate annual report contains four basic financial statements, illustrated in Appendix 1A for Sage Inc., pp. 20 to 32.

1. The *balance sheet or statement of financial position* shows the financial position—assets, liabilities, and stockholders' equity—of the firm on a particular date, such as the end of a quarter or a year.
2. The *income or earnings statement* presents the results of operations—revenues, expenses, net profit or loss, and net profit or loss per share—for the accounting period.
3. The *statement of stockholders' equity* reconciles the beginning and ending balances of all accounts that appear in the stockholders' equity section of the balance sheet. Some firms prepare a statement of retained earnings, frequently combined with the income statement, which reconciles the beginning and ending balances of the retained earnings account. Companies choosing the latter format will generally present the statement of stockholders' equity in a footnote disclosure.
4. The *statement of cash flows* provides information about the cash inflows and outflows from operating, financing, and investing activities during an accounting period.

Each of these statements will be illustrated, described, and discussed in detail in later chapters of the book.

Notes to the Financial Statements

Immediately following the four financial statements is the section entitled Notes to the Financial Statements (Appendix 1A, pp. 20 to 32). The notes are, in fact, an integral part of the statements and must be read in order to understand the presentation on the face of each financial statement.

The first note to the financial statements usually provides a summary of the firm's accounting policies. If there have been changes in any accounting policies during the reporting period, these changes will be explained and the impact quantified

FIGURE 1.2 Form 10-K Components

Item #	Item Title
Item 1.	Business
Item 1A.	Risk Factors
Item 1B.	Unresolved Staff Comments
Item 2.	Properties
Item 3.	Legal Proceedings
Item 4.	Submission of Matters to a Vote of Security Holders
Item 5.	Market for Registrant's Common Equity and Related Stockholder Matters
Item 6.	Selected Financial Data
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations
Item 7A.	Quantitative and Qualitative Disclosures about Market Risk
Item 8.	Financial Statements and Supplementary Data
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure
Item 9A.	Controls and Procedures
Item 9B.	Other Information
Item 10.	Directors and Executive Officers of the Registrant
Item 11.	Executive Compensation
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters
Item 13.	Certain Relationships and Related Transactions
Item 14.	Principal Accountant Fees and Services
Item 15.	Exhibits, Financial Statement Schedules, and Reports on Form 8-K

in a financial statement note. Other notes to the financial statements present details about particular accounts, such as

- Inventory
- Property, plant, and equipment
- Investments
- Long-term debt
- Equity accounts

The notes also include information about

- Any major acquisitions or divestitures that have occurred during the accounting period