EIGHTH EDITION

Financial Reporting and Analysis

Revsine Collins Johnson Mittelstaedt Soffer

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FINANCIAL REPORTING & ANALYSIS

8th EDITION

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Late of Northwestern University

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The authors dedicate this work to:

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

W. Bruce Johnson–Diane and Cory

H. Fred Mittelstaedt–Laura and Grace

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

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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

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

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

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

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

W. Bruce Johnson

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

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

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

His teaching and research interests included 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 Accounting and Reporting 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

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

Fred Mittelstaedt joined the University of Notre Dame faculty in 1992, and he served as the Department of Accountancy chairperson from 2007 to 2019. 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, 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 has served as president of the Federation of Schools of Accountancy (FSA), and he received the FSA 2016 Joseph A. Silvoso Award for his contributions to accounting education. He is a member of the American Accounting Association and the American Institute of Certified Public Accountants. Prior to joining academia, he was an auditor with Price Waterhouse & Co. and received an Elijah Watt Sells Award for exceptional performance on the Uniform CPA Exam.

Leonard C. Soffer

Clinical Professor of Accounting, Booth School of Business, 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.

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

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

Another challenge to interpreting financial statements arises from the Tax Cuts and Jobs Act, which was passed into law in late 2017 and took effect for the most part in 2018. Although the new tax law did not change U.S. GAAP, the interaction of income tax law and financial reporting rules created significant aberrations in financial statements for many firms in 2017. Without an understanding of how the tax law change affected firms' effective tax rates and deferred tax positions, financial statement users could easily be misled about the performance of the firms they analyze. We provide extensive coverage of the tax law change and its financial statement analysis implications. We have adapted examples throughout the text, not just in the income tax chapter, to be consistent with the new tax environment. And we show how to eliminate the one-time financial statement effects of the tax law change to make financial statement comparisons across periods or across firms more meaningful.

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

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

An important feature of our approach is that it integrates the perspectives of accounting, corporate finance, economics, and critical analysis to help students grasp how business transactions get reported and understand the decision implications of financial statement numbers. We cover all of the core topics of intermediate accounting as well as several topics often found in advanced accounting courses, such as consolidations, joint venture accounting, derivatives, and foreign currency translation. For each topic, we describe the underlying business transaction, the GAAP guidelines that apply, how the guidelines are implemented in practice, and how the financial statements are affected. We then go a step further and ask: What do the reported numbers mean? Does the accounting process yield numbers that faithfully present the underlying economic situation of a company? And, if not, what can financial statement users do to overcome this limitation in order to make more informed decisions? A Global Vantage Point discussion then summarizes the key similarities and differences between U.S. GAAP and IFRS, and previews potential changes to both.

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

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

Key Changes in the Eighth Edition

The first seven 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 seven 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:

- As described above, significant updates to the revenue recognition, lease, and tax chapters.
- Expanded to now consist of 20 chapters, including the new Chapter 5 on accounting changes, notes, and non-GAAP metrics; new Chapter 18 on foreign operations and segments; and new Chapter 19 on derivatives.
- The running example used in many chapters has been changed from Whole Foods to Kroger, due to Amazon's acquisition of Whole Foods.

- Updated examples and end-of-chapter problems throughout the text to reflect the new income tax environment, including a corporate tax rate of 21% rather than 35%, as well as other changes in tax law arising from the Tax Cuts and Jobs Act.
- Changed hypothetical and end-of-chapter materials to 20X1 year format.
- Made examples more salient by putting them in Example boxes or Exhibits.
- New or updated company examples throughout the book.
- New and revised end-of-chapter materials including exercises, problems, and cases.

Chapter Revision Highlights

Chapter 1: The Economic and Institutional Setting for Financial Reporting

- Added a learning objective for sustainability information.
- Included a discussion of "conflict minerals" disclosures.
- Added a section on the use of nonfinancial information.
- Added a section on sustainability accounting.
- Updated financial statement information in exhibits and end-of-chapter materials.
- Added end-of-chapter materials on nonfinancial and sustainability information.

Chapter 2: Accrual Accounting and Income Determination

- Moved the material on accounting changes and errors and restatements to the new Chapter 5.
- Updated statistics on transitory items in financial statements.
- Updated examples throughout the chapter.

Chapter 3: Revenue Recognition

- Eliminated discussion of revenue recognition standards prior to ASC Topic 606.
- New live examples of transition to the new revenue recognition standard.
- Added data on the methods firms chose to implement adoption of ASC Topic 606.
- Included survey results on the financial statement effects of adopting ASC Topic 606.
- Added data on the revenue recognition issues raised in SEC comment letters to registrants.

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

- Streamlined chapter by removing material on financial statement notes and moving it to the new Chapter 5.
- Moved in material on contingencies, which had previously been in the chapter on financial instruments and liabilities.
- Updated many of the financial statement examples in the chapter.
- Incorporated ASU 2016-18 on the definition of cash to be used in the cash flow statement.

Chapter 5: Accounting Changes and Restatements, Financial Statement Notes, and Non-GAAP Metrics

- This is a new chapter combining material from Chapters 2 and 4 of the previous edition and new material. The material in this chapter relates to all of the financial statements but does not involve specific accounting methods.
- Expanded treatment of reporting accounting changes so that students can understand the financial statement implications of the new revenue recognition and leasing standards.
- New discussion of SAB 74 disclosures about the expected financial statement effects of recently issued, but not yet implemented, accounting standards.
- Expanded discussion of restatements, including the distinction between reissuance restatements and revision restatements.
- All new section on the use of non-GAAP metrics.

Chapter 6: Essentials of Financial Statement Analysis

- All new running example based on The Kroger Co.
- Additional emphasis on adjusting for unusual or one-time events, with focus on the 2017 income statement effects of the Tax Cuts and Jobs Act.
- Expanded discussion of the economic trade-offs in setting credit-granting policies.

Chapter 7: The Role of Financial Information in Valuation and Credit Risk Assessment

- Deleted material on goodwill impairment and combined it with the existing material on the topic in Chapter 17.
- Incorporated all new valuation of Kroger using the abnormal earnings valuation model.
- Updated examples in the text for the new corporate tax rate under the Tax Cuts and Jobs Act.
- Updated end-of-chapter problems to reflect current valuation ratios.

Chapter 8: The Role of Financial Information in Contracting

- Added a discussion of the CEO pay ratio disclosure.
- Updated discussion of Internal Revenue Code Section 162(m) on the limitation of deductibility of executive

compensation to reflect the changes introduced by the Tax Cuts and Jobs Act.
- Added discussion of mine safety and conflict mineral disclosures.
- Updated statistics presented on the form of compensation.

Chapter 9: Receivables
- Revised bad debt discussion for ASU 2016-13.
- Revised discussion of notes receivable.
- Replaced Krispy Kreme with Mattel in analysis of uncollectible accounts.
- Updated Global Vantage Point section.
- Added new Caterpillar allowance analysis case to the end-of-chapter material.
- Updated end-of-chapter material for ASU 2016-13.

Chapter 10: Inventories
- Replaced Whole Foods with Kroger in the LIFO discussion.
- Updated financial statement illustrations throughout chapter.
- Updated LIFO reserve and tax statistics.
- Revised discussion of lower of cost or net realizable.
- Replaced Danier with Richemont for IFRS example.
- Added and updated problems and cases.

Chapter 11: Long-Lived Assets
- Updated financial statement examples throughout chapter.
- Replaced ExxonMobil with Disney as the interest capitalization example.
- Added a section on deferred costs and included a salesforce .com example.
- Replaced Krispy Kreme with L Brands as the asset impairment example.
- Replaced Whole Foods with Kroger in the discussion of depreciation assumptions.
- Updated the Global Vantage Point section and LVMH example.
- Added exercises and problems on deferred costs.
- Added an AT&T capitalization of interest case and updated the Marston's case on IFRS accounting for long-lived assets.

Chapter 12: Financial Instruments and Liabilities
- Streamlined the chapter by moving the derivatives and hedging content to the new Chapter 19 and the contingencies content to Chapter 4's balance sheet coverage.
- Moved the Debt or Equity? discussion to Chapter 16, Financial Reporting for Owners' Equity.
- Updated financial statement examples.
- Created a new section for Extinguishment of Debt by combining the Managerial Incentives and Financial Reporting sections.
- Moved the Fair Value Accounting Option to its own section and revised the discussion for ASU 2016-1.
- Created a separate section for floating-rate debt.
- Developed a new example for imputed interest on notes payable.
- Substituted Kroger Co. for Snap-on, Inc., in the second self-study problem.
- Added a new case on Toys "R" Us.

Chapter 13: Financial Reporting for Leases
- Eliminated most discussions of ASC Topic 840 from the main part of the chapter and created Appendix 13A, Evolution of Lease Accounting.
- Removed prior appendix on constructive capitalization.
- Created a Lessee Short-Term and Finance Lease Accounting section.
- Moved Sale and Leaseback accounting to Appendix 13C.
- Created a new Lessee Operating Lease Accounting section.
- Revised the Interpreting Lessee Financial Statement Information section to compare finance lease effects to short-term and operating lease effects.
- Used Microsoft to illustrate the ASC Topic 842 lessee accounting and the financial statement effects caused by the change from ASC Topic 840.
- Updated comparison of operating and finance lease payments for firms in different industries and included estimated impact from adopting ASC Topic 842.
- Moved the discussion of Unequal Lease Payments to Appendix 13B.
- Revised Global Vantage Point discussions.
- Integrated ASC Topic 840 and ASC Topic 842 Lessor Accounting discussions.
- Edited exercises, problems, and cases to conform all the material to ASC Topic 842.
- Added three cases tied to early adopters of ASC Topic 842 (Target and Delta Air Lines).

Chapter 14: Income Tax Reporting
- Revised the chapter to reflect current tax law following enactment of the Tax Cuts and Jobs Act of 2017.
- Revised all examples and end-of-chapter problems to reflect new tax rate environment following enactment of the Tax Cuts and Jobs Act.
- Provided a separate section detailing the important corporate tax law changes made by the Tax Cuts and Jobs Act.
- Added a discussion of stranded tax effects, which became more relevant with enactment of the Tax Cuts and Jobs Act, including the FASB's response to the issue.
- Expanded all journal entry examples to show separately amounts charged or credited to the current tax provision and the deferred tax provision.
- Added many new end-of-chapter problems related to the financial statement effects of tax rate changes, which has become a significant issue with the enactment of the Tax Cuts and Jobs Act.

- Included a new case in the end-of-chapter material focusing on forecasting effective tax rates when there are aberrations in historical effective tax rates.

Chapter 15: Pensions and Postretirement Benefits

- Updated all figures and exhibits with recent data and updated interpretations.
- Expanded discussion of cash balance plans.
- Included new discussion on income statement presentation and ASU 2017-07.
- Renamed sections and updated PBGC discussion as well as all exhibits and interpretations for GE.
- Included a new Exhibit 15.7 to show the effects of assumptions on pension amounts.
- Updated discussion of disclosure for ASU 2018-14.
- Included a new Figure 15.9 for trends of pension risk ratios and expanded discussion of risk.
- Updated Siemens example and discussion in the Global Vantage Point section.
- Revised selected exercises and problems.
- Added new cases on AT&T's immediate recognition of actuarial gains and losses, Kroger's pension plans, and GE's other postretirement plans.

Chapter 16: Financial Reporting for Owners' Equity

- Created a new section, Why Companies Repurchase Their Common Shares.
- Updated all statistics in figures.
- Moved most of the option history to Appendix 16A.
- Updated the stock compensation example for 2017 Tax Cuts and Jobs Act.
- Replaced Whole Foods with Kroger as the main stock compensation example.
- Revised convertible debt discussion substantially and included Twitter as an example.
- Changed the Global Vantage Point section convertible debt example to Nokia and revised journal entries and amounts.
- Moved the earnings per share section to the end of the chapter.
- Updated exhibits from company reports throughout the chapter.
- Revised selected exercises and problems.
- Updated four cases and added a case on Etsy convertible debt.

Chapter 17: Intercorporate Investments

- Streamlined the chapter by moving material on foreign currency translation into a separate chapter.
- Incorporated new guidance on using the Current Expected Credit Loss (CECL) approach to measuring impairments of held-to-maturity and available-for-sale debt securities.
- Examined the increased earnings volatility brought on by the change in accounting for minority-passive equity investments, which are now all accounted for with fair value adjustments recognized in net income.
- Restructured the format of the consolidation worksheet example to highlight the interaction of the income statement, retained earnings statement, and balance sheet.
- Updated the discussion of goodwill impairment testing to incorporate the simplified, one-step approach adopted by the FASB.
- Expanded discussion of continuity issues for financial analysis arising because acquired companies are consolidated from date of acquisition.
- Re-incorporated the discussion of how joint ventures can be used as vehicles for keeping debt off the balance sheet that had appeared in prior editions.

Chapter 18: Accounting for Foreign Operations and Segment Reporting

- This is a new chapter containing the material on accounting for foreign subsidiaries and foreign currency transactions that had been included with the consolidations material and the material on segment reporting.
- Greatly expanded explanations of foreign currency translation (current rate method) and remeasurements (temporal method) and provided extensive illustrations.
- Devoted more time to the financial statement analysis implications of foreign subsidiaries.
- Updated case example on segment reporting.
- Added cause-of-change analysis, explored initially in Chapter 6, to the segment case study.

Chapter 19: Derivatives and Hedging

- Created a separate chapter from the material that had previously been in Chapter 12, Financial Instruments and Liabilities.
- Updated chapter for ASU 2017-12.
- Expanded Cash Flow Hedge discussions.
- Added a new section on interpreting derivative disclosures with Boeing as the example.
- Updated the Global Vantage Point discussion.
- Added new exercises.
- Added a new Mattel derivative disclosure case.

Chapter 20: Statement of Cash Flows

- Incorporates several recent ASUs, including one that defines the cash amounts to be used to determine the change in cash over a period to include restricted cash.
- Updated discussion of cash flow effects of stock-based compensation to reflect ASU reporting excess tax benefits in the tax provision rather than in additional paid-in capital and therefore being treated as an operating cash flow rather than a financing cash flow.

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

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We gratefully acknowledge the McGraw-Hill Education editorial and marketing teams for their encouragement and support throughout the development of the eighth 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

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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

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This chapter describes the key concepts and practices that govern the measurement of annual or quarterly income.[1] The cornerstone of income measurement is **accrual accounting.** Under accrual accounting, ***revenues are recorded (recognized) when the seller has transferred control over goods or services to a buyer,*** which entitles the seller to the benefits represented by the revenues.[2] ***Expenses are the expired costs or assets that are used to produce those revenues. Expense recognition is tied to revenue recognition. That is, expenses are recorded in the same accounting period as the related revenues are recognized. The approach of tying expense recognition to revenue recognition is commonly referred to as the "matching principle."*** Revenues less expenses, together with gains and losses, constitute income.

A natural consequence of accrual accounting is the decoupling of measured earnings from operating cash inflows and outflows. Except in the case of cash sales, such as for a meal at a restaurant, revenues under accrual accounting generally do not correspond to cash received during the period. Similarly, accrual-based expenses generally do not correspond to cash outlays during the period. In fact, ***there are often large differences between the firm's reported profit performance and the amount of cash generated from operations. Frequently, however, accrual accounting earnings provide a more accurate measure of the economic value added during the period than do operating cash flows.***[3]

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

CASH FLOW VERSUS ACCRUAL INCOME MEASUREMENT

In January 20X1, Canterbury Publishing sells three-year subscriptions to its quarterly publication, *Windy City Living,* to 1,000 subscribers. The subscription plan requires prepayment by the customers, so Canterbury receives the full subscription price of

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

[2] Revenue recognition criteria are discussed in far greater detail in Chapter 3.

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

LEARNING OBJECTIVES

After studying this chapter, you will understand:

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

2-1

Boxed Readings

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

Mythical Corporation discontinued a component of its business in 20X3 (Exhibit 2.2, item 3). The operating results of this recently discontinued operation are excluded from continuing operations in the current period (20X3) when the decision to discontinue was made. In addition, they are excluded from continuing operations in any prior years (20X2 and 20X1 for Mythical) for which comparative data are provided.[8] This makes the Income from continuing operations number of $987 million in 20X3 comparable with the corresponding amounts of $1,059 million and $966 million in 20X2 and 20X1, respectively. While restating the 20X2 and 20X1 results makes continuing operations comparable to the 20X3 results, it means that all the numbers from the Net sales line through the Income from continuing operations line reported in the 20X2 and 20X1 columns of the 20X3 annual report differ from the amounts originally reported in the 20X2 and 20X1 financial statements. However, net income amounts for 20X2 and 20X1 are the same as originally reported because the amounts removed from continuing operations are reclassified to discontinued operations for those years.

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

How is a disposition evaluated to determine if it will receive discontinued operations treatment? First, under U.S. GAAP, a **component of an entity**[9] comprises operations and cash flows that can be clearly distinguished, both operationally and for financial reporting purposes, from the rest of the entity. It may be a reportable segment under segment accounting rules (see Chapter 18), an operating segment, a reporting unit, a subsidiary, or an asset group.

If the component has been disposed of, it is treated as a discontinued operation if ". . . the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results."[10] If the component has not yet been disposed of, it must first be determined whether it is classified as held for sale. A disposal group is considered **held for sale** if the following six conditions are met:[11]

Other boxes provide engaging articles that capture real-world financial reporting issues and controversies.

WHY CRITICS SAY OPTIONS SHOULD BE EXPENSED

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

WHY DEFENDERS DISAGREE

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

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

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RECAP

The criteria for revenue and expense recognition are intended to provide general guidance for accrual accounting income determination. However, these general criteria leave ample room for judgment and interpretation that create flexibility in GAAP. Analysts and investors must be alert for management's attempts to exploit this flexibility in ways that push the boundaries of acceptable revenue and expense recognition.

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.

EXAMPLE

On January 1, 20X1, Monson Corporation sells equipment it manufactured to Davenport Products in exchange for a $5 million non–interest-bearing note due in three years. The note bears no explicit interest. It says only that the entire $5 million is to be paid at the end of three years. Monson's published cash selling price for the equipment is $3,756,600.

Example boxes set out the facts of a scenario so that students can easily refer to them as they work through subsequent calculations, journal entries, or financial statement effects.

Icons

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

International

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

Analysis

Valuation

Contracting

STRETCH

Collaborative

AICPA ADAPTED

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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.

Summary

SUMMARY

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

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

Exercises

EXERCISES

E9-1

Analyzing accounts receivable (LO 9-2)

AICPA ADAPTED

For the month of December 20X1, Ranger Corporation's records show the following information:

Cash received on accounts receivable	$35,000
Cash sales	30,000
Accounts receivable, December 1, 20X1	80,000
Accounts receivable, December 31, 20X1	74,000

Problems / Discussion Questions

PROBLEMS / DISCUSSION QUESTIONS

P9-1

Determining balance sheet presentation and preparing journal entries for various receivables transactions (LO 9-1, LO 9-4, LO 9-6)

Aardvark, Inc., began 20X1 with the following receivables-related account balances:

Accounts receivable	$575,000
Allowance for credit losses	43,250

Aardvark's transactions during 20X1 include the following:

a. On April 1, 20X1, Aardvark accepted an 8%, 12-month note from Smith Bros. in settlement of a $17,775 past due account.

Cases

CASES

C2-1

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

Corrpro Companies, Inc., founded in 1984, provides corrosion control–related services, systems, equipment, and materials to the infrastructure, environmental, and energy markets. Corrpro's products and services include (a) corrosion control engineering services, systems, and equipment; (b) coatings services; and (c) pipeline integrity and risk assessment services. The following information was abridged from the company's March 31, 20X3, Form 10-K.

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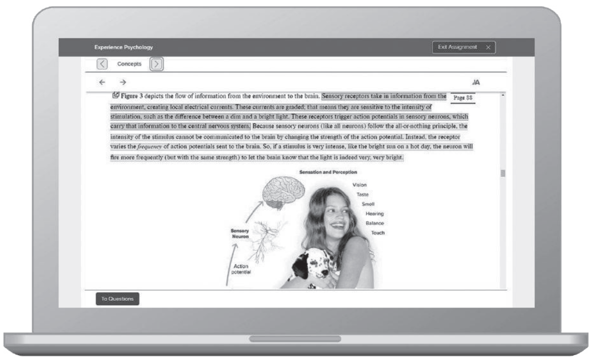

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- Jordan Cunningham,
Eastern Washington University

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The Economic and Institutional Setting for Financial Reporting | 1

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

Accounting is the key to understanding the economics of a business. How does Google generate revenue, and how much does it cost to generate that revenue? What financial information could have been used to predict the bankruptcies of Toys "R" Us and Sears? How does Amazon's growth in net cash flows compare to its growth in net income? To answer these questions, we need a system that provides valid and useful information. This book helps you understand this system and how to use it to evaluate your business and other businesses.

LEARNING OBJECTIVES

After studying this chapter, you will understand:

- LO 1-1 Why financial statements are valuable sources of information about companies.
- LO 1-2 How financial reporting addresses the information demands of current or potential stakeholders allocating resources and monitoring manager activities.
- LO 1-3 How the supply of financial information is influenced by the costs of producing and disseminating it and by the benefits it provides.
- LO 1-4 How accounting rules are established, and why management can shape the financial information communicated to outsiders and still be within those rules.
- LO 1-5 Why companies disclose sustainability information.
- LO 1-6 Why financial reporting philosophies and detailed accounting practices may differ across countries.
- LO 1-7 How International Financial Reporting Standards (IFRS) differ from U.S. Generally Accepted Accounting Principles (GAAP).

WHY FINANCIAL STATEMENTS ARE IMPORTANT

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

Why? Because financial statements and accompanying disclosures provide information about a company's economic wealth and changes in that wealth. Some financial statements provide a picture of the company at a moment in time; others describe changes that took place over a period of time. Both provide a basis for *evaluating* what happened in the 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

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

sales and receivable growth rates compare to those of competitors? Are expenses holding steady? What rates of growth can be expected next year? These trends and relationships provide insights into a company's economic opportunities and risks including market acceptance, costs, productivity, profitability, and liquidity. Consequently, ***a company's financial statements can be used for various purposes:***

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

Financial statements contain information that investors need to know to decide whether to invest in the company. Others need financial statement information to decide whether to extend credit, negotiate contract terms, or do business with the company. Financial statements serve a crucial role in allocating capital to the most productive and deserving firms. Doing so promotes the efficient use of resources, encourages innovation, and provides a liquid market for buying and selling securities and for obtaining and granting credit. Periodic financial statements provide an economic history that is comprehensive and quantitative and, therefore, can be used to gauge company performance.[2] ***For this reason, financial statements are indispensable for developing an accurate profile of ongoing performance and prospects.***

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

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

Financial statement fraud is rare.[3] Most managers are honest and responsible, and their financial statements are free from the type of intentional distortions that occurred at WorldCom, HealthSouth, and Enron in the 2000s. However, these examples underscore the fact that investors and others should not simply accept the numbers in financial statements at face value. Instead, they must analyze the numbers in sufficient detail to assess the degree to which the financial statements faithfully represent the economic events and activities of the company.

Statement readers must:

- Understand current financial reporting standards.
- Recognize that management can shape the financial information communicated to outside parties.
- Distinguish between financial statement information that is highly reliable and information that is judgmental.

[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.

[3] See *2012 Report to the Nation on Occupational Fraud & Abuse* (Austin, TX: Association of Certified Fraud Examiners Inc., 2012). To learn more about the types 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).

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

ECONOMICS OF ACCOUNTING INFORMATION

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

Information asymmetry just means that management has access to more and better information about the business than do people outside the company. The details vary from one business to another, but the idea is that information initially available only to management can help people outside the company form more accurate assessments of past economic performance, resource availability, future prospects, and risks. Financial statements are the primary formal mechanism for management to communicate some of this inside 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 8 explains how).

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* 21, no. 2 (June 2007), pp. 215–227.

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 information reported in them improves decision making.

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

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

Standards Board (FASB), and the International Accounting Standards Board (IASB) influence the amount and type of financial information companies disclose as well as when and how it is disclosed.

Demand for Financial Statements

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

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

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.

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.

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

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

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

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

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

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

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

Employees demand financial statement information for several reasons:

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

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

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

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

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.

Congress may also use the SEC to require firms to disclose nonfinancial information. For example, the 2010 Dodd-Frank Act required the SEC to develop rules for company disclosures on (1) the ratio of chief executive officer's (CEOs) pay to the median pay of all other employees and (2) "conflict minerals" (tantalum, tin, gold, or tungsten).[4] Congress required the pay disclosure to highlight the enormous salaries being paid to CEOs, especially those at banks. It wanted the conflict mineral disclosure because it was concerned that sales of these minerals were financing the armed conflict in the Democratic Republic of the Congo (DRC).

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 14 for details.

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

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

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

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

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

[4] See *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Public Law 111-203, Washington, D.C., July 21, 2010.

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

RECAP

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

Disclosure Incentives and the Supply of Financial Information

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

What forces induce managers to supply information? Browse through several corporate financial reports and you will notice substantial differences across companies—and perhaps over time—in the quality and quantity of the information provided. Some companies routinely disclose **nonfinancial metrics** that help analysts predict future cash flows and net income. Exhibit 1.1 illustrates some of the metrics used by companies in different industries. For example, The Walt Disney Company reports hotel occupancy percentage, per room guest spending, and park attendance growth percentages. Other companies seem to disclose only the bare minimum required. What explains this diversity in the quality and quantity of financial information?

We discuss non-GAAP *financial* metrics in Chapter 5.

EXHIBIT 1.1 **Nonfinancial Metric Examples**

Company	Industry	Measures
Alphabet Inc. (Google)	Internet/online	Paid clicks Cost per click
American Airlines Group Inc.	Air transportation	Number of aircraft Passenger load factor Fuel consumption (gallons)
The Boeing Company	Aerospace products/parts	Production rate Order Backlog
Citigroup Inc.	Financial services	Change in number of credit cards FICO distribution of credit cards
The Walt Disney Company	Broadcasting, parks, resorts	Hotel occupancy percentage Per room guest spending Park attendance growth
Exxon Mobil Corp.	Oil and gas exploration/production	Proved crude oil reserves Proved bitumen reserves
Ford Motor Company	Vehicle manufacturer	Production volume
The Kroger Company	Supermarket	Supermarket square footage Number of stores
Nucor Corp.	Steel production	Steel production Steel shipments
salesforce.com, inc.	CRM software	Marketing and sales headcount Unbilled deferred revenue

Source: Company Form 10-Ks or annual reports.

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

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

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

Disclosure Benefits Companies compete with one another in capital, labor, and product markets. This competition creates incentives for management to reveal "good news" financial information about the firm. The news itself may be about a successful new product introduction, increased consumer demand for an existing product, an effective quality improvement, or other matters favorable to the financial perception of the company. By voluntarily disclosing otherwise unknown good news, the company may be able to obtain capital more cheaply or get better terms from suppliers.

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

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

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

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

[6] "Lemon," when describing an automobile, refers to an auto with hidden defects. In financial capital markets, "lemon" refers to a financial instrument (for example, stock or debt securities) with hidden risks. See G. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 84, no. 3 (August 1970), pp. 488–500.

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

Many firms promise to pay some of the health care costs of retired employees. See Chapter 15 for details.

Disclosure Costs Four costs can arise from informative financial disclosures:

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

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

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

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

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

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

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

Litigation costs result when shareholders, creditors, and other financial statement users initiate court actions against the company and its management for alleged financial misrepresentations. For example, it's common for shareholders to initiate litigation when there's a sudden drop in stock price soon after the company has released new financial information. Shareholders who

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

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

sue will claim that they would not have purchased company shares if they had known then (back when they bought the stock) what they know now (after the company's disclosure).

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

There are potential **political costs** of financial reporting, especially for companies in highly visible industries such as oil and pharmaceuticals. Politically vulnerable firms with high earnings are often attacked in the financial and popular press, which alleges that those earnings constitute evidence of anticompetitive business practices. Politicians sometimes respond to (or exploit) heightened public opinion. They propose solutions to the "crisis" that is causing high earnings, thereby gaining media exposure for themselves and improving their chances for reelection or reappointment. These "solutions" are often political initiatives designed to impose taxes on unpopular companies or industries. The windfall profits tax levied on U.S. oil companies in the early 1980s is one example. This tax was prompted, in part, by the large profit increases that oil companies reported during several years prior to enactment of the legislation.[9]

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

RECAP

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

A CLOSER LOOK AT PROFESSIONAL ANALYSTS

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

It would be difficult (maybe impossible!) to frame our examination of corporate financial reporting and analysis around the diverse information needs of all potential users—investors, lenders, customers, suppliers, managers, employees, regulators, and so on—and the varied decisions

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

[10] To learn more about the costs and benefits of accounting disclosures, see A. Beyer, D. Cohen, T. Lys, and B. Walther, "The Financial Reporting Environment: Review of Recent Literature," *Journal of Accounting and Economics* 50 (2010), pp. 296–343.

they might possibly confront. Instead, we focus attention on professional analysts. But we define *analyst* broadly to include investors, creditors, financial advisors, and auditors—anyone who uses financial statements to make decisions as part of their job. Let's see what professional analysts do.

Analysts' Decisions

The task confronting **equity investors** is first to form an educated opinion about the value of the company and its equity securities—common and preferred stock—and then to make investment decisions based on that opinion. Investors who follow a *fundamental analysis approach* estimate the value of a stock by assessing the amount, timing, and uncertainty of future cash flows that will accrue to the company issuing the stock (Chapter 7 shows how). The company's financial statements and other data are used to develop projections of its future cash flows. These cash flow estimates are then discounted for risk and the time value of money. The discounted cash flow estimate or **fundamental value** (say, $25 per share) is then compared to the current price of the company's stock (say, $18 per share). This comparison allows the investor to make decisions about whether to buy, hold, or sell the stock. ***Financial statement information is essential, in one way or another, to this and other equity investment strategies.***

Creditors' decisions require an assessment of the company's ability to meet its debt-related financial obligations through the timely payment of interest and principal or through asset liquidation in the event interest and principal cannot be repaid. Creditors include commercial banks, insurance companies and other lenders, suppliers who sell to the company on credit, and those who invest in the company's publicly traded debt securities. Creditors form educated opinions about the company's **credit risk** by comparing required principal and interest payments to estimates of the company's current and future cash flows (Chapter 6 explains how). Companies that are good credit risks have projected operating cash flows that are more than sufficient to meet these debt payments, or they possess **financial flexibility:** the ability to raise additional cash by selling assets, issuing stock, or borrowing more.

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

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

Independent auditors carefully examine financial statements prepared by the company prior to conducting an audit of those statements. An understanding of management's reporting incentives coupled with detailed knowledge of

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

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

accounting rules enables auditors to recognize vulnerable areas where financial reporting abuses are likely to occur. Astute auditors choose audit procedures designed to ensure that major improprieties can be detected.

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

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

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

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

RECAP

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

FUNDAMENTAL CONCEPTS OF FINANCIAL REPORTING

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

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

Financial statements and notes describe a firm's economic wealth at a specific point in time and changes in economic wealth over a specific period of time, say a year. The statements consider prior transactions and events and estimate their effects on the firm's economic wealth. For example, if a company sells products on credit, the accountant must estimate how much cash will ultimately be collected (see Chapters 3 and 9). The financial statements provide analysts a jumping-off point for forecasting future earnings, future cash flows, and the ability to pay interest and dividends in the future. Analysts use the projected information to estimate the value of a company or its ability to repay debt.

To extrapolate into the future from financial statement data, investors, creditors, and their financial advisors must first understand the accounting measurement rules, estimates, and judgments used to produce the data. The linkage between economic events and how those events are depicted in a financial statement can sometimes seem mysterious or confusing. For example, some companies record sales revenue *before* goods are actually delivered to customers. Other companies record revenue at the date of customer delivery. And still others record revenue only

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

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

when payment for the goods is received from the customer, which can be long *after* delivery. The timing of revenue recognition for accounting purposes depends of the specific contract (implicit or explicit) between the company and its customer (see Chapter 3). We'll now look more closely at the principles that govern accounting and financial reporting practices.

Generally Accepted Accounting Principles

Over time, the accounting practitioners and standards setters have developed a network of conventions, rules, and procedures, collectively referred to as **generally accepted accounting principles (GAAP).** The principles and rules that govern financial reporting continue to develop and evolve in response to changing business conditions. Consider, for example, the lease of retail store space at a shopping mall. As people moved from the city to the suburbs, shopping malls emerged as convenient and accessible alternatives to traditional urban retail stores. Leasing became a popular alternative to ownership because it enabled retailing companies to gain access to store space without having to bear the burden of the large dollar outlay necessary to buy or build the store. Leasing was also attractive because it shared risks—such as the risk of competition from a new mall opening nearby—between the retailer and shopping mall owner. As leasing increased in popularity, the accounting profession developed practices, some complex, that are followed when accounting for leases. The practices that evolved are now part of GAAP and are discussed in detail in Chapter 13.

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

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

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

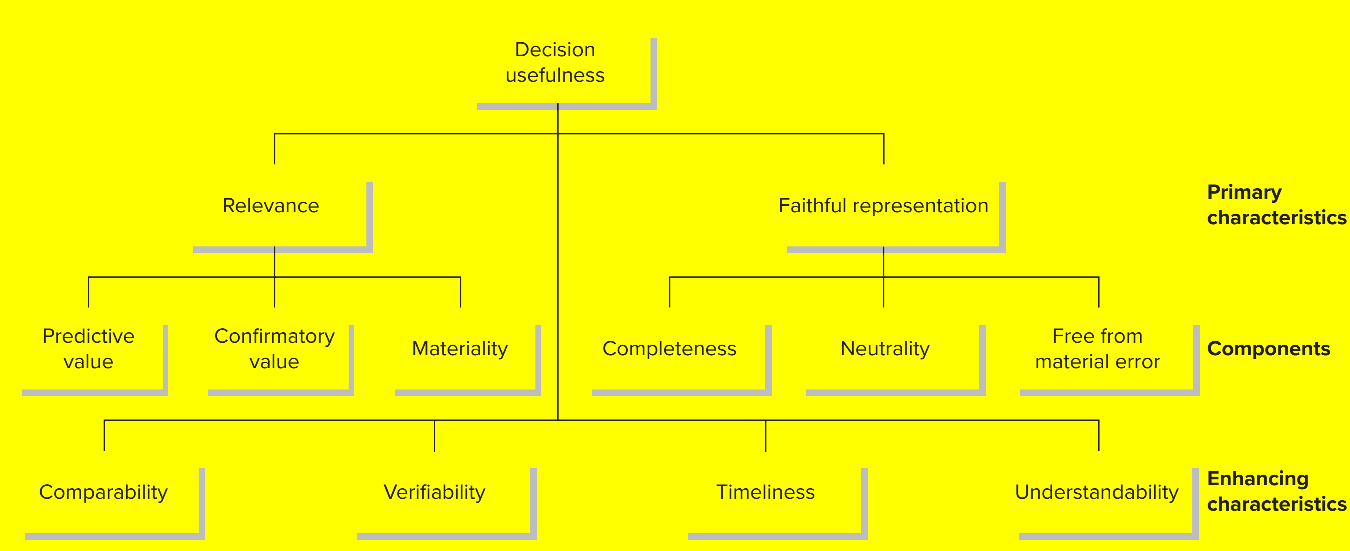

Figure 1.1 DESIRABLE CHARACTERISTICS OF ACCOUNTING INFORMATION

Source: "Conceptual Framework for Financial Reporting: Chapter 1, The Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information," *Statement of Financial Accounting Concepts No. 8*—As Amended (Norwalk, CT: FASB, August 2018).

[13] See "Conceptual Framework for Financial Reporting: Chapter 1, The Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information," *Statement of Financial Accounting Concepts No. 8*—As Amended (Norwalk, CT: FASB, August 2018). This concept statement replaces *SFAC No. 1* and *No. 2.*

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

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

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

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

As part of its Disclosure Framework project, in 2015, the FASB issued an exposure draft that would have defined materiality as a legal concept.[15] The FASB changed the definition because it viewed the *SFAC No. 8* definition of materiality, based on the ability of the information to affect *user* decisions, to be inconsistent with the current U.S. legal definition, based on the ability of information to affect *reasonable resource provider* decisions. The proposed definition of materiality was criticized in numerous comment letters.[16] These comment letters questioned whether the current *SFAC No. 8* definition is in fact inconsistent with the current U.S. legal definition and whether the change would improve financial disclosure effectiveness. Comment letters also argued that materiality is a financial reporting concept that requires professional judgment. Ultimately, the FASB decided to replace the *SFAC No. 8* definition with the superseded definition contained in *SFAC No. 2.* Our coverage reflects the new definition.[17]

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

Verifiability means that independent measurers should get similar results when using the same yardstick. For example, the 2017 sales of $122.7 billion reported by Kroger Co., the grocery chain, is verifiable to the extent that knowledgeable accountants and auditors would agree on this amount after examining the company's sales transactions for the year. So, verifiability refers to the degree of consensus among measurers. Financial information that lacks verifiability is less reliable for decision purposes. **Timeliness** refers to information that is available to decision makers while it is still fresh and capable of influencing their decisions. An example is sales to customers made during the current quarter as opposed to sales made a distant quarter ago. **Understandability** is the characteristic of information that enables users to comprehend its meaning. Management has a responsibility to ensure that the company's financial information is properly assembled, classified, characterized, and presented clearly and concisely. Professional analysts also have a responsibility. They must not only possess a reasonable understanding of the business and economic events, they must also be able to read financial reports and be willing to study the information.

Conservatism means that when there is uncertainty about the correct accounting approach for an event, accountants choose the approach that leads to lower assets or higher liabilities. Accounting strives to ensure that business risks and uncertainties are adequately reflected in the financial reports. For example, it is prudent to record possible losses from product liability litigation as soon as those losses become probable and measurable. Doing so helps statement readers assess the potential cash flow implications of the litigation even though an exact dollar amount has not yet been determined. Unfortunately, conservatism is sometimes used to defend poor accounting judgments such as understating income for "big bath" restructuring costs or "cookie-jar" reserves described in Chapter 2.[18] *Today's understatement of income leads to tomorrow's overstatement of income.*

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

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

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

[17] See Amendments to *Statement of Financial Accounting Concepts No. 8* (Chapter 3, Qualitative Characteristics of Useful Financial Information) (Norwalk, CT: FASB, August 2018).

[18] See R. L. Watts, "Conservatism in Accounting, Part I: Explanations and Implications," *Accounting Horizons* 17, no. 3 (September 2003), pp. 207–221; and R. L. Watts, "Conservatism in Accounting, Part II: Evidence and Research Opportunities," *Accounting Horizons* 17, no. 4 (December 2003), pp. 287–301.

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

Who Determines the Standards?

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

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

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

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

International

How are financial reporting standards determined outside the United States? In some countries, it's by professional accounting organizations akin to the FASB, and in other countries, it's by commercial law and/or tax law requirements. The growth of global investing has spurred the development of worldwide accounting standards. These standards are now written by the **International Accounting Standards Board (IASB).** The IASB works to formulate accounting standards, promote their worldwide acceptance, and achieve greater convergence of financial reporting regulations, standards, and procedures across countries. The IASB has issued 16

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

The Politics of Accounting Standards

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

- Congress enacted the **investment tax credit (ITC)** in 1962 as part of an economic stimulus package. Under the ITC, businesses were permitted to reduce their income tax payable in the year in which a qualifying asset (think "equipment") is purchased and put to use. A newly established accounting standard spread GAAP recognition of the ITC benefit over several years instead of recording it immediately. Many companies were not pleased by this approach because it presented a less favorable near-term income picture. Under pressure from industry, accounting firms, and the Kennedy administration, the SEC stepped in and allowed immediate recognition, thus forcing a change to established GAAP.
- As part of the Energy Policy and Conservation Act of 1975, Congress instructed the SEC to require all oil and gas companies to use the same accounting method in their financial statements. At the time, companies could choose between two alternatives—one that expensed the costs of unsuccessful wells immediately and one that expensed the costs over the lives of the successful wells. Based on accounting theory, the FASB required that costs of unsuccessful wells be expensed immediately. However, most small and medium-sized oil and gas producers used the other approach. They vigorously protested FASB's decision and enlisted support in Congress, the Departments of Energy and Justice, and the Federal Trade Commission. Those agencies believed that immediate expensing would cause many producers to curtail their exploration activities (thus contributing to an oil shortage) or drive them into mergers with big oil companies (thus reducing the number of competitors in the industry). Once again, the SEC stepped in and overruled FASB's position.[19]
- By the 1990s, employee stock options were a popular form of compensation especially among cash-starved high-technology firms. One reason was that GAAP did not require firms to record an expense when stock options were doled out. FASB was increasingly uncomfortable with this approach and moved to require a recorded expense. An unprecedented lobbying campaign by small, high-technology firms secured congressional support and prevented FASB from requiring recognition of the stock option expense in companies' financial statements. Chapter 16 tells you more of the story.

[19] A chronology of the events surrounding this oil and gas accounting controversy can be found in G. Foster, "Accounting Policy Decisions and Capital Markets," *Journal of Accounting and Economics* 2, no. 1 (March 1980), pp. 29–62.

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

Chapter 9 describes fair value accounting and the role it may have played in the crisis.

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

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

FASB Accounting Standards Codification™

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

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

> . . . a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures. (para. 2.02)
>
> *Source:* "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles," *Statement of Auditing Standards No. 69* (New York: AICPA, 1975).

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

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

In 2009, the FASB completed a five-year effort to distill the existing GAAP literature into a single database by creating the **Accounting Standards Codification** (or **ASC**), an online filing cabinet that groups all authoritative rules into roughly 90 topics.[23] ASC is now the

[20] For example, see B. Badertscher, J. Burks, and P. Easton, "A Convenient Scapegoat: Fair Value Accounting by Commercial Banks during the Financial Crisis," *The Accounting Review* 87, no. 1 (January 2012), pp. 59–90.

[21] To learn more about the politics of U.S. accounting standards, see Z. Palmrose, "Science, Politics, and Accounting: A View from the Potomac," *The Accounting Review* 84, no. 2 (March 2009), pp. 281–98; and S. Zeff "The Evolution of U.S. GAAP: The Political Forces behind Professional Standards," *The CPA Journal* 75, no. 1 (January 2005), pp. 19–27, and no. 2 (February 2005), pp. 19–29.

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

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

authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). **Accounting Standards Updates** (or ASUs) modify the codification, provide background information about the revised guidance, and provide the basis for conclusions on changes made to ASC.

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

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

ASC Topical Structure and Referencing The ASC uses a structure in which the FASB's authoritative accounting guidance is organized into topics, subtopics, sections, subsections, and paragraphs. *Topics,* the broadest categorization of related guidance, are grouped into four areas: *presentation* matters relating to financial statements or notes; *financial statement accounts* such as Receivables, Inventory, or Revenue; *broad transactions* including business combinations and derivatives; and *industries* where specialized GAAP unique to an industry (airlines or gaming) or type of activity (software development) is described. *Subtopics* represent numbered subdivisions of a topic and are generally distinguished by type or scope. For example, 10 Overall and 20 Lessee are two subtopics of the Lease topic. *Sections* are numbered subdivisions of Subtopics, such as 25 Recognition, 30 Initial Measurement, or 55 Implementation Guidance and Illustrations, which denote the specific nature of the content. *Subsections* and *paragraphs* allow further segregation and navigation of content.

See Book Appendix B for a list of current ASC topics by topic number.

An example of the numerical referencing is ASC 842–10-05, where 842 is the "Leases" topic, 10 denotes the "Overall" subtopic, and 05 is the "Overview and Background" section.

INCENTIVE CONFLICTS AND FINANCIAL REPORTING

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

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

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

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

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

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

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

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

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

SUSTAINABILITY ACCOUNTING

Over the past 20 years, investors, creditors, governments, non-government organizations (NGOs), and the public have become interested in both how firms address climate change risk and how they contribute to the problem. To address this information demand, many companies issue separate sustainability reports, which provide such items as greenhouse gas (GHG) emissions, carbon

[24] Lenders are fooled when they mistakenly assign too little risk (thus charging too low an interest rate) to the borrowing. An interest cost savings of one-half of a percentage point on $1 billion of borrowings equates to $5 million (pre-tax) per year. If the company is in the 21% tax bracket and its stock trades at 15 times earnings, the payoff for concealing credit risk on financial statements is $59.25 million in share value ($5 million × [1 minus 0.21 tax rate] × earnings multiple of 15). This value increase represents a wealth transfer to shareholders from creditors.

dioxide equivalents (CO_2e), energy use, and freshwater consumption. Numerous entities have been formed to increase consistency in company disclosures. In addition, regulators have issued guidelines on climate change-related disclosures. This section outlines briefly some of these efforts.

The Global Reporting Initiative (GRI) issued its first guidelines for sustainability reporting in 2000. GRI defines its mission as helping "businesses and governments worldwide understand and communicate their impact on critical sustainability issues such as climate change, human rights, governance and social well-being."[25] Companies that voluntarily disclose under these standards provide general information about strategy, ethics, governance, and stakeholder engagement. The companies can then provide additional information for categories such as energy, emissions, environmental compliance, and so on.

CDP (formerly, the Carbon Disclosure Project), founded in 2000, has a similar goal—to maintain a "global disclosure system that enables companies, cities, states and regions to measure and manage their environmental impacts."[26] CDP collects and publishes company information on climate change, water, and forest use. The climate change information includes GHG emissions, emissions trading, climate change risks and opportunities, and governance and strategy data. CDP publishes its information in reports and on its website.[27]

Parallel with the development of GRI and CDP guidelines, other organizations have developed principles and guidelines around sustainability disclosures. In 2015, the United Nations adopted 17 Sustainable Development Goals (SDGs).[28] Also in 2015, the G20's Financial Stability Board established the Task Force on Climate-Related Financial Disclosures (TCFD). The purpose of the task force is to "develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders."[29] Finally, in 2016, the Sustainability Accounting Standards Board (SASB) developed industry-based frameworks for assessing and measuring climate-related risks.[30]

Some of the above organizations have begun working together to align the standards. For example, CDP has attempted to align its recent questionnaires with GRI and TCFD standards.[31] In addition, firms will often cross-reference their sustainability reports to the various standards. For example, Exxon-Mobil's 2017 Sustainability Report includes cross-references for the Global Reporting Initiative G4 Sustainability Reporting Guidelines and the United Nations Sustainable Development Goals.[32]

To date, neither the FASB nor the SEC has required specific disclosures about the effects of climate change risks and opportunities on companies' operations and financial performance. However, the SEC has outlined how climate change could affect Regulation S-K disclosures. The SEC mentions four items that could require climate-related disclosures: description of business, legal proceedings, risk factors, and management's discussion and analysis.[33] It also

[25] See www.globalreporting.org and Securities and Exchange Commission (SEC), *Commission Guidance Regarding Disclosure Related to Climate Change,* 17 CFR Parts 211, 231 and 241 [Release Nos. 33-9106; 34-6469; FR-82], February 8, 2010, p. 9.

[26] See www.cdp.net and SEC, *Commission Guidance,* p. 9.

[27] These data have been used in accounting research to show that a firm's level of carbon emissions is negatively correlated with its stock price. See E. M. Matsumura, R. Prakash, and S. Vera-Muñoz, "Firm-Value Effects of Carbon Emissions and Carbon Disclosures," *The Accounting Review* 89, no. 2 (March 2014), pp. 695–724. The results are consistent with lower carbon emissions leading to positive stakeholder perceptions, a more committed work force, and fewer future regulation costs. Higher levels of carbon emissions may also indicate higher risk, which would reduce share price.

[28] See United Nations, *Transforming Our World: The 2030 Agenda for Sustainable Development* (2015), https://sustainabledevelopment.un.org/post2015/transformingourworld.

[29] www.fsb-tcfd.org/about/#

[30] See https://navigator.sasb.org/ and U.S. Government Accountability Office, *Climate-Related Risks: SEC Has Taken Steps to Clarify Disclosure Requirements* (GAO-18-188) (February2018), www.gao.gov/assets/700/690237.pdf.

[31] See GRI, *Linking GRI and CDP* (2018), and CDP, *Higher Ambitions, Higher Expectations—CDP Europe Report 2018.*

[32] See https://corporate.exxonmobil.com/en/community-engagement/sustainability-report/content-index.

[33] See GAO-18-188, pp. 7–8.

mentions four categories of risks and opportunities that disclosures should address: pending or existing regulation, international accords, indirect consequences of regulation or business trends, and physical impacts such as high sea levels or water availability.[34]

Though the U.S. accounting regulators have not required specific climate-related disclosures, other government regulators are moving more aggressively. For example, the European Commission plans to increase sustainability disclosures under its Sustainable Finance Action Plan.[35] In addition, some stock exchanges require environmental, social, and governance (ESG) reporting as a listing rule, and others require registrants to issue reports that integrate financial and sustainability information (e.g., Johannesburg Stock Exchange).

In addition to having different views on sustainability accounting, countries have different views toward reporting financial information. We discuss these differences in the next section.

RECAP

Over the past 20 years there has been an increased demand for disclosures on climate change. Numerous organizations have developed standards for reporting, and some of these organizations have joined forces to make the requirements consistent. Though the European Union plans to increase required sustainability disclosures for firms under its jurisdiction, the United States does not require uniform disclosures about climate change.

AN INTERNATIONAL PERSPECTIVE

Because financial reporting practices vary widely in countries outside the United States and because international business transactions are now more frequent and complex, the professional life of an analyst—in any country—has become more difficult. Multinational companies are regularly shifting resources throughout the world. These shifts cannot be accomplished efficiently without reliable financial information that permits careful analysis of investment opportunities and continuous control over how resources are deployed. Multinational companies must also resolve differences in national currencies and accounting rules when combining the financial statements of all their foreign and domestic businesses into consolidated reports.

The Coca-Cola Company, for example, conducts business in more than 200 countries, hedges foreign currency cash flows, and uses foreign loans to finance investments outside the United States. Revenue in North America represented 24.5% of 2017 worldwide revenue and generated 34.4% of worldwide operating income. By contrast, Latin America represented only 11.2% of worldwide revenue but produced 29.5% of Coca-Cola's worldwide operating income.

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

Global competition is prevalent in most industries today as companies facing mature domestic markets look outside their home borders for new customers and growth. Exhibit 1.2 presents sales, net income, and assets for three automobile manufacturers that compete on a worldwide basis: Ford Motor Company, Fiat S.A., and Honda Motor Company. Honda, a Japanese firm, reports financial statements in Japanese yen, Ford uses U.S. dollars, and Fiat, an Italian company, uses the euro for financial reporting purposes. Which company was the most profitable?

In the upper part of Exhibit 1.2, the financial statement amounts reported by these three companies are not directly comparable because each firm uses a different currency.

[34] Ibid., p. 9.

[35] See CDP, *Higher Ambitions, Higher Expectations,* pp. 3–5.

EXHIBIT 1.2 **Ford, Fiat, and Honda**

	Ford Motor Co. (United States)	Fiat S.A. (Italy)	Honda Motor Co. (Japan)
As reported in local currency			
Revenue	$156,766	€110,934	¥13,999,200
Net income	7,628	3,510	679,394
Assets	257,808	96,299	18,958,123
U.S. dollar equivalents			
Revenue	$156,766	€125,910	¥ 125,346
Net income	7,628	3,984	6,083
Assets	257,808	116,522	170,948
Accounting methods	U.S. GAAP	IFRS	U.S. GAAP
Fiscal year-end	December 31	December 31	March 31

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

Source: Company annual reports for 2017.

For example, Honda had sales of 13,999,200 million yen but how does this yen-denominated amount compare to Ford's revenue of $156,776 million? The yen/dollar exchange rate averaged 111.68 for the year ended March 31, 2017. This means that each U.S. dollar was worth about 111.68 yen. In the case of Fiat, the euro/dollar exchange rate averaged about 0.88 for the year. The lower part of the exhibit shows each company's revenue, net income, and assets expressed in U.S. dollars. Here, you can see that Ford has both the largest sales ($156,776 million) and most net income ($7,628 million).

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

International Financial Reporting

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

Before the early 1990s—when cross-border investing was nascent—accounting standards for use by domestic companies were developed by home-country organizations (e.g., This approach originated and evolved in both the United Kingdom and the United States. In turn, this Anglo-American accounting perspective influenced financial reporting practices in most British Commonwealth countries and many others. The phrase **true and fair view** is central to this perspective because it expresses the notion that a company's financial statements must reflect the underlying economic performance and conditions experienced by the company.

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

Accounting Standards Board in the United Kingdom and the French Conseil National de la Comptabilité in France).[36] The resulting diversity of financial reporting recognition, measurement, and disclosure rules used in different countries complicated global investment decisions. Even the philosophy and objective of financial reporting varied considerably between nations.

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

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

Why Do Reporting Philosophies Differ across Countries?

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

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

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

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