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LEARNING OBJECTIVES

After completing the chapter, you should be able to:

- L01** Identify the users of accounting information and discuss the costs and benefits of disclosure (p. 4)
- L02** Describe a company's business activities and explain how these activities are represented by the accounting equation. (p. 7)
- L03** Introduce the four key financial statements including the balance sheet, income statement, statement of stockholders' equity, and statement of cash flows. (p. 11)
- L04** Describe the institutions that regulate financial accounting and their role in establishing generally accepted accounting principles. (p. 17)
- L05** Compute two key ratios that are commonly used to assess profitability and risk—return on equity and the debt-to-equity ratio. (p. 20)
- L06** Appendix 1A—Explain the conceptual framework for financial reporting. (p. 23)

| ✓ <input checked="" type="checkbox"/> Action Plan | |
|---|---|
| ✓ <input type="checkbox"/> | Read Learning Objectives |
| ✓ <input type="checkbox"/> | Review Opening Story |
| ✓ <input type="checkbox"/> | Review Chapter Organization Chart |
| ✓ <input type="checkbox"/> | Study text and do Mid-Chapter Review(s) |
| ✓ <input type="checkbox"/> | Study text and do Chapter-End Review |
| ✓ <input type="checkbox"/> | Read solutions to You Make the Call |
| ✓ <input type="checkbox"/> | Review Summary and Key Terms |
| ✓ <input type="checkbox"/> | Answer Self-Study Assignments |
| ✓ <input type="checkbox"/> | Complete Assignments |

> Introducing Financial Accounting

> > > NIKE



By 2007, **Nike** products were marketed on six continents and total company sales exceeded \$16 billion. The company recently announced plans to open 100 new retail stores with a goal of reaching sales of \$23 billion by 2011.

Phil Knight majored in accounting and was a member of the track team at the University of Oregon. Today he is the chairman of the board of the largest sports and fitness company in the world.

A few years after graduation, Knight teamed up with his former track coach, Bill Bowerman, to form a business called Blue Ribbon Sports to import, sell, and distribute running shoes from Japan. **Blue Ribbon Sports**, or BRS as it came to be known, was started on a shoestring—Knight and Bowerman each contributed \$500 to start the business. BRS introduced its own line of running shoes called Nike, named for the Greek goddess of victory. It also unveiled a new logo, the now familiar Nike swoosh. Following the overwhelming success of the Nike shoe line, BRS officially changed its company name to **Nike, Inc.** Today, the company is worth more than \$20 billion.

Nike is one of the premier marketing companies of the last 30 years. The swoosh along with advertising campaigns featuring taglines such as “just do it,” have made the company and its products instantly recognizable to consumers all over the world. Endorsements by the most recognizable icons in sports, including Michael Jordan, Tiger Woods, Maria Sharapova, Alex Rodriguez, Mia Hamm, and Lance Armstrong, add to Nike’s brand recognition.

Besides its marketing prowess, Nike owes much of its success to innovative design and development of products including athletic shoes, athletic apparel, sports equipment, eyewear, and watches. In recent years, Nike expanded its product offering by acquiring other companies such as Converse, an established athletic shoe company, and Hurley International, a leading designer and distributor of surf, skate and snowboarding apparel and footwear.

How does someone take a \$1,000 investment and turn it into a company with sales of over \$16 billion? Well, Nike’s success is not an accident. Along the way, Nike management made countless decisions that ultimately led the company to where it is today.



Each of these decisions involved identifying alternative courses of action and weighing their costs, benefits, and risks in light of the available information.

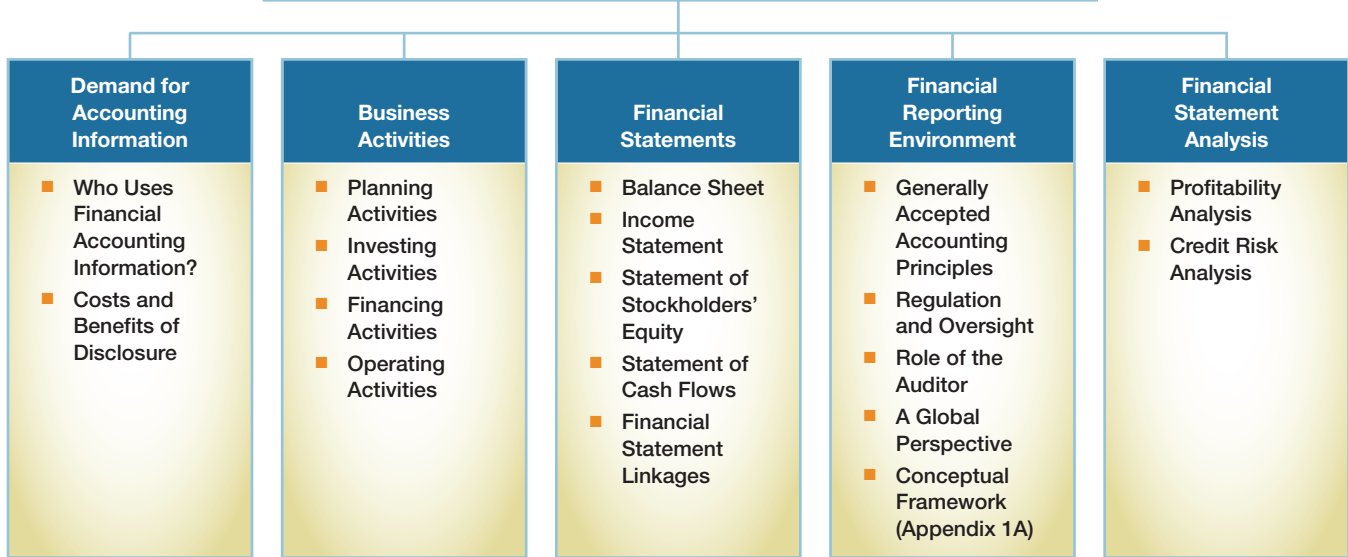
Accounting is the process of identifying, measuring and communicating financial information to help people make *economic* decisions. People use financial accounting information to facilitate a wide variety of transactions, including assessing whether, and on what terms, they should invest in a firm, seek employment in a business, or continue purchasing its products. Accounting information is crucial to any successful business, and without it, most businesses would not even exist.

This book explains how to create and analyze *financial statements*; an important source of accounting information prepared by companies to communicate with a variety of users. We begin by introducing transactions between the firm and its various parties, such as investors, suppliers, employees, customers, and regulatory agencies. We continue by demonstrating how accounting principles are applied to these transactions to create the financial statements. Then, at the conclusion of the text, we “invert” the process and learn how to analyze the firm’s financial statements to assess the firm’s underlying economic performance. Our philosophy is simple—we believe it is crucial to have a deep understanding of financial accounting to become critical readers and users of financial statements. Financial statements tell a story—a business story. Our goal is to understand that story, and apply the knowledge gleaned to make good business decisions.

Sources: Nike.com; Nike, Inc. 2007 10-K Report; Business Week (October 2007); Portland Business Journal (October 2007)

CHAPTER ORGANIZATION

> Introducing Financial Accounting



> DEMAND FOR ACCOUNTING INFORMATION

LO1 Identify the users of accounting information and discuss the costs and benefits of disclosure.

Accounting can be defined as the process of recording, summarizing, and analyzing financial transactions. While accounting information attempts to satisfy the needs of a diverse set of users, the accounting information a company produces can be classified into two categories:

- **Financial accounting**—designed primarily for decision makers outside of the company
- **Managerial accounting**—designed primarily for decision makers within the company

Financial accounting reports include information about company profitability and financial health. This information is useful to various economic actors who wish to engage in contracts with the firm, including investors, employees, customers, and governments. Managerial accounting information is not reported outside of the company because it includes proprietary information about the profitability of specific products, divisions, or customers. Company managers use managerial accounting reports to make decisions such as whether to drop or add products or divisions, or whether to continue serving

different types of customers. This text focuses on understanding and analyzing financial accounting information.

| EXHIBIT 1.1 Information Needs of Decision Makers Who Use Financial and Managerial Accounting | | | |
|--|--|--|--|
| | Decision Makers | Decisions | Information |
| Financial Accounting | <ul style="list-style-type: none"> Investors and Analysts Creditors Suppliers and Customers | <ul style="list-style-type: none"> Buy or sell stock? Lend or not? Purchase/sell goods or not? | <ul style="list-style-type: none"> Sales and Costs Cash In and Out Assets and Liabilities |
| Managerial Accounting | <ul style="list-style-type: none"> Top management Marketing teams Production and operations | <ul style="list-style-type: none"> Develop new strategy? Launch a new product or not? Manage operations | <ul style="list-style-type: none"> Product sales and costs Department performance reports Budgets and quality reports |

Who Uses Financial Accounting Information?

Demand for financial accounting information derives from numerous users including:

- Shareholders and potential shareholders
- Creditors and suppliers
- Managers and directors
- Financial analysts
- Other users

Shareholders and Potential Shareholders Corporations are the dominant form of business organization for large companies around the world, and corporate shareholders are one important group of decision makers that have an interest in financial accounting information. A **corporation** is a form of business organization that is characterized by a large number of owners who are not involved in managing the day-to-day operations of the company.¹ A corporation exists as a legal entity that issues **shares of stock** to its owners in exchange for cash and, therefore, the owners of a corporation are referred to as *shareholders* or *stockholders*.

Because the shareholders are not involved in the day-to-day operations of the business, they rely on the information in financial statements to evaluate management performance and assess the company's financial condition.

In addition to corporations, sole proprietorships and partnerships are also common forms of business ownership. A **sole proprietorship** has a single owner who typically manages the daily operations. Small family-run businesses, such as corner grocery stores, are commonly organized as sole proprietorships. A **partnership** has two or more owners who are also usually involved in managing the business. Many professionals, such as lawyers and CPAs, organize their businesses as partnerships.

Most corporations begin as small, privately held businesses (sole proprietorships or partnerships). As their operations expand, however, they require additional capital to finance their growth. One of the principle advantages of a corporation over sole proprietorships and partnerships is the ability to raise large amounts of cash by issuing (selling) stock. For example, as Nike grew from a small business with only two owners into a larger company, it raised the funds needed for expansion by selling shares of Nike stock to new shareholders. Large corporations can raise funds by issuing stock on organized exchanges, such as the **New York Stock Exchange (NYSE)** or **NASDAQ** (which is an acronym for the National Association of Securities Dealers Automated Quotations system). Corporations with stock traded on public exchanges are known as *publicly traded corporations* or simply *public corporations*.

FYI Shareholders of a corporation are its owners; although managers can own stock in the corporation, most stockholders are not managers.

¹ Most countries have business forms that are similar in structure to a U.S. corporation, though they are referred to by different names. For example, while firms that are incorporated in the United States have the extension, Inc. appended to their names, similar firms in the United Kingdom are referred to as a Public Limited Company, which has the extension, PLC.

Financial statements and the accompanying footnotes provide information on the risk and return associated with owning shares of stock in the corporation, and they reveal how well management has performed. Financial statements also provide valuable insights into future performance by revealing management's plans for new products, new operating procedures, and new strategic directions for the company. Corporate management provides this information because the information reduces uncertainty about the company's future prospects which, in turn, increases the market price of its shares and helps the company raise the funds it needs to grow.

FYI Financial statements are typically required when a business requests a bank loan.

Creditors and Suppliers Few businesses rely solely on shareholders for the cash needed to operate the company. Instead, most companies borrow from banks or other lenders known as **creditors**. Creditors use financial accounting information to help determine loan terms, loan amounts, interest rates, and collateral. In addition, creditors' loans often include contractual requirements based on information found in the financial statements.

Suppliers use financial information to establish credit sales terms and to determine their long-term commitment to supply-chain relations. Supplier companies often justify an expansion of *their* businesses based on the growth and financial health of their customers. Both creditors and suppliers rely on information in the financial statements to monitor and adjust their contracts and commitments with a company.

Managers and Directors Financial statements can be thought of as a financial report card for management. A well-managed company earns a good return for its shareholders, and this is reflected in the financial statements. In most companies, management is compensated, at least in part, based on the financial performance of the company. That is, managers often receive cash bonuses, stock options, or other *incentive compensation* that is linked directly to the information in the financial statements.

FYI The Sarbanes-Oxley Act requires issuers of securities to disclose whether they have a code of ethics for the senior officers.

Publicly traded corporations are required by law to have a **board of directors**. Directors are elected by the shareholders to represent shareholder interests and oversee management. The board hires executive management and regularly reviews company operations. Directors use financial accounting information to review the results of operations, evaluate future strategy, and assess management performance.

Both managers and directors use the published financial statements of *other companies* to perform comparative analyses and establish performance benchmarks. For example, managers in some companies are paid a bonus for financial performance that exceeds the industry average.

BUSINESS INSIGHT

Recent court cases involving corporations such as **Enron**, **Tyco**, and **WorldCom** (now **MCI**) have found executives, including several CEOs, guilty of issuing fraudulent financial statements. These executives have received substantial fines and, in some cases, long jail sentences. These trials have resulted in widespread loss of reputation and credibility among corporate boards.

Financial Analysts Many decision makers lack the time, resources, or expertise to efficiently and effectively analyze financial statements. Instead, they rely on professional financial analysts, such as credit rating agencies like **Moody's** investment services, portfolio managers, and security analysts. Financial analysts play an important role in the dissemination of financial information and often specialize in specific industries. Their analysis helps to identify and assess risk, forecast performance, establish prices for new issues of stock, and make buy or sell recommendations to investors.

Other Users of Financial Accounting Information External decision makers include many users of accounting information in addition to those listed above. For example, *prospective employees* often examine the financial statements of an employer to learn about the company before interviewing for or accepting a new job.

Labor unions examine financial statements in order to assess the financial health of firms prior to negotiating labor contracts on behalf of the firms' employees.

Customers use accounting information to assess the ability of a company to deliver products or services and to assess the company's long-term reliability. *Tax agencies* use financial accounting to help establish and implement tax policies. Other *government agencies* rely on accounting information to develop and enforce regulations, including public protection, price setting, import-export, and various other policies. Timely and reliable information is crucial to effective regulatory policy. Moreover, accounting information is often used to assess penalties for companies that violate various regulations.

Costs and Benefits of Disclosure

The act of providing financial information to external users is called **disclosure**. As with every decision, the benefits of disclosure must be weighed against the costs of providing the information.

One reason companies are motivated to disclose financial information to external decision makers is that it may lower financing and operating costs. For example, when a company applies for a loan, the bank uses the company's financial statements to help determine the appropriate interest rate. Without adequate financial disclosures in its financial statements, the bank is likely to demand a higher interest rate or perhaps not make the loan at all. Thus, in this setting, a benefit of financial disclosure is that it reduces the company's cost of borrowing.

While there are benefits from disclosing financial information, there are also costs. Besides the obvious cost of hiring accountants and preparing the financial statements, financial disclosures can also result in costs being imposed by competitors. It is common practice for managers to scrutinize the financial statements of competitors to learn about successful products, new strategies, innovative technologies, and changing market conditions. Thus, disclosing too much information can place a company at a competitive disadvantage. Disclosure may also raise investors' expectations about a company's future profitability. If those expectations are not met, they may bring litigation against the managers.

There are also political costs that are potentially associated with accounting disclosure. Highly visible companies, such as defense contractors and oil companies, are often the target of scrutiny by the public and by government officials. When these companies report unusually large accounting profits, they are often the target of additional regulation or increased taxes. Stock market regulators impose disclosure standards for publicly traded corporations, but the nature and extent of the required disclosures varies substantially across countries. Further, since the requirements only set the minimum level of disclosure, the quantity and quality of information provided by firms can vary.

YOU MAKE THE CALL

You are a Product Manager There is often friction between investors' needs for information and a company's desire to safeguard competitive advantages. Assume that you are the product manager for a key department at your company and you are asked for advice on the extent of information to disclose in the annual report on a potentially lucrative new product that your department has test marketed. What advice do you provide and why? [Answer on page 27]

> BUSINESS ACTIVITIES

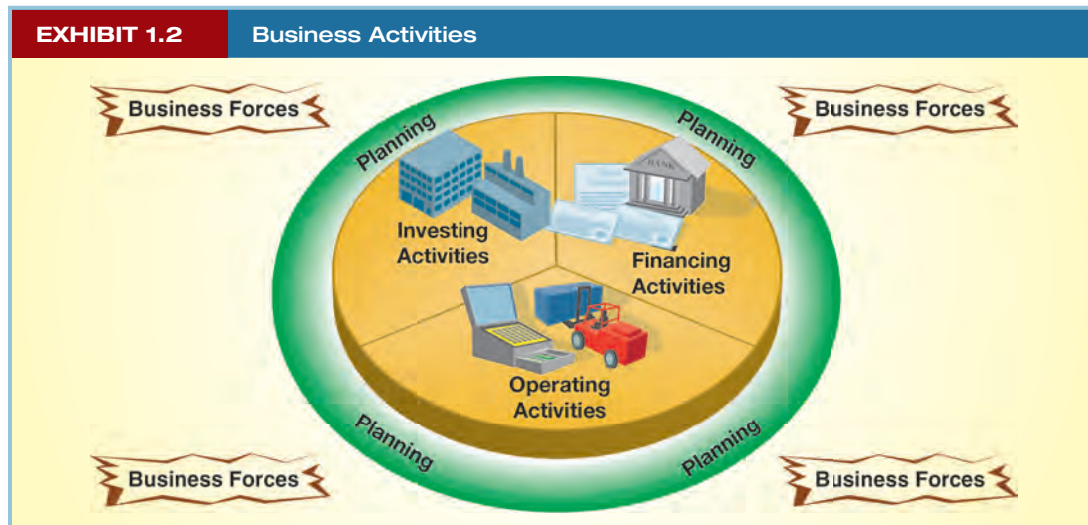
Businesses produce accounting information to help develop strategies, attract financing, evaluate investment opportunities, manage operations, and measure performance. Before we can attempt to understand the information provided in financial statements, we must understand these business activities. That is, what does a business actually do? For example:

- Where does a company such as Nike find the resources to develop new products and open new retail stores?
- What new products should Nike bring to market?
- How much should Nike spend on product development? On advertising? On executive compensation?
- How does Nike management determine if a product is a success?

Questions such as these define the activities of Nike and other companies.

LO2 Describe a company's business activities and explain how these activities are represented by the accounting equation.

Exhibit 1.2 illustrates the activities of a typical business. All businesses *plan* business activities, *finance* those activities, *invest* resources in those activities, and then engage in *operating* activities. Companies conduct all these activities while confronting a variety of *business forces*, including competition from other businesses, government regulation, economic conditions and market forces, and changing preferences of customers. The financial statements provide information that helps us understand and evaluate each of these activities.



Planning Activities

A company's goals, and the strategies adopted to reach those goals, are the product of its **planning activities**. Nike, for example, states that its mission is "To bring inspiration and innovation to every athlete in the world" adding "If you have a body, you are an athlete." However, in its 2007 annual report to shareholders, **Nike** management suggests another goal that focuses on financial success and earning a return for the shareholders.

| |
|---|
|  NIKE NYSE :: NKE |
|---|

"Our promise is to deliver consistent, profitable growth over the long-term—high single-digit revenue growth and mid-teens earnings per share."

As is the case with most businesses, Nike's primary goal is to create value for its owners, the shareholders. How the company plans to do so is the company's *strategy*.

A company's *strategic* (or *business*) *plan* describes how it plans to achieve its goals. The plan's success depends on an effective review of market conditions. Specifically, the company must assess both the demand for its products and services, and the supply of its inputs (both labor and capital). The plan must also include competitive analyses, opportunity assessments, and consideration of business threats. The strategic plan specifies both broad management designs that generate company value and tactics to achieve those designs.

Most information in a strategic plan is proprietary and guarded closely by management. However, outsiders can gain insight into planning activities through various channels, including newspapers, magazines, and company publications. Understanding a company's planning activities helps focus accounting analysis and place it in context.

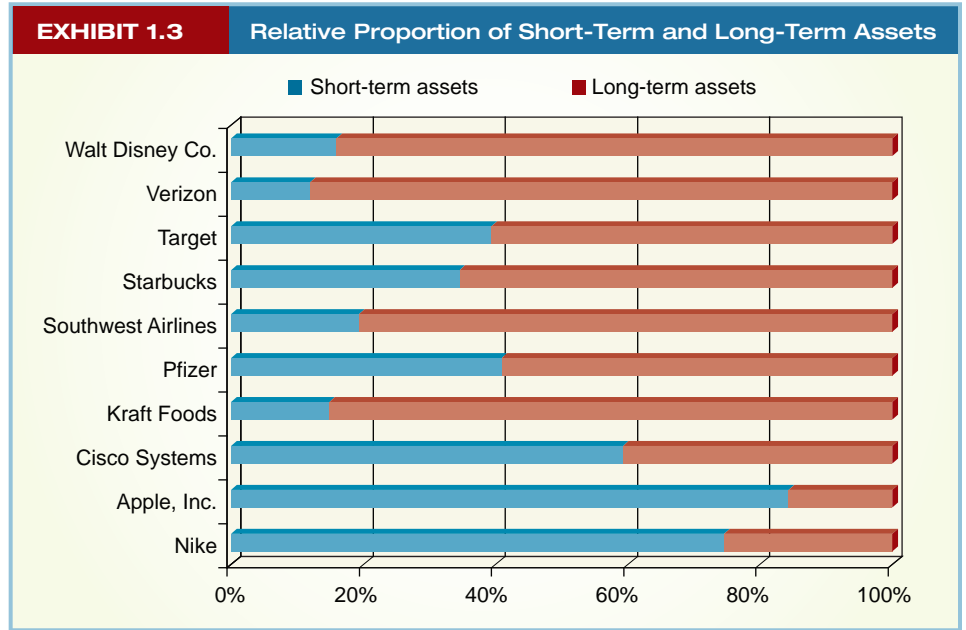
Investing Activities

Investing activities consist of acquiring and disposing of the resources needed to produce and sell a company's products and services. These resources, called **assets**, provide future benefits to the company. Companies differ on the amount and mix of these resources. Some companies require buildings and equipment while others have abandoned "bricks and mortar" to conduct business through the Internet.



Some assets that a company invests in are used quickly. For instance, a retail clothing store hopes to sell its spring and summer merchandise before purchasing more inventory for the fall and winter. Other assets are acquired for long-term use. Buildings are typically used for several decades. The relative proportion of short-term and long-term investments depends on the type of business and the strategic plan that the company adopts. For example, Nike has relatively few long-term assets because it outsources most of the production of its products to other companies.

The graph in Exhibit 1.3 compares the relative proportion of short-term and long-term assets held by Nike and nine other companies, several of which are featured in later chapters. Apple has adopted a business model that requires very little investment in long-term resources. A majority of its investments are short-term assets. In contrast, Verizon, Southwest Airlines, and Walt Disney all rely heavily on long-term investments. These companies hold relatively small proportions of short-term assets. This mix of long-term and short-term assets is described in more detail in Chapter 2.



Financing Activities

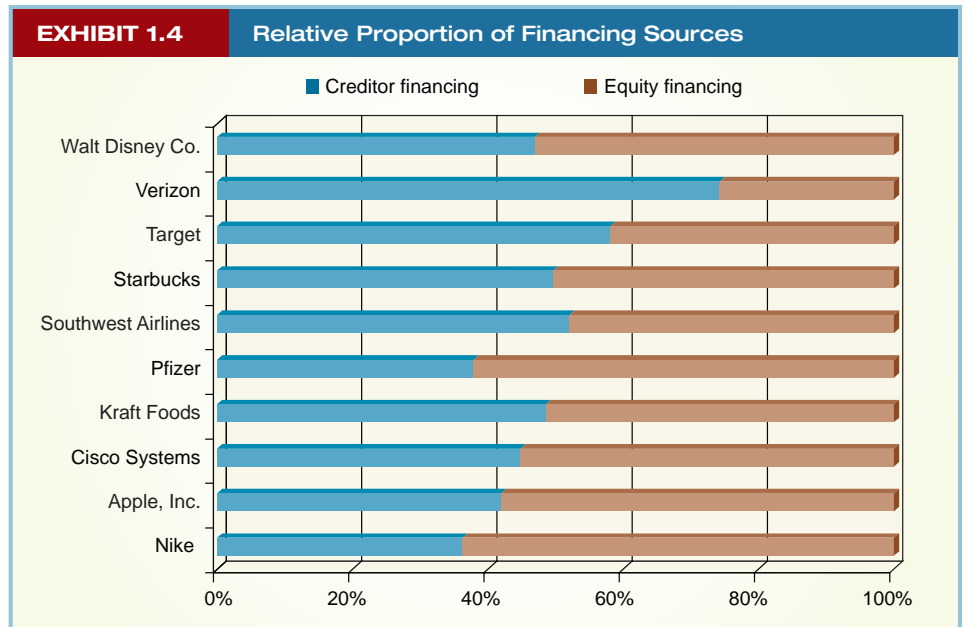
Investments in resources require funding, and **financing activities** refer to the methods companies use to fund those investments. *Financial management* is the planning of resource needs, including the proper mix of financing sources.

Companies obtain financing from two sources: equity (owner) financing and creditor (non-owner) financing. *Equity financing* is the funds contributed to the company by its owners along with any income retained by the company. One form of equity financing is the cash raised from the sale (or issuance) of stock by a corporation. *Creditor (or debt) financing* is funds contributed by non-owners, which create *liabilities*. **Liabilities** are obligations the company must repay in the future. One example of a liability is a bank loan. We draw a distinction between equity and creditor financing for an important reason: creditor financing imposes a legal obligation to repay, usually with interest, and failure to repay amounts borrowed can result in adverse legal consequences such as bankruptcy. In contrast, equity financing does not impose an obligation for repayment.

Exhibit 1.4 compares the relative proportion of creditor and equity financing for Nike and other companies. Verizon uses liabilities to finance 74%



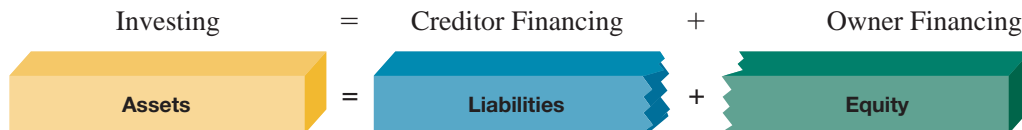
FYI Creditors are those to whom a company owes money.



FYI It is useful to separate equity from creditor financing when analyzing a company's performance.

of its resources. In contrast, pharmaceutical company **Pfizer** relies more heavily on its equity financing, receiving 38% of its financing from creditors. **Nike** has the lowest proportion of creditor financing in this sample of companies with just 34% of its assets financed by nonowners.

As discussed in the previous section, companies acquire resources, called assets, through investing activities. The cash to acquire these resources is obtained through financing activities, which consist of owner financing, called equity, and creditor financing, called liabilities (or debt). Thus, we have the following basic relation: *investing equals financing*. This equality is called the **accounting equation**, which is expressed as:



At fiscal year-end 2007, the accounting equation for **Nike** was as follows (\$ millions):

$$\$10,688.3 = \$3,662.9 + \$7,025.4$$

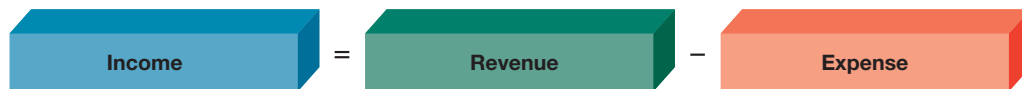
By definition, the accounting equation holds for all companies at all times. This relation is a very powerful tool for analyzing and understanding companies, and we will use it often throughout the text.

Operating Activities



Operating activities refer to the production, promotion, and selling of a company's products and services. These activities extend from a company's input markets involving its suppliers to its output markets involving its customers. Input markets generate *operating expenses* (or *costs*) such as inventory, salaries, materials, and logistics. Output markets generate *operating revenues* (or *sales*) from customers. Output markets also generate some operating expenses such as marketing and distributing products and services to customers. When operating revenues exceed operating expenses, companies report *operating income*, also called *operating profit* or *operating earnings*. When operating expenses exceed operating revenues, companies report operating losses.

Revenue is the increase in equity resulting from the sale of goods and services to customers. The amount of revenue is determined *before* deducting expenses. An **expense** is the cost incurred to generate revenue, including the cost of the goods and services sold to customers as well as the cost of carrying out other business activities. **Income**, also called *net income*, equals revenue minus expense, and is the net increase in equity from the company's operating activities.

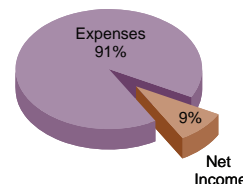


For fiscal year 2007, Nike reported revenues of over \$16 billion, yet its reported income was a fraction of that amount—just under \$1.5 billion.

BUSINESS INSIGHT

Each year, *Fortune* magazine ranks the 500 largest corporations in the U.S. based on total revenues. For fiscal year 2006, **Nike** ranked 158th on the *Fortune 500* list with revenues of just under \$15 billion. The company also ranked 136th in profits, with net income of approximately \$1.4 billion. For comparison, the largest corporation was **Wal-Mart**, with revenues of \$351.1 billion. Wal-Mart was not the most profitable company. That distinction went to **Exxon Mobil** with \$39.5 billion in net income. (Source: *Fortune*, April 2007)

Nike's Net Income as a Fraction of Revenue



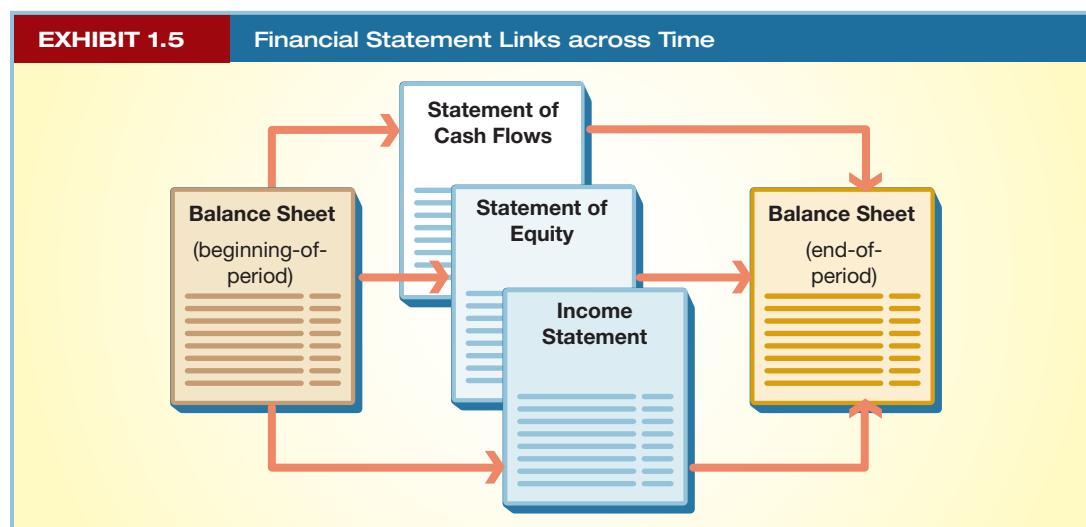
> FINANCIAL STATEMENTS

Four financial statements are used to periodically report on a company's business activities. These statements are:

- **balance sheet**, which lists the company's investments and sources of financing using the accounting equation;
- **income statement**, which reports the results of operations;
- **statement of stockholders' equity**, which details changes in owner financing;
- **statement of cash flows**, which details the sources and uses of cash.

Exhibit 1.5 shows how these statements are linked across time. A balance sheet reports on a company's position at a *point in time*. The income statement, statement of stockholders' equity, and the statement of cash flows report on performance over a *period of time*. The three statements in the middle of Exhibit 1.5 (period-of-time statements) link the balance sheet from the beginning of a period to the balance sheet at the end of a period.

LO3 Introduce the four key financial statements including the balance sheet, income statement, statement of stockholders' equity, and statement of cash flows.



A one-year, or annual, reporting period is common, which is called the *accounting*, or *fiscal year*. Semiannual, quarterly, and monthly reporting periods are also common. *Calendar-year* companies have a reporting period that begins on January 1 and ends on December 31. **Kraft Foods** and **Verizon** are examples of calendar-year companies. Some companies choose a fiscal year ending on a date other than December 31. Seasonal businesses, such as retail stores, often choose a fiscal year that ends when sales and inventories are at their lowest level. For example, **Target**, the retail variety store chain, ends its fiscal year on January 31, after the busy holiday season. **Nike** has a May 31 fiscal year. The heading of each statement identifies the: (1) company name, (2) statement title, and (3) date or time period of statement.

FYI The heading of each financial statement includes Who, What, and When.

Balance Sheet

A **balance sheet** reports a company's financial position at a point in time. It summarizes the result of the company's investing and financing activities by listing amounts for assets, liabilities, and equity. The balance sheet is based on the accounting equation, also called the *balance sheet equation*: $\text{Assets} = \text{Liabilities} + \text{Equity}$.

Nike's balance sheet for fiscal year 2007 is reproduced as Exhibit 1.6 and reports that assets are \$10,688.3 million, liabilities are \$3,662.9 million, and equity is \$7,025.4 million, where owner financing is the sum of contributed capital of \$1,962.8, retained earnings of \$4,885.2, and other equity of \$177.4. Thus, the balance sheet equation holds true for Nike's balance sheet: assets equal liabilities plus equity.

FYI The balance sheet is also known as the statement of financial position and the statement of financial condition.

| EXHIBIT 1.6 Balance Sheet (\$ millions) | |
|---|----------------------------------|
| NIKE Balance Sheet May 31, 2007 | |
| | Reports amounts at point in time |
| Assets | |
| Cash | \$ 1,856.7 |
| Noncash assets | 8,831.6 |
| Total assets | <u>\$10,688.3</u> |
| Liabilities and equity | |
| Total liabilities | <u>\$ 3,662.9</u> |
| Equity | |
| Contributed capital | 1,962.8 |
| Retained earnings | 4,885.2 |
| Other stockholders' equity* | 177.4 |
| Total equity | <u>7,025.4</u> |
| Total liabilities and stockholders' equity | <u>\$10,688.3</u> |

*Other stockholders' equity includes accumulated other comprehensive income. Other components of stockholders' equity are discussed in Chapter 10.

Income Statement

The **income statement** reports the results of a company's operating activities over a period of time. It details amounts for revenues and expenses, and the difference between these two amounts is net income. Revenue is the increase in equity that results from selling goods or providing services to customers and expense is the cost incurred to generate revenue. Net income is the increase in equity *after* subtracting expenses from revenues.

An important difference between the income statement and the balance sheet is that the balance sheet presents the company's position at a *point in time*, for instance December 31, 2008, while the income statement presents a summary of activity over a *period of time*, such as January 1, 2008, through December 31, 2008. Because of this difference, the balance sheet reflects the cumulative history of a company's activities. The amounts listed in the balance sheet carry over from the end of one fiscal year to the beginning of the next fiscal year, while the amounts listed in the income statement do not carry over from one year to the next.

Refer to Nike's income statement for the fiscal year ended May 31, 2007, shown as Exhibit 1.7. It reports that revenues = \$16,325.9 million, expenses = \$14,834.4 million, and net income = \$1,491.5 million. Thus, revenues minus expenses equal net income for Nike.

FYI The income statement is also known as statement of income, statement of earnings, statement of operations, and statement of profit and loss.

FYI The term "gross" refers to an amount before subtractions, such as Gross Sales. An exception is made for the term Gross Profit (Gross Margin), defined as Sales less Cost of Goods Sold (Cost of Sales). When items are subtracted from a gross amount, the term "net" is generally used, as in the case of Net Sales (Gross Sales less returns and other items) or Net Income (Sales less all expenses).

| EXHIBIT 1.7 Income Statement (\$ millions) | |
|--|---------------------------------------|
| NIKE Income Statement For Year Ended May 31, 2007 | |
| | Reports amounts over a period of time |
| Revenues | \$16,325.9 |
| Expenses | <u>14,834.4</u> |
| Net income (or loss) | <u>\$ 1,491.5</u> |

For manufacturing and merchandising companies, the cost of goods sold is an important measure that is typically disclosed separately in the income statement immediately following revenues. It is also common to report a subtotal for gross profit (also called gross margin), which is revenues less the cost of goods sold. The company's remaining expenses are then reported below gross profit. Nike's income statement is presented in this format in Exhibit 1.8:

EXHIBIT 1.8 Income Statement with Gross Profit Subtotal (\$ millions)

| NIKE Income Statement For Year Ended May 31, 2007 | |
|---|-------------------|
| Revenues | \$16,325.9 |
| – Cost of goods sold | <u>9,165.4</u> |
| = Gross profit | 7,160.5 |
| – Other expenses | <u>5,669.0</u> |
| = Net income (or loss) | <u>\$ 1,491.5</u> |

Cost of products including materials, labor, and overhead

Statement of Stockholders' Equity

The **statement of stockholders' equity**, or simply *statement of equity*, reports the changes in the equity accounts over a period of time. Nike's statement of stockholders' equity for fiscal year ended May 31, 2007, is shown as Exhibit 1.9. During the year ended May 31, 2007, Nike's equity changed due to share issuance and income reinvestment. The exhibit details and classifies these changes into three categories:

- Contributed capital (includes common stock, and additional paid-in capital)
- Retained earnings (includes cumulative net income or loss, and deducts dividends)
- Other stockholders' equity

Contributed capital represents the net amount received from issuing stock to shareholders (owners). **Retained earnings** (also called *earned capital*) represents the income the company has earned since its inception, minus the dividends it has paid out to shareholders. Thus, retained earnings equals the amount of income retained in the company. The change in retained earnings links consecutive balance sheets through the income statement. Nike's retained earnings increased from \$4,713.4 million at May 31, 2006 to \$4,885.2 million at May 31, 2007. This increase is explained by net income of \$1,491.5 million, less dividends of \$1,319.7 million. The category titled "other changes" refers to changes in equity that are not recorded in income and is discussed in Chapter 10.

FYI Dividends are reported in the statement of equity, and not in the income statement.

EXHIBIT 1.9 Statement of Stockholders' Equity (\$ millions)

| NIKE Statement of Stockholders' Equity For Year Ended May 31, 2007 | | | | |
|--|------------------------|----------------------|----------------------------------|----------------------------------|
| | Contributed Capital | Retained Earnings | Other Stockholders' Equity | Total Stockholders' Equity |
| Balance, May 31, 2006 | \$1,450.1 | \$4,713.4 | \$121.7 | \$6,285.2 |
| Stock issuance | 512.7 | | | 512.7 |
| Net income | | 1,491.5 | | 1,491.5 |
| Dividends | | (1,319.7) | | (1,319.7) |
| Other changes | | | 55.7 | 55.7 |
| Balance, May 31, 2007 | <u>\$1,962.8</u> | <u>\$4,885.2</u> | <u>\$177.4</u> | <u>\$7,025.4</u> |

Reports amounts over a period of time

Beginning period amounts

Change in balances over a period

Ending period amounts

Statement of Cash Flows

The **statement of cash flows** reports net cash flows from operating, investing, and financing activities over a period of time. Nike's statement of cash flows for fiscal year ended May 31, 2007, is shown in Exhibit 1.10. The statement reports that the cash balance increased by \$902.5 million during the fiscal year. Operating activities provided \$1,878.7 million (a cash inflow), investing activities provided \$92.9 million (a cash inflow), and financing activities used \$1,069.1 million

FYI Cash is critical to operations because it is necessary for purchasing resources and paying bills.

(a cash outflow). The resulting increase of \$902.5 million brought Nike’s ending balance of cash to \$1,856.7 million.

FYI Common formatting for US financial statements includes:

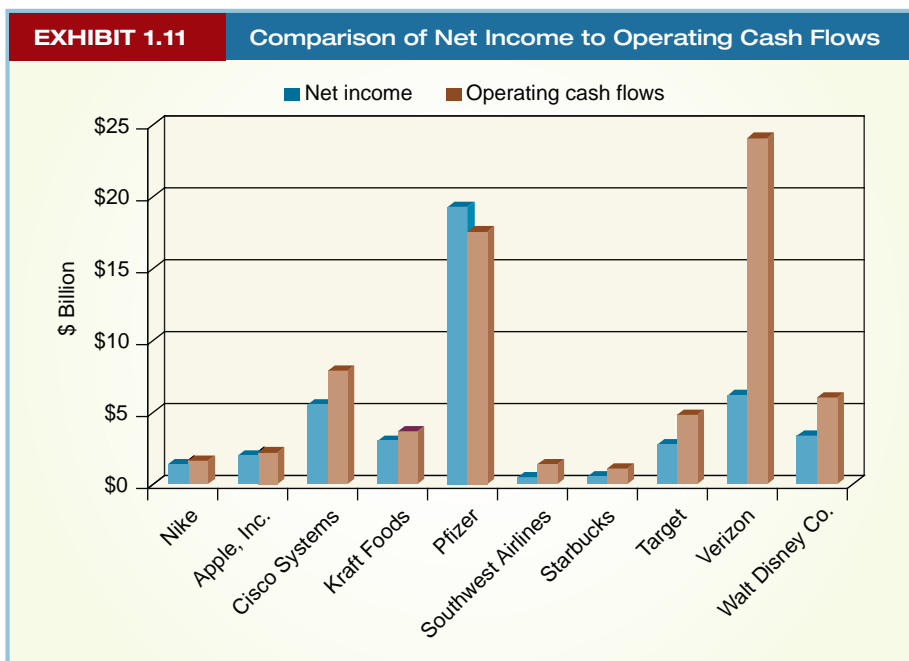
- Dollar sign next to first and last amount listed in a column
- Single underline before a subtraction or addition; double underline after a major total
- Assets listed in order of liquidity, which is nearness to cash
- Liabilities listed in order of due dates

| NIKE Statement of Cash Flows For Year Ended May 31, 2007 | |
|--|-----------|
| Operating cash flows | \$1,878.7 |
| Investing cash flows | 92.9 |
| Financing cash flows..... | (1,069.1) |
| Net increase (decrease) in cash | 902.5 |
| Cash, May 31, 2006..... | 954.2 |
| Cash, May 31, 2007..... | \$1,856.7 |

Operating cash flow is the amount of cash generated from operating activities. This amount usually differs from net income due to differences between the time that revenues and expenses are recorded, and the time that the related cash receipts and disbursements occur. For example,

a company may report revenues for goods sold to customers this period, but not collect the payment until next period. Consistent with most companies, Nike’s operating cash flows of \$1,878.7 do not equal its net income of \$1,491.5. Exhibit 1.11 compares net income and operating cash flows for Nike and several other companies. The exhibit shows that there is large variation across companies in the amount of net income and operating cash flows.

Both cash flow and net income are important for making business decisions. They each capture different aspects of firm performance and together help financial statement users better understand and assess a company’s past, present, and future business activities.

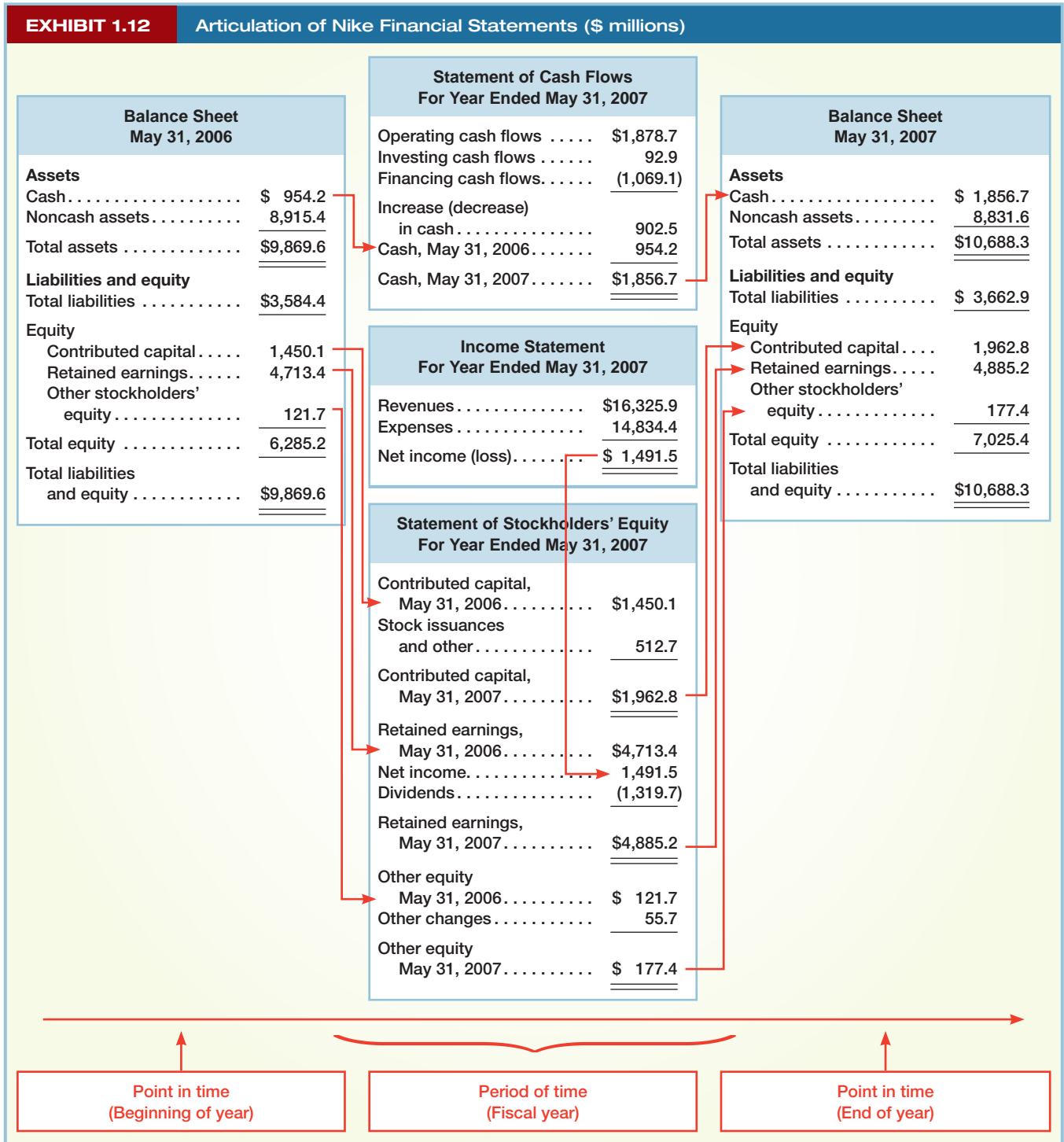


Financial Statement Linkages

A central feature of the accounting system is the linkage among the four primary statements, referred to as the *articulation* of the financial statements. Three of the key linkages are:

- The statement of cash flows links the beginning and ending cash in the balance sheet.
- The income statement links the beginning and ending retained earnings in the statement of stockholders’ equity.
- The statement of stockholders’ equity links the beginning and ending equity in the balance sheet.

Exhibit 1.12 demonstrates these links using Nike’s financial statements from Exhibits 1.6 through 1.10. The left side of Exhibit 1.12 presents Nike’s beginning-year balance sheet for fiscal year



2007 and the right side presents Nike’s year-end balance sheet for fiscal year 2007. These balance sheets report Nike’s investing and financing activities at the beginning and end of fiscal year, two distinct points in time. The middle column of Exhibit 1.12 presents the three financial statements that report Nike’s fiscal year 2007 business activities over time: the statement of cash flows, the income statement, and the statement of stockholders’ equity. The three key linkages shown in Exhibit 1.12 are:

- The statement of cash flows explains how operating, financing, and investing activities increased the cash balance by \$902.5 million, from the \$954.2 million reported in the beginning-year balance sheet, to the \$1,856.7 million reported in the year-end balance sheet.
- The net income of \$1,491.5 million reported in the income statement is added to beginning-year retained earnings in the statement of stockholder's equity to compute year-end retained earnings.
- The statement of stockholders' equity explains how total equity of \$6,285.2 million, reported in the beginning-year balance sheet, becomes total equity of \$7,025.4 million, reported in the year-end balance sheet.

Information Beyond Financial Statements

Important information about a company is communicated to various decision makers through reports other than financial statements. These reports include the following:

- Management Discussion and Analysis (MD&A)
- Independent Auditor Report
- Financial statement footnotes
- Regulatory filings, including proxy statements and other SEC filings

We describe and explain the usefulness of these additional information sources throughout the book.

FYI An analysis of a firm's activities requires extensive study of its footnotes and the MD&A.

MID-CHAPTER REVIEW

QUIKSILVER
NYSE :: ZQK

Quiksilver markets surf, skate and snowboard apparel, footwear, and equipment under brand names including Quiksilver and Roxy. These brands compete with **Nike's** Hurley brand. In addition, Quiksilver sells Rosignol skis and Cleveland golf equipment, competing head-to-head with Nike's golf equipment products. The following information is from Quiksilver's financial statements for the fiscal year ended October 31, 2007 (\$ millions).

| | |
|---------------------------|---------|
| Cash, end of year | \$ 74.3 |
| Cash flow from operations | 124.3 |
| Sales revenue | 2,426.0 |
| Stockholders' equity | 886.6 |
| Cost of goods sold | 1,303.8 |
| Cash flow from financing | 73.7 |
| Total liabilities | 1,754.9 |
| Other expenses | 1,243.3 |
| Noncash assets | 2,567.2 |
| Cash flow from investing | (160.5) |
| Net income (loss) | (121.1) |
| Cash, beginning of year | 36.8 |

Required

- Prepare Quiksilver's balance sheet at October 31, 2007, and its income statement, and cash flow statement for the fiscal year ended October 31, 2007.
- Compare Quiksilver's revenue, net income (loss), and cash flow from operations to that of Nike (as reported in this chapter).

The solution to this review problem can be found on page 35.

> FINANCIAL REPORTING ENVIRONMENT

Information presented in financial statements is of critical importance to external decision makers. Financial statements affect the prices paid for equity securities and interest rates attached to debt securities. To the extent that financial performance and condition are accurately communicated to business decision makers, debt and equity securities are more accurately priced. By extension, financial reporting plays a crucial role in efficient resource allocation within and across economies. Accounting information contributes to the efficient operation of securities markets, labor markets, commodity markets and other markets.

To illustrate, imagine the consequences of a breakdown in the integrity of financial reporting. The Enron scandal provides a case in point. At the beginning of 2001, **Enron** was one of the most innovative and respected companies in the United States. With revenues of over \$100 billion and total company value of over \$60 billion, it was the fifth largest U.S. corporation based on market value. In October 2001, the company released its third quarter earnings report to the public. Although *pro forma* operating earnings were higher than in previous years, the income statement contained a \$1 billion “special charge.” Financial analysts began investigating the cause of this charge and discovered that it was linked to related-party transactions and questionable accounting practices. Once it became clear to the capital markets that Enron had not faithfully and accurately reported its financial condition and performance, people became unwilling to purchase its securities. The value of its debt and equity securities dropped precipitously and the company was unable to obtain the cash needed for operating activities. By the end of 2001, Enron was bankrupt!

The Enron case illustrates the importance of reliable financial reporting. Accountants recognize the importance of the information that they produce and, as a profession, they agree to follow a set of standards for the presentation of financial statements and the disclosure of related financial information. In the following paragraphs, we discuss these standards, or *principles*, as well as the institutional and regulatory environment in which accountants operate.

LO4 Describe the institutions that regulate financial accounting and their role in establishing generally accepted accounting principles.

Generally Accepted Accounting Principles

Decision makers who rely on audited financial statements expect that all companies follow similar procedures in preparing their statements. In response to these expectations, accountants have developed a set of standards and procedures called **generally accepted accounting principles (GAAP)**. GAAP is not a set of immutable laws. Instead, it is a set of standards and accepted practices, based on underlying principles, that are designed to guide the preparation of the financial statements. GAAP is subject to change as conditions warrant. As a result, specific rules are altered or new practices are formulated to fit changes in underlying economic circumstances or business transactions.

Some people mistakenly assume that financial accounting is an exact discipline—that is, companies select the proper standard to account for a transaction and then follow the rules. The reality is that GAAP allows companies considerable discretion in preparing financial statements. The choice of methods often yields financial statements that are markedly different from one company to another in terms of reported income, assets, liabilities, and equity amounts. In addition, financial statements depend on numerous estimates. Consequently, even though two companies may engage in the same transactions and choose the same accounting methods, their financial statements will differ because their managements have made different estimates about such things as the amount to be collected from customers who buy on credit, the length of time that buildings and equipment will be in use, and the future costs for product warranties.

Accounting standard setters walk a fine line regarding choice in accounting. On one hand, they are concerned that management discretion in preparing financial statements will lead to abuse by those seeking to influence the decisions of those who rely on the statements. On the other hand, they are concerned that companies are too diverse for a ‘one size fits all’ financial accounting system. Ultimately, GAAP attempts to strike a balance by imposing constraints on the choice of accounting procedures, while allowing companies some flexibility within those constraints.

YOU MAKE THE CALL

You are a Financial Analyst Accountants, business leaders, and politicians have long debated the importance of considering the **economic consequences** of accounting standards (GAAP). Should accounting standards be designed to influence behavior and effect social or economic change considered by, say, a government body or other interested group? Alternatively should such standards be designed simply to provide relevant and reliable information on which economic decisions can be made by others with a reasonable degree of confidence? What do you believe the objectives of financial reporting should be? [Answers on page 27]

Regulation and Oversight

Following the U.S. stock market crash of 1929, the United States Congress passed the Securities Acts of 1933 and 1934. These acts were passed to require disclosure of financial and other information about securities being offered for public sale and to prohibit deceit, misrepresentations, and other fraud in the sale of securities. The 1934 Act created the **Securities and Exchange Commission (SEC)** and gave it broad powers to regulate the issuance and trading of securities. The act also provided that companies with more than \$10 million in assets and whose securities are held by more than 500 owners must file annual and other periodic reports, including a complete set of financial statements.

While the SEC has ultimate authority over financial reporting by companies in the United States, it has ceded the task of setting accounting standards to a professional body, the **American Institute of Certified Public Accountants (AICPA)**. Over the years, the AICPA has sponsored three standard-setting organizations.

Currently, accounting standards are established by the **Financial Accounting Standards Board (FASB)**. The FASB is a seven-member board that has the primary responsibility for setting financial accounting standards in the United States. It has published over 150 accounting statements governing the preparation of financial reports. These, along with numerous bulletins, interpretations, opinions, and earlier standards form the body of GAAP.

Besides setting standards for financial accounting, the FASB has developed a framework to form the basis for future discussion of proposed standards and serve as a guide to accountants for reporting information that is not governed by specific standards. A summary of this *Conceptual Framework* is presented in Appendix 1A at the end of this chapter.

In the wake of the Enron and other scandals, concerns over the quality of corporate financial reporting led Congress to pass the **Sarbanes-Oxley Act** in 2002. The goal of this Act—sometimes referred to as SOX—was to increase the level of confidence that external users, particularly investors, have in the financial statements. To accomplish this objective, SOX imposed a number of requirements to:

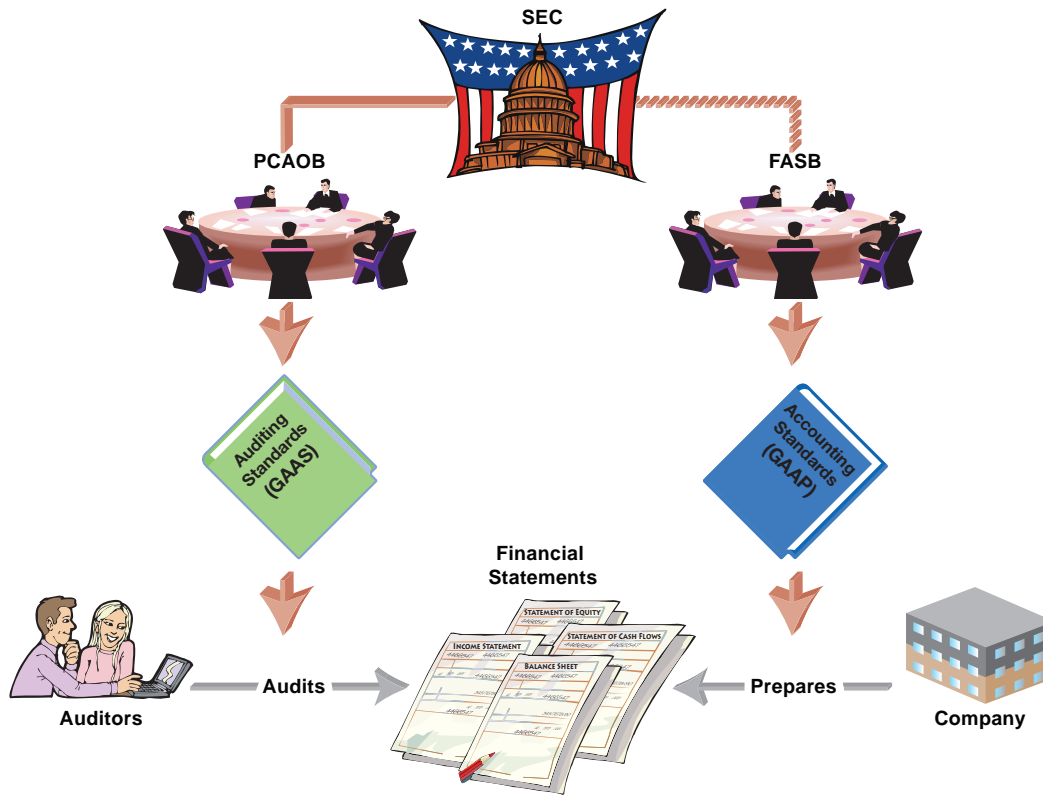
- Increase management's responsibility for accounting information
- Increase the independence of the auditors
- Increase the accountability of the board of directors
- Establish adequate **internal controls** to prevent fraud

SOX requires that the chief executive officer (CEO) and the chief financial officer (CFO) of a publicly traded corporation personally sign a statement attesting to the accuracy and completeness of financial statements. The prospect of severe penalties is designed to make these managers more vigilant in monitoring the financial accounting process. In addition, SOX established the **Public Company Accounting Oversight Board (PCAOB)** to approve auditing standards and monitor the quality of financial statements and audits.

SOX has had an impact on financial disclosures. One source reports that approximately nine percent of publicly traded corporations restated their financial statements in 2005 and 2006. While this percentage may seem small, it represents more than 1,200 companies per year.

The Sarbanes-Oxley Act is not without critics. Many small companies complain that the additional reporting and auditing requirements established in the act are prohibitively costly. Of even greater concern is the criticism that the penalties imposed on management for misstatements or errors are too severe. Some argue that managers have become less forthcoming in their disclosures

and more conservative in choosing accounting methods and making accrual estimates to avoid the possibility of heavy fines or criminal charges.



Role of the Auditor

What prevents a company from disclosing false or misleading information? For one thing, the financial statements are prepared by management, and management must take responsibility for what is disclosed. Management's reputation can be severely damaged by false disclosures when subsequent events unfold to refute the information. This situation can adversely affect the firm's ability to compete in capital, labor, and consumer markets. It can also lead to litigation and even criminal charges against management.

Even though management must personally attest to the accuracy and completeness of the financial statements, markets also demand assurances from independent parties. Therefore, the financial statements of publicly traded corporations must be **audited** by an *independent audit firm*. The auditors provide an opinion as to whether the statements *present fairly and in all material respects* a company's financial condition and the results of its operations.

The audit opinion is not a guarantee. Auditors only provide reasonable assurance that the financial statements are free of material misstatements. Even so, auditors provide a valuable service. Auditors effectively ensure that the information contained in the financial statements is reliable, thus increasing the confidence of outside decision makers in the information they use to make investment, credit, and other decisions. Therefore, creditors and shareholders of privately held corporations often demand that the financial statements be audited as well.

YOU MAKE THE CALL

You are a Member of the Board of Directors Until recently accounting firms were permitted to earn money for consulting activities performed for clients they audited. Do you see any reason why this might not be an acceptable practice? Do you see any advantage to your firm from allowing such activity? [Answer on page 27]

A Global Perspective

Businesses increasingly operate in global markets. Consumers and businesses with access to the Internet can purchase products and services from anywhere in the world. Products produced in one country are often made with parts and materials imported from many different countries. Businesses outsource parts of operations to other countries to take advantage of better labor markets in those countries. Capital markets are global as well. Corporations whose securities trade on the New York Stock Exchange may also trade on exchanges in London, Toronto, Tokyo, or Hong Kong.

Because countries have a variety of laws and customs, accounting principles and practices vary considerably from one country to the next. Many companies based in countries other than the United States choose to present financial statements that conform to U.S. GAAP because they believe that doing so provides them better access to investors in the U.S. capital markets. Many other companies prepare financial statements following GAAP of the country in which they are based.

The globalization of capital markets combined with the diversity of international accounting principles has led to an effort to increase comparability of financial information across countries. To this end, the **International Accounting Standards Board (IASB)** was established to develop acceptable accounting standards on a worldwide basis. Because it is international in its scope, the IASB has no legal authority to impose accounting standards on any country. However, by working with standard setters within countries, such as the FASB within the U.S., the IASB is working to reduce diversity in financial reporting practice. Many stock exchanges now require that companies prepare financial statements in compliance with IASB standards as a prerequisite for listing their securities.

BUSINESS INSIGHT

Prior to 2007, foreign-based companies wishing to sell securities in the U.S. were required to reconcile their financial statements to be consistent with U.S. GAAP. However, in June 2007, the SEC adopted a rule that allows foreign companies using international accounting standards to stop reconciling their financial statements to American rules. Some observers speculate that the SEC will probably follow that step with a proposal to give some foreign stock markets direct access to American investors. While such changes will make it easier for U.S. investors to purchase securities from around the world, a June 2007 **New York Times** article referred to a “Tower of Babel in Accounting.” The article raises concerns about the difficulty of comparing companies when their financial statements are based on diverse reporting standards.

> FINANCIAL STATEMENT ANALYSIS

LO5 Compute two key ratios that are commonly used to assess profitability and risk—return on equity and the debt-to-equity ratio.

The financial statements provide insights into the financial health and performance of a company. However, the accounting data presented in these statements is difficult to interpret in its raw form. For example, knowing that Nike’s net income was \$1,491.5 million in 2007 is, by itself, not very useful. Similarly, knowing the dollar amount of liabilities does not tell us whether or not Nike relies too heavily on creditor financing.

Financial analysts use a number of tools to help interpret the information found in the financial statements. They look at trends over time and compare one company to another. They calculate ratios using financial statement information to summarize the data in a form that is easier to interpret. Ratios also allow us to compare the performance and condition of different companies even if the companies being compared are dramatically different in size. Ratios also help analysts spot trends or changes in performance over time.

Throughout the book, we introduce ratios that are commonly used by financial analysts and other users who rely on the financial statements. Our goal is to develop an understanding of how to effectively use the information in the financial statements, as well as to demonstrate how these statements are prepared. In this chapter we introduce one important measure of **profitability** and one measure of financial **risk**.

Profitability Analysis

There are many ways to measure company success. One crucial measure is profitability. Profitability reveals whether or not a company is able to bring its product or service to the market in an efficient

manner, and whether the market values that product or service. Companies that are consistently unprofitable are unlikely to succeed in the long run.

A key profitability metric for stockholders and other decision makers is company return on equity. This metric compares the level of net income with the amount of equity financing used to generate that income. **Return on equity (ROE)** is computed as:

$$\text{Return on Equity (ROE)} = \frac{\text{Net Income}}{\text{Average Stockholders' Equity}}$$

The income number in the numerator of the return measure reflects performance for a specific period. This implies that the measure used in the denominator should reflect the *average* level equity investment for that same period. Accordingly, we use the average equity level for ratio analysis in our examples and end-of-chapter assignments since it normally provides a better measure of capital utilization for a period and is the predominant method for analyst services, such as **S&P Compustat**.

Nike's ROE is calculated by dividing its 2007 net income of \$1,491.5 million by its average stockholders' equity of \$6,655.3 million:

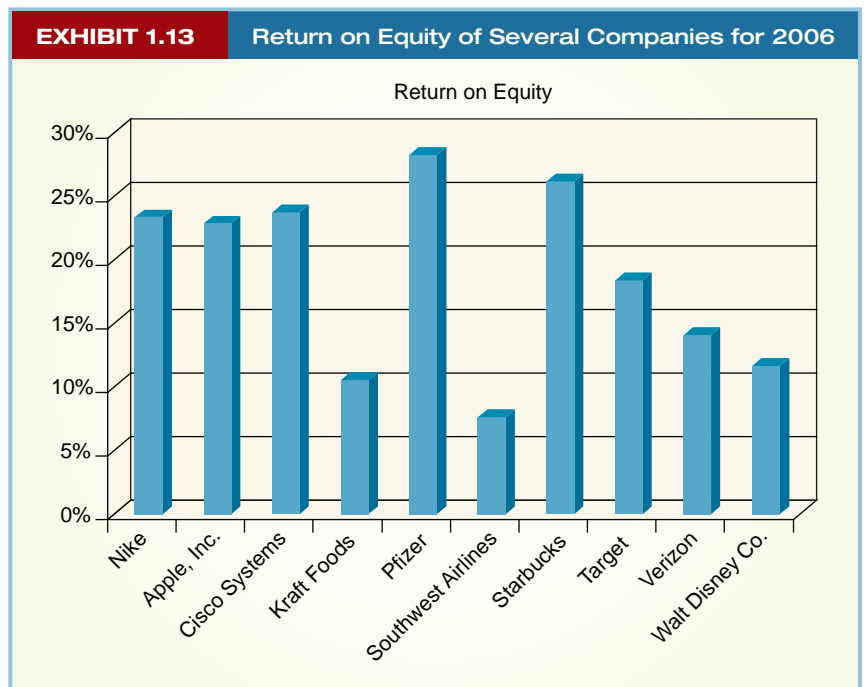
$$\frac{\$1,491.5}{\$6,655.3} = 0.224 \text{ or } 22.4\%$$

The average stockholders' equity was calculated by adding together the stockholders' equity at May 31, 2006, and at May 31, 2007, and dividing by 2: $(\$6,285.2 \text{ million} + \$7,025.4 \text{ million})/2$. Thus, Nike's stockholders earned an accounting return of 22.4% on their investment in 2007.

While Nike's ROE seems reasonable, it is useful to compare this return with the ROE earned by other companies. Exhibit 1.13 presents ROE for several companies in graphical form.

From this exhibit we can see that Nike's ROE is somewhat lower than two companies—**Pfizer** and **Starbucks**—while it was significantly higher than **Walt Disney**, **Verizon**, **Southwest Airlines** and **Kraft Foods**. It is also useful to make comparisons with companies in the same line of business or industry. As an illustration, the chapter-end review compares Nike with **Quiksilver** and **Adidas**.

| |
|-------------|
| NIKE |
| NYSE :: NKE |



Credit Risk Analysis

In addition to measuring profitability, analysts also frequently analyze the level of risk associated with investing in or lending to a given company. The riskier an investment is, the greater the return demanded by investors. For example, a low-risk borrower is likely to be able to borrow money at a lower interest rate than would a high-risk borrower. Similarly, there is a risk-return trade-off in equity returns. Investments in risky stocks are expected to earn higher returns than investments in low-risk stocks, and stocks are priced accordingly. The higher expected rate of return is compensation for accepting greater uncertainty in returns.

Many factors contribute to the risk of an investment. One important factor is a company's *long-term solvency*. **Solvency** refers to the ability of a company to remain in business and avoid bankruptcy or financial distress. Solvency is closely related to the extent to which a company relies on creditor financing. As the amount of creditor financing increases, the possibility of bankruptcy also increases. Short of bankruptcy, a company that has borrowed too much will occasionally find that the required interest payments are hurting the company's cash flow. Analysts use measures

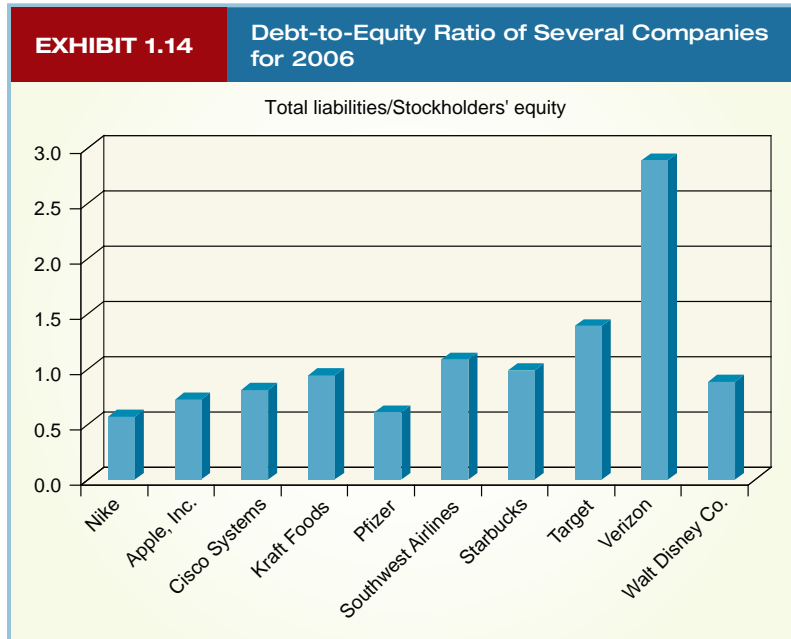
FYI Return cannot be evaluated without considering risk; the greater the risk of any decision, the greater the expected return.

of long-term solvency to assess a company’s ability to make the necessary interest and principal payments on its debt. One such measure is the debt-to-equity ratio:

$$\text{Debt-to-Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Total Stockholders' Equity}}$$

This measure captures the extent to which a company relies on creditor versus owner financing to fund its investment in assets. The higher the ratio, the more the firm is financed with debt. Nike’s debt-to-equity ratio was 0.52 at May 31, 2007, calculated as follows (\$ millions):

$$\frac{\$3,662.9}{\$7,025.4} = 0.52$$



A debt-to-equity ratio equal to 1 indicates that the company is using equal parts debt and equity financing. Nike financed less than half of its assets with liabilities, so its debt-to-equity ratio is well below 1. To see how this compares with some other companies, consider Exhibit 1.14.

The graph shows that Nike had the lowest debt-to-equity ratio among this group of firms, followed closely by **Pfizer**. In contrast, **Verizon** had a debt-to-equity ratio of 2.9. Verizon financed 74% of its assets with debt.

There are other measures of profitability and risk that will be introduced in later chapters. Collectively, these ratios, when placed in the context of the company’s business activities, help to provide a clear picture of the *drivers* of a company’s financial performance and the factors affecting its financial condition. Understanding these performance drivers and their impact on the financial health of a company is key to effectively using the information presented in the financial statements.

CHAPTER-END REVIEW

QUIKSILVER
NYSE :: ZQK

ADIDAS
Frankfurt :: ADS

The financial statements of **Quiksilver** are presented in the solution to the mid-chapter review (page 35). Another competitor of both Nike and Quiksilver is **Adidas**. Adidas markets athletic shoes and apparel under the Adidas and Reebok brands. It also sells Solomon ski equipment and TaylorMade golf equipment. The following information is from these two companies’ 2007 financial statements (Adidas’ financial statements are reported in Euros, the currency of the European Union):

| (millions) | Quiksilver | Adidas |
|--|------------|--------|
| Net income (loss) (2007) | \$ (121.1) | € 555 |
| Stockholders’ equity (2007 year-end) | 886.6 | 3,023 |
| Stockholders’ equity (2006 year-end) | 881.1 | 2,828 |
| Total liabilities (2007 year-end) | 1,754.9 | 5,291 |

Required

1. Calculate the 2007 return on equity (ROE) ratio for both Quiksilver and Adidas.
2. Calculate the 2007 debt-to-equity ratio for both Quiksilver and Adidas.
3. Compare the profitability and risk of Quiksilver and Adidas to that of Nike.

The solution to this review problem can be found on page 35.

APPENDIX 1A: Conceptual Framework for Financial Reporting

Accountants establish GAAP to ensure that the financial statements published by a company reflect its economic condition and performance. To meet this objective, the FASB sets accounting standards that reduce management discretion for reporting much of the information in the financial statements. To provide a structure for considering future standards, as well as to guide accountants in areas where standards do not currently exist, the FASB has developed a **Conceptual Framework**. This conceptual framework includes, among other things, a statement of the *objectives* of financial reporting along with a discussion of the *qualitative characteristics* of accounting information that are important to users. We discuss these objectives and characteristics in this appendix, along with some of the important assumptions underlying the preparation of financial statements.

LO6 Explain the conceptual framework for financial reporting.

Objectives of Financial Reporting

A fundamental goal of financial accounting is to provide information that promotes the efficient allocation and use of economic resources. To this end, the FASB established several objectives of financial reporting which are summarized here.

- Financial accounting should provide information that is useful to investors, creditors, and other decision makers who possess a reasonable knowledge of business activities and accounting.
- Financial accounting should provide information to help investors and creditors assess the amount, timing, and uncertainty of cash flows. This includes the information presented in the cash flow statement as well as other information that might help investors and creditors assess future dividend and debt payments.
- Financial accounting should provide information about economic resources and financial claims on those resources. This includes the information in the balance sheet and any supporting information that might help the user assess the value of the company's assets and future obligations.
- Financial accounting should provide information about a company's financial performance, including net income and its components (i.e., revenues and expenses).
- Financial accounting should provide information that allows decision makers to monitor company management to evaluate their effective, efficient, and ethical stewardship of company resources.

Qualitative Characteristics of Accounting Information

Qualitative characteristics of useful accounting information were developed to help managers, accountants, auditors, and standard setters make reasonable choices among accounting alternatives. These qualitative characteristics are depicted in Exhibit 1A.1 and discussed below.

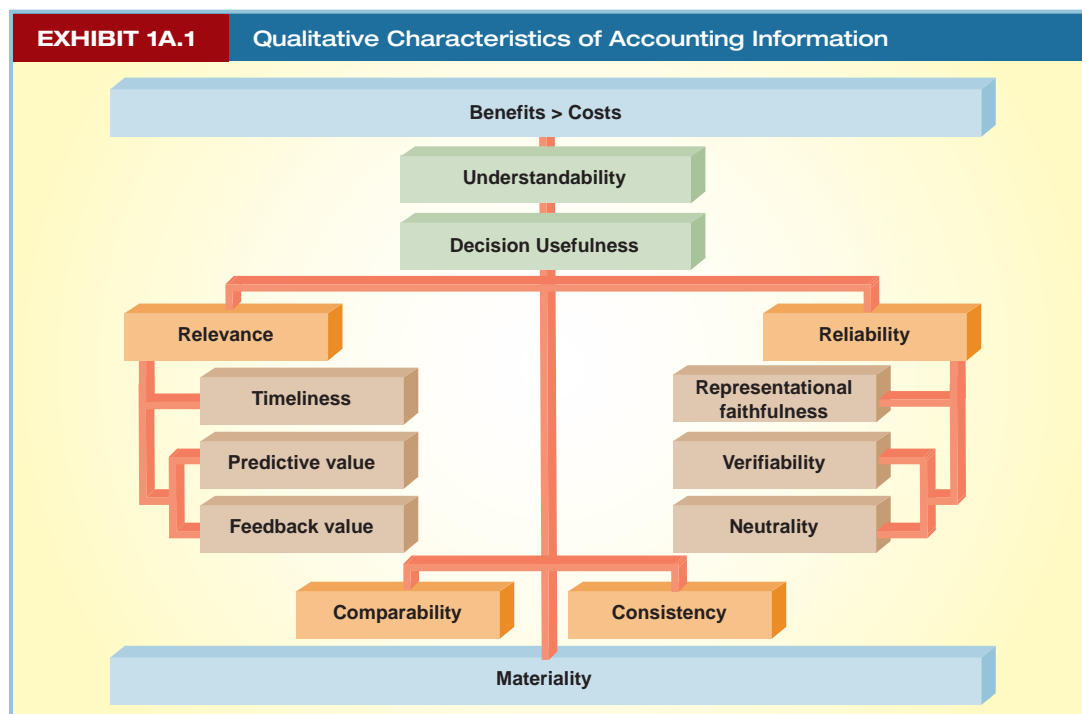


Exhibit 1A.1 neither distinguishes between primary and secondary qualities nor does it assign priorities among the qualities. It is an explanatory device and must be applied with consideration of the specific application intended. Each of the qualities is essential in some degree, but that degree will differ depending on the circumstances. We now expand briefly on each of the qualities delineated in the Exhibit.

Benefits > Costs. Reported accounting information must be cost-effective. This characteristic implies that if the benefit to the economy does not exceed the cost, the information does not meet the test of usefulness. The operational difficulty with this information quality is that while the reporting cost can usually be ascertained, the benefit to information users is often difficult to quantify. Nevertheless, the need to weigh costs and benefits is seen as an overriding constraint on the financial reporting process.

Materiality. Materiality refers to whether or not a particular amount is large enough to affect a decision. Some items are not reported based on this constraint because they are considered *not material* in that the magnitude of the omission would not influence the judgment of a reasonable decision maker. In practice, materiality is typically judged by the relative size of an item related to a major reported variable such as total assets, sales revenues, or net income. However, some items are required to meet a lower threshold of materiality. The more critical an item is to understanding the condition and performance of the company, the finer the screen that should be used to determine whether or not it is material.

BUSINESS INSIGHT

What Is Material? *The Wall Street Journal* (August 26, 2005) reported that the SEC initiated an informal inquiry into **Pixar Animation Studios** concerning its disclosure of “heavier than expected returns of its *The Incredibles* DVD that forced the Emeryville, California-based studio to miss its second quarter earnings forecast.” This inquiry follows an informal SEC investigation of **DreamWorks Animation**, the filmmaker that twice reduced earnings forecasts after substantial returns of its *Shrek 2* DVD. The issue in these two cases is whether companies are under obligation to inform market participants of material events affecting earnings. The Journal points out that “in the wave of recent corporate scandals some companies have been more conservative in assessing what constitutes a material event.”

Understandability and Decision Usefulness. Accounting information should be presented so that a knowledgeable reader can understand how it relates to the decision problem at hand. Because different users will require different information, suppliers (standard setters) must tread a fine line between reporting (requiring) too much or too little information.

Relevance. Accounting information must have the ability to make a difference in a decision. Such information may be useful in making *predictions* about future performance of the company or in providing *feedback* to evaluate past events. In either case, the *timeliness* of the disclosure is paramount to its relevance.

- **Timeliness:** The information must be available to decision makers before it loses its capacity to influence decisions. That is, information that is reported *after* a decision is made is not relevant to that decision.
- **Predictive value:** Refers to the ability of the information to increase the accuracy of a forecast.
- **Feedback value:** Refers to the quality of information that enables users to confirm or correct prior expectations.

RESEARCH INSIGHT

Research has documented a decline in the value relevance of accounting information, particularly earnings, over the past few decades. The decline has been attributed by some to conservatism in reporting. However, recent research has not been able to establish an association between this decrease in value relevance and conservatism despite using several alternative measures of conservative accounting. One explanation offered for the research finding is that conservatism favors more objective measures while avoiding additional estimation, thereby increasing reliability. If true, conservative accounting measurement could lead to greater relevance. The issue remains unresolved at this time and conservatism in reporting continues.

Reliability. Accounting information should be accurate and free of misstatement or bias. It must be reasonably neutral, verifiable, and possess representational faithfulness.

- **Representational Faithfulness:** Accounting information should reflect the underlying economic events it purports to measure.
- **Verifiability:** This characteristic implies that consensus among measures assures that the information is free of error. An independent auditor should be able to examine the economic events and transactions underlying the financial statements and reach conclusions that are similar to those of management concerning how these events are measured and reported.
- **Neutrality:** Information must be free of any bias intended to attain a predetermined result or to induce a particular mode of behavior.

YOU MAKE THE CALL

You are the Bank Loan Officer Hertz, the rental car firm, has a fleet of relatively new automobiles that it rents to customers for usually short periods. Suppose that Hertz applied to your bank for a loan and offered their fleet of cars as collateral. Would you, as the loan officer, be satisfied with the value shown on Hertz's balance sheet as a measure of the fleet's value? If not, what value would you prefer and how might you estimate that value? [Answers on page 27]

Comparability. Accounting information should enable users to identify similarities and differences between sets of economic phenomena. For instance, the financial statements of different companies should be presented in a way that allows users to make comparisons across companies concerning their activities, financial condition, and performance. Although management has the flexibility to choose how events are measured and reported, this discretion should not be used to obscure the underlying economic substance of the event. One of the consequences of comparability is that firms in the same business (industry) should use the same, or similar, reporting techniques.

Consistency. The information supplied to decision makers should exhibit conformity from one reporting period to the next with unchanging policies and procedures. Companies can choose to change accounting methods, and sometimes they are required to do so by standard setters. However, such changes make it difficult to evaluate financial performance over time. Accounting changes should be rare and supported as the better means of reporting the organization's financial condition and performance. Whenever possible, using the same accounting methods from one period to the next increases the quality of accounting information.

Underlying Assumptions

Four assumptions underlie the preparation of financial statements. Knowing these assumptions is helpful in understanding how the statements are prepared and in interpreting the information reported therein. These assumptions include:

Separate Economic Entity. For accounting purposes, the activities of a company are considered independent, distinct, and separate from the activities of its stockholders and from other companies.

Going Concern. Companies are assumed to have continuity in that they can be expected to continue in operation over time. This assumption is essential for valuing assets (future benefits) and liabilities (future obligations).

Accounting Period. While continuity is assumed, company operations must be reported periodically, normally each fiscal year. Interim reporting periods, such as quarterly or monthly reports, allow companies to supplement the annual financial statements with more timely information.

Measuring Unit. The unit of measure is the monetary unit of the country in which the firm's accounting reports are issued. The dollar is the monetary unit in the U.S.

> SUMMARY

Identify the users of accounting information and discuss the costs and benefits of disclosure. (p. 4)

LO1

- There are many diverse decision makers who use financial information.
- The benefits of disclosure of credible financial information must exceed the costs of providing the information.

LO2 Describe a company's business activities and explain how these activities are represented by the accounting equation. (p. 7)

- To effectively manage a company or infer whether it is well managed, we must understand its activities as well as the competitive and regulatory environment in which it operates.
- All corporations *plan* business activities, *finance* and *invest* in them, and then engage in *operations*.
- Financing is obtained partly from stockholders and partly from creditors, including suppliers and lenders.
- Investing activities involve the acquisition and disposition of the company's productive resources called assets.
- Operating activities include the production of goods or services that create operating revenues (sales) and expenses (costs). Operating profit (income) arises when operating revenues exceed operating expenses.

LO3 Introduce the four key financial statements including the balance sheet, income statement, statement of stockholders' equity, and statement of cash flows. (p. 11)

- The four basic financial statements used to periodically report the company's progress are the balance sheet, the income statement, the statement of stockholders' equity, and the statement of cash flows. These statements articulate with one another.
- The balance sheet reports the company's financial position *at a point* in time. It lists the company's asset, liability, and equity items, and it typically aggregates similar items.
- The income statement reports the firm's operating activities to determine income earned, and thereby the firm's performance *over a period* of time.
- The stockholders' equity statement reports the changes in the key equity accounts *over a period* of time.
- The statement of cash flows reports the cash flows into and out of the firm from its operating, investing, and financing sources *over a period* of time.

LO4 Describe the institutions that regulate financial accounting and their role in establishing generally accepted accounting principles. (p. 17)

- Generally Accepted Accounting Principles (GAAP) are established standards and accepted practices designed to guide the preparation of the financial statements.
- While the Securities and Exchange Commission (SEC) has ultimate authority over financial reporting by companies in the United States, it has ceded the task of setting accounting standards to the accounting profession.
- The Financial Accounting Standards Board (FASB) has the primary responsibility for setting financial accounting standards in the United States.
- The Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB) to approve auditing standards and monitor the quality of financial statements and audits.
- International accounting standards are set by the International Accounting Standards Board (IASB).

LO5 Compute two key ratios that are commonly used to assess profitability and risk—return on equity and the debt-to-equity ratio. (p. 20)

- **Return on Equity (ROE)**—a measure of profitability that assesses the performance of the firm relative to the investment made by stockholders (equity financing)
 - Return on equity (ROE) is an important profitability metric for stockholders.

$$\text{ROE} = \frac{\text{Net income}}{\text{Average stockholders' equity}}$$

- **Debt-to-equity Ratio**—a measure of long term solvency that relates the amount of creditor financing to the amount of equity financing
 - The debt-to-equity ratio is an important measure of long-term solvency, a determinant of overall company risk.

$$\text{D/E} = \frac{\text{Total liabilities}}{\text{Total stockholders' equity}}$$

LO6 Appendix 1A—Explain the conceptual framework for financial reporting. (p. 23)

- The conceptual framework includes, among other things, a statement of the *objectives* of financial reporting along with a discussion of the *qualitative characteristics* of accounting information that are important to users.

> GUIDANCE ANSWERS . . . YOU MAKE THE CALL

You are a Product Manager There are at least two considerations that must be balanced—namely, the disclosure requirements and your company’s need to protect its competitive advantages. You must comply with all minimum required disclosures. The extent to which you offer additional disclosures depends on the sensitivity of the information; that is, how beneficial it is to your existing and potential competitors. Another consideration is how the information disclosed will impact your existing and potential investors. Disclosures such as this can be beneficial in that they convey the positive investments that are available to your company. Still, there are many stakeholders impacted by your decision and each must be given due consideration.

You are a Financial Analyst This question has received a lot of discussion from both sides under the title “Economic Consequences.” On one side are those who maintain that accounting rules should not only reflect a rule’s economic consequences but should be designed to facilitate the attainment of a specific economic goal. A recent example is the case where the oil industry lobbied for an accounting rule that they and others believed would increase the incentive to explore and develop new oil deposits.

Those on the other side of the argument believe that accounting should try to provide data that is objective, reliable, and free from bias without considering the economic consequences of the decisions to be made. They believe that accounting rule makers have neither the insight nor the public mandate to attempt forecasts of the economic effects of financial reporting. Decisions that will affect the allocation of resources or that affect society’s social structure should be made only by our elected representatives. While there are substantive points on both sides, we believe that it is the job of accounting rule makers to work toward the objective of financial reporting that reflects economic reality, subject to practical measurement limitations.

You are a Member of the Board of Directors In order to perform a thorough audit, a company’s auditors must gain an intimate knowledge of its operations, its internal controls, and its accounting system. Because of this familiarity, the accounting firm is in a position to provide insights and recommendations that another consulting firm might not be able to provide. However, the independence of the auditor is critical to the credibility of the audit and there is some concern that the desire to retain a profitable consulting engagement might lead the auditors to tailor their audit opinions to “satisfy the customer.” Contrary to this concern, however, research finds that there is no evidence that auditors provide more optimistic audit reports for the companies they consult for. Rather, it appears that litigation and/or reputation concerns are reasonably effective in keeping auditors honest. Nevertheless, recent legislation in the US now prohibits auditors from performing consulting services for their audit clients.

You are the Bank Loan Officer The value shown on Hertz’s books will be the purchase price, though perhaps reduced for the time the fleet has been in use. However, the bank would want to know the current market value of the fleet, not its book value, and the bank would then adjust this market value. The current market value of a single car can be found in used-car market quotes. If the bank ultimately becomes the owner of the fleet, it will need to sell the cars, probably a few at a time through wholesalers. Therefore, the adjusted market value and the book value are likely to differ for several reasons, including:

1. Hertz would have been able to buy the fleet at a reduced value due to buying in large volume regularly (market value lower than used-car quotes).
2. Hertz is likely to have kept the cars in better condition than would the average buyer (market value higher than used-car quotes).
3. The bank would reduce the value by some percentage due to the costs associated with disposing of the fleet (including the wholesaler’s discount) and the length of the bank loan (reduction to the value as otherwise determined).

> KEY RATIOS

$$\text{Return on equity (ROE)} = \frac{\text{Net Income}}{\text{Average Stockholders' Equity}}$$

$$\text{Debt-to-equity} = \frac{\text{Total Liabilities}}{\text{Total Stockholders' Equity}}$$

> KEY TERMS

Accounting (p. 4)
 Accounting equation (p. 10)
 American Institute of Certified Public Accountants (AICPA) (p. 18)
 Assets (p. 8)

Audited (p. 19)
 Balance sheet (p. 11)
 Board of directors (p. 6)
 Conceptual Framework (p. 23)
 Corporation (p. 5)
 Creditors (p. 6)

Disclosure (p. 7)
 Economic consequences (p. 18)
 Expense (p. 10)
 Feedback value (p. 24)
 Financial accounting (p. 4)

| | | |
|---|---|--|
| Financial Accounting Standards Board (FASB) (p. 18) | Partnership (p. 5) | Sarbanes-Oxley Act (p. 18) |
| Financing activities (p. 9) | Planning activities (p. 8) | Securities and Exchange Commission (SEC) (p. 18) |
| Generally accepted accounting principles (GAAP) (p. 17) | Predictive value (p. 24) | Shares of stock (p. 5) |
| Income (p. 10) | Profitability (p. 20) | Sole proprietorship (p. 5) |
| Income statement (p. 11, 12) | Public Company Accounting Oversight Board (PCAOB) (p. 18) | Solvency (p. 21) |
| Internal controls (p. 18) | Representational faithfulness (p. 25) | Statement of cash flows (p. 11) |
| Investing activities (p. 8) | Retained earnings (p. 13) | Statement of stockholders' equity (p. 11, 13) |
| Liabilities (p. 9) | Return on equity (ROE) (p. 21) | Suppliers (p. 6) |
| Managerial accounting (p. 4) | Revenue (p. 10) | Timeliness (p. 24) |
| Neutrality (p. 25) | Risk (p. 20) | Verifiability (p. 25) |
| Operating activities (p. 10) | | |

> MULTIPLE CHOICE

Multiple Choice Answers
1. d 2. a 3. a 4. d 5. b

- Which of the following is a potential cost of the public disclosure of accounting information?
 - Loss of competitive advantage caused by revealing information to competitors.
 - Potential increased regulation and taxes due to reporting excessive profits in politically sensitive industries.
 - Raising and then failing to meet the expectations of investors.
 - All of the above are potential costs of disclosure.
- Banks that lend money to corporations are considered
 - creditors.
 - stockholders.
 - both a and b above.
 - neither a nor b above.
- Which of the following financial statements reports the financial condition of a company at a point in time?
 - the balance sheet
 - the income statement
 - the statement of cash flows
 - the statement of stockholders' equity.
- Which of the following is *not* one of the four basic financial reports?
 - The balance sheet
 - The income statement
 - The statement of stockholders' equity
 - The notes to the financial statements
- Which of the following expressions is a correct statement of the accounting equation?
 - Equity + Assets = Liability
 - Assets - (Liabilities + Equity) = 0
 - Liabilities - Equity = Assets
 - Liabilities + Assets = Equity

Superscript ^A denotes assignments based on Appendix 1A.

> DISCUSSION QUESTIONS

- Q1-1. What are the three major business activities of a company that are motivated and shaped by planning activities? Explain each activity.
- Q1-2. The accounting equation (Assets = Liabilities + Equity) is a fundamental business concept. Explain what this equation reveals about a company's sources and uses of funds and the claims on company resources.
- Q1-3. Companies prepare four primary financial statements. What are those financial statements and what information is typically conveyed in each?
- Q1-4. Does a balance sheet report on a period of time or at a point in time? Also, explain the information conveyed in that report.
- Q1-5. Does an income statement report on a period of time or at a point in time? Also, explain the information conveyed in that report.

- Q1-6. Does a statement of cash flows report on a period of time or at a point in time? Also, explain the information and activities conveyed in that report.
- Q1-7. Explain what is meant by the articulation of financial statements.
- Q1-8. The trade-off between risk and return is a fundamental business concept. Briefly describe both risk and return and their trade-off. Provide some examples that demonstrate investments of varying risk and the approximate returns that you might expect to earn on those investments.
- Q1-9. Why might a company voluntarily disclose more information than is required by GAAP?
- Q1-10. Financial statements are used by several interested stakeholders. Develop a listing of three or more potential external users of financial statements and their applications.
- Q1-11. What ethical issues might managers face in dealing with confidential information?
- Q1-12. Return on equity (ROE) is an important summary measure of financial performance. How is it computed? Describe what this metric reveals about company performance.
- Q1-13. Access the 2006 10-K for **Procter & Gamble** at the SEC’s EDGAR database of financial reports (www.sec.gov). Who is P&G’s auditor? What specific language does its auditor use in expressing its opinion and what responsibilities does it assume?
- Q1-14. Business decision makers external to the company increasingly demand more financial information on business activities of companies. Discuss the reasons why companies have traditionally opposed the efforts of regulatory agencies like the SEC to require more disclosure.
- Q1-15. What are generally accepted accounting principles and what organization presently establishes them?
- Q1-16. What is the primary function of the auditor? To what does the auditor attest in its opinion?
- Q1-17.^A What are the objectives of financial accounting? Which of the financial statements satisfies each of these objectives?
- Q1-18.^A What are the four qualitative characteristics of accounting information? Explain how each characteristic improves the quality of accounting disclosures.



Assignments with the **WebAssign** logo in the margin are available in WebAssign.
See the Preface of the book for details.

> MINI EXERCISES

M1-19. Financing and Investing Relations, and Financing Sources

Total assets of **Dell Computer Corporation** equal \$23,109 million and its equity is \$4,129 million. What is the amount of its liabilities? Does Dell receive more financing from its owners or nonowners, and what percentage of financing is provided by its owners?

LO2



M1-20. Financing and Investing Relations, and Financing Sources

Total assets of **Ford Motor Company** equal \$315,920 million and its liabilities equal \$304,269 million. What is the amount of its equity? Does Ford receive more financing from its owners or nonowners, and what percentage of financing is provided by its owners?

LO2



M1-21. Applying the Accounting Equation and Computing Financing Proportions

Use the accounting equation to compute the missing financial amounts (a), (b), and (c). Which of these companies is more owner-financed? Which of these companies is more nonowner-financed?

LO2

| (\$ millions) | Assets | = | Liabilities | + | Equity |
|---------------------------|----------|---|-------------|---|----------|
| Hewlett-Packard | \$81,981 | | \$43,837 | | \$ (a) |
| General Mills | \$18,207 | | \$ (b) | | \$ 5,772 |
| Coca-Cola | \$ (c) | | \$13,043 | | \$16,920 |

M1-22. Identifying Key Numbers from Financial Statements

Access the 2006 10-K for **Apple, Inc.**, at the SEC’s EDGAR database for financial reports (www.sec.gov). What are Apple’s dollar amounts for assets, liabilities, and equity at September 30, 2006? Confirm that the accounting equation holds in this case. What percent of Apple’s assets is financed from creditor financing sources?

LO3



M1-23. Verifying Articulation of Financial Statements

Access the 2006 10-K for **DuPont** at the SEC’s EDGAR database of financial reports (www.sec.gov). Using its December 31, 2006, consolidated statement of stockholders’ equity, prepare a table showing the articulation of its retained (reinvested) earnings for calendar-year 2006.

LO3



LO3 M1-24. Identifying Financial Statement Line Items and Accounts

Several line items and account titles are listed below. For each, indicate in which of the following financial statement(s) you would likely find the item or account: income statement (IS), balance sheet (BS), statement of stockholders' equity (SE), or statement of cash flows (SCF).

- a. Cash asset
- b. Expenses
- c. Noncash assets
- d. Contributed capital
- e. Cash outflow for land
- f. Retained earnings
- g. Cash inflow for stock issued
- h. Cash outflow for dividends
- i. Net income

LO1 M1-25. Ethical Issues and Accounting Choices

Assume that you are a technology services provider and you must decide whether to record revenue from the installation of computer software for one of your clients. Your contract calls for acceptance of the software by the client within six months of installation before payment is due. Although you have not yet received formal acceptance, you are confident that it is forthcoming. Failure to record these revenues will cause your company to miss Wall Street's earnings estimates. What stakeholders will be affected by your decision and how might they be affected?

LO4 M1-26. Internal Controls and Their Importance

The **Sarbanes-Oxley** legislation requires companies to report on the effectiveness of their internal controls. What are internal controls and their purpose? Why do you think Congress felt it to be such an important area to monitor and report on?

> EXERCISES

LO2 E1-27. Applying the Accounting Equation and Assessing Financing Contributions



| |
|----------------------------|
| MOTOROLA NYSE :: MOT |
| KRAFT FOODS NYSE :: KFT |
| MERCK & CO. NYSE :: MRK |

Determine the missing amount from each of the separate situations (a), (b), and (c) below. Which of these companies is more owner-financed? Which of these companies is more creditor-financed?

| (\$ millions) | Assets | = | Liabilities | + | Equity |
|---------------------------------|----------|---|-------------|---|----------|
| a. Motorola, Inc. | \$38,593 | | \$? | | \$17,142 |
| b. Kraft Foods | \$? | | \$27,019 | | \$28,555 |
| c. Merck & Co. | \$44,570 | | \$27,010 | | \$? |

LO2, 3 E1-28. Applying the Accounting Equation and Financial Statement Articulation



| |
|------------------------------------|
| INTEL NASDAQ :: INTC |
| JETBLUE NASDAQ :: JBLU |
| WALT DISNEY COMPANY NYSE :: DIS |

Answer the following questions. (*Hint:* Apply the accounting equation.)

- a. **Intel** had assets equal to \$44,224 million and liabilities equal to \$8,756 million for a recent year-end. What was the total equity for Intel's business at year-end?
- b. At the beginning of a recent year, **JetBlue**'s assets were \$1,378 million and its equity was \$415 million. During the year, assets increased \$70 million and liabilities increased \$30 million. What was its equity at the end of the year?
- c. At the beginning of a recent year, **The Walt Disney Company**'s liabilities equaled \$26,197 million. During the year, assets increased by \$400 million, and year-end assets equaled \$50,388 million. Liabilities decreased \$100 million during the year. What were its beginning and ending amounts for equity?

LO1 E1-29. Financial Information Users and Uses

Financial statements have a wide audience of interested stakeholders. Identify two or more financial statement users that are external to the company. Specify two questions for each user identified that could be addressed or aided by use of financial statements.

LO3 E1-30. Financial Statement Relations to Compute Dividends



| |
|---------------------------------|
| COLGATE-PALMOLIVE NYSE :: CL |
|---------------------------------|

Colgate-Palmolive reports the following balances in its retained earnings.

| (\$ millions) | 2006 | 2005 |
|-------------------------|-----------|-----------|
| Retained earnings | \$9,643.7 | \$8,968.1 |

During 2006, Colgate-Palmolive reported net income of \$1,353.4 million.

- a. What amount of dividends, if any, did Colgate-Palmolive pay to its shareholders in 2006?
- b. Assuming it paid dividends, this dividend amount constituted what percent of its net income?

E1-31. Calculating Gross Profit and Preparing an Income Statement

In 2006, **Colgate-Palmolive** reported sales revenue of \$12,237.7 million and cost of goods sold of \$5,536.1 million. Its net income was \$1,353.4 million. Calculate gross profit and prepare an income statement using the format illustrated in Exhibit 1.8.

LO3

| |
|--------------------------|
| COLGATE-PALMOLIVE |
| NYSE :: CL |

E1-32. Applying the Accounting Equation and Calculating Return on Equity and Debt-to-equity Ratio

At the end of 2006, **Colgate-Palmolive** reported stockholders' equity of \$1,410.9 million and total assets of \$9,138.0. Its balance in stockholders' equity at the end of 2005 was \$1,350.1 million. Net income in 2006 was \$1,353.4 million.

LO2, 5

WebAssign.

| |
|--------------------------|
| COLGATE-PALMOLIVE |
| NYSE :: CL |

- Calculate Colgate-Palmolive's return on equity ratio for 2006.
- Calculate its debt-to-equity ratio as of December 31, 2006. (Hint: apply the accounting equation to determine total liabilities.)

E1-33.^A Accounting in Society

Financial accounting plays an important role in modern society and business.

LO1, 4, 6

WebAssign.

- What role does financial accounting play in the allocation of society's financial resources?
- What are three aspects of the accounting environment that can create ethical pressure on management?

> PROBLEMS

P1-34. Applying the Accounting Equation and Calculating Ratios

The following table contains financial statement information for **Procter & Gamble** (\$ millions):

LO2, 5

WebAssign.

| Year | Assets | Liabilities | Equity | Net Income |
|------|---------|-------------|----------|------------|
| 2004 | \$? | \$39,770 | \$18,190 | \$6,156 |
| 2005 | 61,527 | ? | 18,475 | 6,923 |
| 2006 | 135,695 | 72,787 | ? | 8,684 |

| |
|-----------------------------|
| PROCTER & GAMBLE |
| NYSE :: PG |

Required

- Compute the missing amounts for assets, liabilities, and equity for each year.
- Compute return on equity for 2005 and 2006. The median ROE for Fortune 500 companies is about 15.1%. How does P&G compare with this median?
- Compute the debt-to-equity ratio for 2005 and 2006. The median debt-to-equity ratio for the Fortune 500 companies is 1.72 in 2006. How does P&G compare to this median?

P1-35. Formulating Financial Statements from Raw Data

Following is selected financial information from **General Mills, Inc.**, for its fiscal year ended May 28, 2006 (\$ millions):

LO2, 3

WebAssign.

| | |
|--------------------------|---------|
| Cash asset | \$ 647 |
| Net cash from operations | 1,771 |
| Sales | 11,640 |
| Stockholders' equity | 5,772 |
| Cost of goods sold | 6,966 |
| Net cash from financing | (1,405) |
| Total liabilities | 12,435 |
| Other expenses | 3,584 |
| Noncash assets | 17,560 |
| Net cash from investing | (292) |
| Net income | 1,090 |
| Cash, beginning year | 573 |

| |
|----------------------|
| GENERAL MILLS |
| NYSE :: GIS |

Required

- Prepare an income statement, balance sheet, and statement of cash flows for General Mills, Inc.
- What portion of the financing is contributed by owners?

P1-36. Formulating Financial Statements from Raw Data

Following is selected financial information from **Abercrombie & Fitch** for its fiscal year ended February 3, 2007 (\$ millions):

LO2, 3

WebAssign.

| |
|--------------------------------|
| ABERCROMBIE & FITCH |
| NYSE :: ANF |

| | |
|--------------------------------------|-------|
| Cash asset | \$ 82 |
| Cash flows from operations | 582 |
| Sales | 3,318 |
| Stockholders' equity | 1,405 |
| Cost of goods sold | 1,109 |
| Cash flows from financing | (77) |
| Total liabilities | 843 |
| Other expenses | 1,787 |
| Noncash assets | 2,166 |
| Cash flows from investing | (474) |
| Net income | 422 |
| Cash, beginning year | 51 |

Required

- Prepare an income statement, balance sheet, and statement of cash flows for Abercrombie & Fitch.
- Determine the owner and creditor financing levels.

LO3 P1-37. Formulating Financial Statements from Raw Data

Following is selected financial information from **Cisco Systems, Inc.**, for the year ended July 29, 2006 (\$ millions):



| | |
|--------------------------------------|----------|
| Cash asset | \$ 3,297 |
| Cash flows from operations | 7,899 |
| Sales | 28,484 |
| Stockholders' equity | 23,912 |
| Cost of goods sold | 9,737 |
| Cash flows from financing | 300 |
| Total liabilities | 19,403 |
| Other expenses | 13,167 |
| Noncash assets | 40,018 |
| Cash flows from investing | (9,644) |
| Net income | 5,580 |
| Cash, beginning year | 4,742 |

Required

Prepare an income statement, balance sheet, and statement of cash flows for Cisco Systems, Inc.

LO3 P1-38. Formulating a Statement of Stockholders' Equity from Raw Data



Crocker Corporation began calendar-year 2008 with stockholders' equity of \$100,000, consisting of contributed capital of \$70,000 and retained earnings of \$30,000. During 2008, it issued additional stock for total cash proceeds of \$30,000. It also reported \$50,000 of net income, of which \$25,000 was paid as a cash dividend to shareholders.

Required

Prepare the 2008 statement of stockholders' equity for Crocker Corporation.

LO3 P1-39. Formulating a Statement of Stockholders' Equity from Raw Data

DP Systems, Inc. reports the following selected information at December 31, 2008 (\$ millions):

| | |
|---|--------|
| Contributed capital, December 31, 2007 and 2008 | \$ 550 |
| Retained earnings, December 31, 2007 | 2,437 |
| Cash dividends, 2008 | 281 |
| Net income, 2008 | 859 |

Required

Use this information to prepare its statement of stockholders' equity for 2008.

LO3, 5 P1-40. Analyzing and Interpreting Return on Equity



Nokia manufactures, markets and sells phones and other electronics. Stockholders' equity for Nokia are €12,060 in 2006 and €12,514 in 2005. In 2006, Nokia reported net income of €4,366 on sales of €41,121.

Required

- What is Nokia's return on equity for 2006?
- Nokia's total assets were €22,617 at the end of 2006. Compute its debt-to-equity ratio.
- What are total expenses for Nokia in 2006?

P1-41. Presenting an Income Statement and Computing Key Ratios

Motorola, Inc. reported the following amounts in its December 31, 2006 and 2005 financial statements.

| (\$ millions) | 2006 | 2005 |
|----------------------------|----------|----------|
| Sales revenue | \$42,879 | \$35,262 |
| Cost of sales | 30,152 | 23,833 |
| Net income..... | 3,661 | 4,578 |
| Total assets | 38,593 | 35,802 |
| Stockholders' equity | 17,142 | 16,663 |

LO3, 5

| |
|-----------------|
| MOTOROLA |
| NYSE :: MOT |

Required

- Prepare an income statement for Motorola as of December 31, 2006, using the format illustrated in Exhibit 1.8.
- Calculate Motorola's return on equity for 2006.
- Compute Motorola's debt-to-equity ratio as of December 31, 2006.

P1-42. Presenting an Income Statement and Computing Key Ratios

Dell, Inc. reported the following amounts in its February 3, 2006, and January 28, 2005, financial statements.

| (\$ millions) | 2006 | 2005 |
|---------------------------|----------|----------|
| Sales revenue | \$55,908 | \$49,205 |
| Cost of sales | 45,958 | 40,190 |
| Other expenses..... | 6,378 | 5,972 |
| Total assets | 23,109 | 23,215 |
| Stockholders' equity..... | 4,129 | 6,485 |

LO3, 5

WebAssign

| |
|------------------|
| DELL INC. |
| NASDAQ :: DELL |

Required

- Prepare an income statement for Dell as of February 3, 2006, using the format illustrated in Exhibit 1.8.
- Calculate Dell's return on equity for 2006.
- Compute Dell's debt-to-equity ratio as of February 3, 2006.

> CASES AND PROJECTS**C1-43. Computing and Interpreting Key Ratios and Formulating an Income Statement**

Data from the financial statements of **Coca-Cola Company** and **PepsiCo, Inc.**, are presented below.

| (\$ millions) | Coca-Cola Company | PepsiCo, Inc. |
|--|-------------------|---------------|
| Total liabilities, December 31, 2006 | \$13,043 | \$14,562 |
| Total liabilities, December 31, 2005 | 13,072 | 17,476 |
| Total assets, December 31, 2006 | 29,963 | 29,930 |
| Total assets, December 31, 2005 | 29,427 | 31,727 |
| Revenue, 2006..... | 24,088 | 35,137 |
| Cost of goods sold, 2006 | 8,164 | 15,762 |
| Net income, 2006..... | 5,080 | 5,642 |

LO2, 3, 5

| |
|--------------------------|
| COCA-COLA COMPANY |
| NYSE :: CO |

| |
|----------------------|
| PEPSICO, INC. |
| NYSE :: PEP |

Required

- Compute the return on equity ratio for Coca-Cola Company and PepsiCo, Inc. for 2006. Which company earned the higher return for its shareholders?
- Compute the debt-to-equity ratio for each company as of December 31, 2006. Which company relies more on creditor financing?
- Prepare a 2006 income statement for each company using the format in Exhibit 1.8. For each firm, compute gross profit as a percentage of sales revenue.
- Based on your answers to questions a, b, and c, compare these two competitors. What might be the cause of any differences in the ratios that you computed?

LO5 C1-44. Computing and Interpreting Key Ratios

Data from the financial statements of **American Airlines** and **Southwest Airlines** are presented below.

| |
|--|
| AMERICAN AIRLINES NYSE :: AMR |
| SOUTHWEST AIRLINES NYSE :: LUV |

| (\$ millions) | American Airlines | Southwest Airlines |
|--|-------------------|--------------------|
| Total liabilities, December 31, 2006 | \$26,916 | \$ 7,011 |
| Total liabilities, December 31, 2005 | 27,220 | 7,328 |
| Total assets, December 31, 2006 | 25,850 | 13,460 |
| Total assets, December 31, 2005 | 26,041 | 14,003 |
| Revenue, 2006 | 22,490 | 9,086 |
| Net income, 2006 | 164 | 499 |

Required

- Compute the return on equity ratio for American and Southwest for 2006. Which company earned the higher return for its shareholders?
- Compute the debt-to-equity ratio for each company as of December 31, 2006. Which company relies more on creditor financing?
- For each firm, compute net income as a percentage of revenue in 2006.
- Based on your answers to questions a, b, and c, compare these two competitors. What might be the cause of any differences in the ratios that you computed?

LO1, 3, 5 C1-45. Interpreting Financial Statement Information

Paula Seale is negotiating the purchase of an extermination firm called Total Pest Control. Seale has been employed by a national pest control service and knows the technical side of the business. However, she knows little about accounting data and financial statements. The sole owner of the firm, Meg Krey, has provided Seale with income statements for the past three years, which show an average net income of \$72,000 per year. The latest balance sheet shows total assets of \$285,000 and liabilities of \$45,000. Seale brings the following matters to your attention and requests advice.

- Krey is asking \$300,000 for the firm. She has told Seale that because the firm has been earning 30% on its investment, the price should be higher than the net assets on the balance sheet.
- Seale has noticed no salary for Krey on the income statements, even though she worked half-time in the business. Krey explained that because she had other income, the firm only paid \$18,000 in cash dividends to Krey (the sole shareholder). If she purchases the firm, Seale will hire a full-time manager for the firm at an annual salary of \$36,000.
- Krey's tax returns for the past 3 years report a lower net income for the firm than the amounts shown in the financial statements. Seale is skeptical about the accounting principles used in preparing the financial statements.

Required

- How did Krey arrive at the 30% return figure in point 1? If Seale accepts Krey's average annual income figure of \$72,000, what would Seale's percentage return be, assuming that the net income remained at the same level and that the firm was purchased for \$300,000?
- Should the dividend to Krey affect the net income reported in the financial statements? What will Seale's percentage return be if she takes into consideration the \$36,000 salary she plans to pay a full-time manager?
- Could there be legitimate reasons for the difference between net income shown in the financial statements and net income reported on the tax returns, as mentioned in point 3? How might Seale obtain additional assurance about the propriety of the financial statements?

LO1, 4 C1-46. Management, Auditing, and Ethical Behavior

Jackie Hardy, CPA, has a brother, Ted, in the retail clothing business. Ted ran the business as its sole owner for 10 years. During this 10-year period, Jackie helped Ted with various accounting matters. For example, Jackie designed the accounting system for the company, prepared Ted's personal income tax returns (which included financial data about the clothing business), and recommended various cost control procedures. Ted paid Jackie for all these services. A year ago, Ted markedly expanded the business; Ted is president of the corporation and also chairs the corporation's board of directors. The board of directors has overall responsibility for corporate affairs. When the corporation was formed, Ted asked Jackie to serve on its board of directors. Jackie accepted. In addition, Jackie now prepares the corporation's income tax returns and continues to advise her brother on accounting matters.

Recently, the corporation applied for a large bank loan. The bank wants audited financial statements for the corporation before it will decide on the loan request. Ted asked Jackie to perform the audit. Jackie replied that she cannot do the audit because the code of ethics for CPAs requires that she be independent when providing audit services.

Required

- Why is it important that a CPA be independent when providing audit services?
- Which of Jackie's activities or relationships impair her independence?

> SOLUTIONS TO REVIEW PROBLEMS**Mid-Chapter Review**

a.

| QUIKSILVER Balance Sheet (\$ millions) October 31, 2007 | | | |
|---|------------------|--|------------------|
| Cash | \$ 74.3 | Total liabilities | \$1,754.9 |
| Noncash assets | 2,567.2 | Stockholders' equity | 886.6 |
| Total assets | <u>\$2,641.5</u> | Total liabilities and stockholders' equity | <u>\$2,641.5</u> |

| QUIKSILVER Income Statement (\$ millions) For Year Ended October 31, 2007 | |
|---|-------------------|
| Sales revenue | \$2,426.0 |
| Cost of goods sold | 1,303.8 |
| Gross profit | 1,122.2 |
| Other expenses | 1,243.3 |
| Net income (loss) | <u>\$ (121.1)</u> |

| QUIKSILVER Statement of Cash Flows (\$ millions) For Year Ended October 31, 2007 | |
|--|----------------|
| Cash flow from operations | \$ 124.3 |
| Cash flow from investing | (160.5) |
| Cash flow from financing | 73.7 |
| Net (increase) in cash | 37.5 |
| Cash, beginning of year | 36.8 |
| Cash, end of year | <u>\$ 74.3</u> |

- Quiksilver's revenues were \$2,426.0 million in 2007 compared to \$16,325.9 million for Nike. This difference indicates that Nike is several times larger than Quiksilver. Although Quiksilver competes with Nike and even outsells Nike in some areas, Nike has a broader product line and is dominant in the athletic shoe market. Nike's \$1,491.5 million in net income exceeds Quiksilver's net loss of \$121.1 million by an equally large margin. Quiksilver reports a cash flow of \$124.3 million from operations while Nike's operations generated a cash flow of \$1,878.7 million.

Chapter-End Review

- $$\text{Quiksilver's ROE} = \frac{(\$121.1 \text{ million})}{[(\$886.6 \text{ million} + \$881.1 \text{ million})/2]} = -0.137 \text{ or } -13.7\%$$

$$\text{Adidas' ROE} = \frac{€55 \text{ million}}{[(€3,023 \text{ million} + €2,828 \text{ million})/2]} = 0.190 \text{ or } 19\%$$
- $$\text{Quiksilver's debt-to-equity} = \frac{\$1,754.9 \text{ million}}{\$886.6 \text{ million}} = 1.98$$

$$\text{Adidas' debt-to-equity} = \frac{€2,291 \text{ million}}{€3,023 \text{ million}} = 1.75$$
- Adidas' ROE of 19% is slightly less than that of Nike's 22.4%, while Quiksilver's ROE is -13.7% due to \$121 million loss it reported in 2007. This indicates that Nike was more profitable in that it earned a higher return for its shareholders in 2007 than either of these companies. By way of comparison, the median ROE for the companies listed in the Fortune 500 was 15.1% in 2006. Quiksilver's debt-to-equity ratio was 1.98 and Adidas' debt-to-equity ratio was 1.75. Both of these companies financed more of their assets with creditor financing than Nike. Based on this ratio, Nike is the least risky among these three companies in terms of long-term solvency. The median debt-to-equity ratio for the Fortune 500 companies was 1.72 in 2006.