

Financial Accounting for MBAs

LEARNING OBJECTIVES

- L01** Identify and discuss the users and suppliers of financial information. (p. 1-5)
- L02** Identify and explain the four financial statements, and define the accounting equation. (p. 1-8)
- L03** Explain the basics of profitability analysis. (p. 1-16)
- L04** Describe business analysis within the context of a competitive environment. (p. 1-18)
- L05** Describe the accounting principles that guide preparation of financial statements. (p. 1-23)

BERKSHIRE HATHAWAY

Berkshire Hathaway is a holding company. It owns numerous businesses that pursue diverse activities. In 2005, Berkshire Hathaway reported total assets of \$198 billion, stockholders' equity of \$92 billion, sales of \$82 billion, net profit of \$8.5 billion, operating cash flow of \$9.5 billion, and employed 192,000 workers.¹

The legendary Warren Buffett, the 'Sage of Omaha,' who studied under the renowned Benjamin Graham (a founder of modern value-investing), manages Berkshire Hathaway. Buffett's investment philosophy is to acquire and hold companies over the long run. His acquisition criteria, taken from Berkshire Hathaway's annual report, follow:

1. Large purchases (at least \$75 million of pretax earnings).
2. Demonstrated consistent earning power (future projections are of *no* interest to us, nor are 'turnaround' situations).
3. Businesses earning good returns on equity while employing little or no debt.
4. Management in place (we can't supply it).
5. Simple businesses (if there's lots of technology, we won't understand it).
6. An offering price (we don't want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown).

At least three of Buffett's six criteria relate to financial performance. First, he seeks businesses with large and consistent earning power. Buffett is

¹ Berkshire Hathaway's 2005 balance sheet includes an atypical third column of numbers labeled "pro forma" (which means "as if") that reflect a stock transaction that happened after the year end. Berkshire Hathaway provides the pro forma numbers so that financial statement readers can see the effect of the transaction and make apples-to-apples comparisons in the future. The balance sheet numbers we discuss in this module are the 2005 numbers that reflect only events that happened in 2005.



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not only looking for consistent earnings, but earnings that are measured according to accounting policies that closely mirror the underlying economic performance of the business.

Second, Buffett focuses on “businesses earning good returns on equity,” defined as net income divided by average stockholders’ equity: “Our preference would be to reach our goal by directly owning a diversified group of businesses that generate cash and consistently earn above-average returns” (Berkshire Hathaway annual report). For management to earn a good return on equity, it must focus on both net income (financial performance) and equity (financial condition).

Third, Buffett values companies based on their ability to generate consistent earnings and cash. He focuses on *intrinsic value*, which he defines in each annual report as follows:

Intrinsic value is an all-important concept that offers the only logical approach to evaluating the relative attractiveness of investments and businesses. Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life.

The discounted value Buffett describes is the present (today’s) value of the cash flows the company expects to generate in the future. Cash is generated when companies are well managed and operate profitably and efficiently.

Warren Buffett provides some especially useful investment guidance in his Chairman’s letter from the Berkshire Hathaway annual report:

Three suggestions for investors: First, beware of companies displaying weak accounting. If a company still does not expense options, or if its pension assumptions are fanciful, watch out. When managements take the low road in aspects that are visible, it is likely they are following a similar path behind the scenes. There is seldom just one cockroach in the kitchen.

Second, unintelligible footnotes usually indicate untrustworthy management. If you can’t understand a footnote or other managerial explanation, it’s usually because the CEO doesn’t want you to. Enron’s descriptions of certain transactions still baffle me.

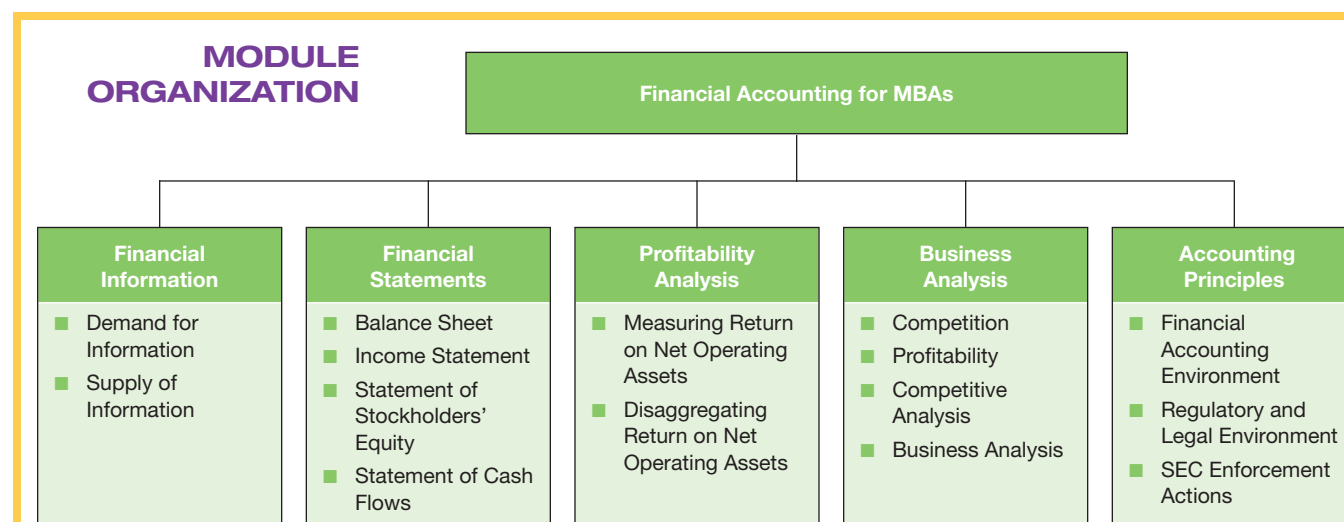
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Finally, be suspicious of companies that trumpet earnings projections and growth expectations. Businesses seldom operate in a tranquil, no-surprise environment, and earnings simply don't advance smoothly (except, of course, in the offering books of investment bankers).

This book will explain Buffett's references to stock option accounting and pension assumptions as well as a host of other accounting issues that affect interpretation and valuation of companies' financial performance. We will analyze and interpret the footnotes, which Buffett views as crucial to quality financial reporting and analysis. Our philosophy is simple: we must understand the intricacies and nuances of financial reporting to become critical readers and users of financial reports for company analysis and valuation. Financial statements tell a story, a business story. The task is to understand that story, to analyze and interpret it in the context of competing stories, and to apply the knowledge gleaned to business decisions.

Sources: Berkshire Hathaway 2005 10-K Report, Berkshire Hathaway 2001–2005 Annual Reports.



REPORTING ON BUSINESS ACTIVITIES

To effectively manage a company or infer whether it is well managed, we must understand the company's fundamental business activities. The information system called *financial accounting* helps us understand these business activities. This system reports on a company's performance and financial condition, and conveys executive management's privileged information and insights.

As managers, financial accounting information helps us to evaluate potential future strategies and ascertain the effectiveness of present and past strategies. It improves the soundness of our investment decisions, such as how to allocate resources across alternative investment projects and whether to invest additional resources in existing product lines or divisions. As managers, we also use financial accounting information to prepare client proposals, analyze the effectiveness of production processes, and evaluate the performance of management teams.

As investors, financial accounting information helps us determine which companies' stock to purchase or sell. Yet, before it is used to make decisions, the financial accounting information must be scrutinized and sometimes adjusted. This is accomplished, in part, by analyzing information contained in footnotes to companies' financial reports to determine the quality of reported figures and to make any necessary adjustments.

More generally, financial accounting satisfies the needs of different groups of users. Within firms, the *functioning* of this information system involves application of accounting standards to produce financial reports. Effectively using this information system involves making judgments, assumptions, and estimates based on data contained in the financial reports. The greatest value we derive from this system as users of financial information is the insight we gain into the business activities of the company under analysis.

To effectively analyze and use accounting information, we must consider the business context in which the information is created—see Exhibit 1.1. Without exception, all companies *plan* business activities, *finance* those activities, *invest* in those activities, and then engage in *operating* activities. Firms

conduct all these activities while confronting *business forces*, including market constraints and competitive pressures. Financial accounting provides crucial input in advance of strategic planning. It also provides information about the relative success of those plans, which can be used to take corrective action or make new operating, investing, and financing decisions.

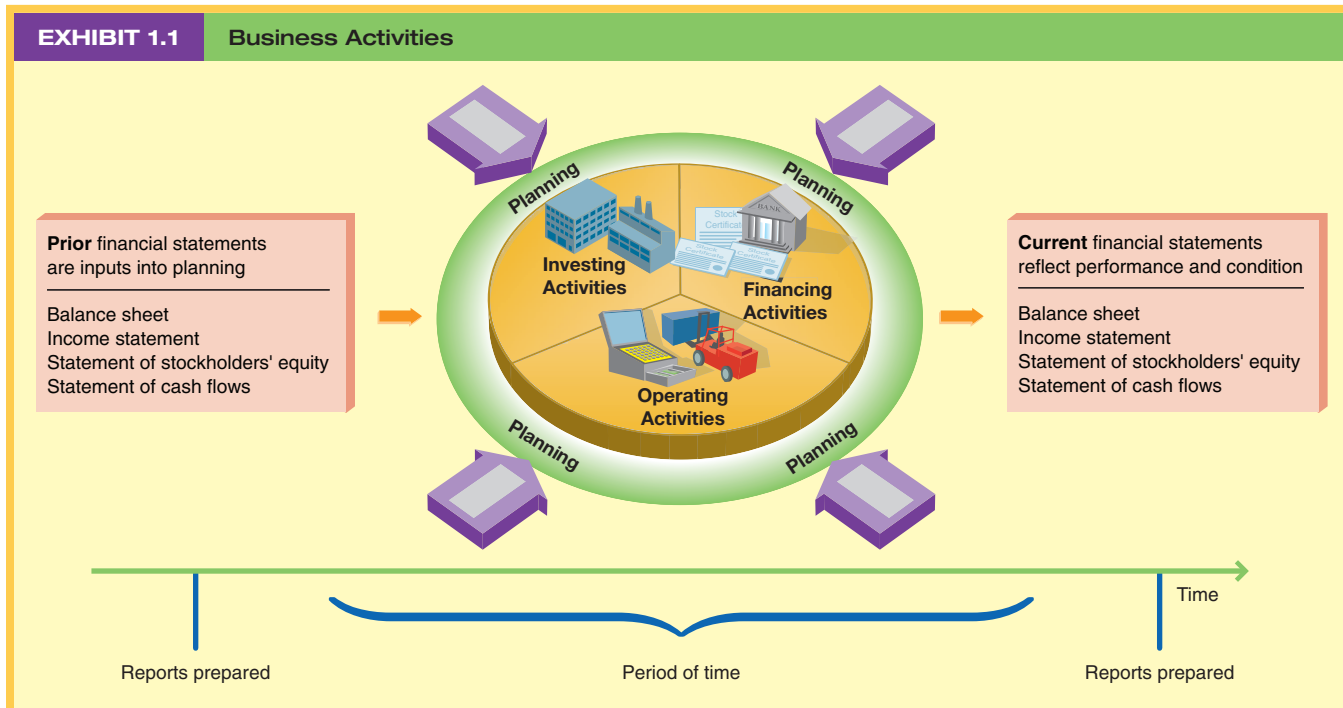


Exhibit 1.1 depicts the business activities for a typical company. The outer (green) ring is the planning process that reflects the overarching goals and objectives of the company within which strategic decisions are made. Those strategic decisions involve company financing, asset management, and daily operations. **Apple, Inc.**, the focus company in Modules 2 and 3, provides the following description of its business strategy in its annual report:

Business Strategy The Company is committed to bringing the best personal computing and music experience to students, educators, creative professionals, businesses, government agencies, and consumers through its innovative hardware, software, peripherals, services, and Internet offerings. The Company's business strategy leverages its unique ability, through the design and development of its own operating system, hardware, and many software applications and technologies, to bring to its customers new products and solutions with superior ease-of-use, seamless integration, and innovative industrial design. The Company believes continual investment in research and development is critical to facilitate innovation of new and improved products and technologies. Besides updates to its existing line of personal computers and related software, services, peripherals, and networking solutions, the Company continues to capitalize on the convergence of digital consumer electronics and the computer by creating innovations like the iPod and iTunes Music Store. The Company's strategy also includes expanding its distribution network to effectively reach more of its targeted customers and provide them a high-quality sales and after-sales support experience.

A company's *strategic (or business) plan* reflects how it plans to achieve its goals and objectives. A plan's success depends on an effective analysis of market demand and supply. Specifically, a company must assess demand for its products and services, and assess the supply of its inputs (both labor and capital). The plan must also include competitive analyses, opportunity assessments, and consideration of business threats.

Historical financial statements provide valuable insight into the success of a company's strategic plan, and are an important input to the planning process. Financial statements highlight those portions of the strategic plan that proved to be effective and, thus, warrant additional capital investment. They also reveal areas that are less effective, and provide valuable information that aids in development of remedial action.

Once strategic adjustments are planned and implemented, the resulting financial statements provide input into the planning process for the following year; and this process recycles. Understanding a company's strategic plan helps focus our analysis of financial statements by placing them in proper context.

FINANCIAL ACCOUNTING INFORMATION: DEMAND AND SUPPLY

LO1 Identify and discuss the users and suppliers of financial information.

Financial accounting information facilitates economic transactions and promotes efficient resource allocations. Demand for financial reporting has existed for centuries as a means to facilitate efficient contracting and risk-sharing. Decision makers and other stakeholders demand information on a company's past and prospective returns and risks. Companies are encouraged to supply such information to lower their costs of financing and to lower some less obvious costs such as political, contracting, and labor costs.

As with all goods, the supply of information depends on companies weighing the costs of disclosure against the benefits of disclosure. Regulatory agencies intervene in this process with various disclosure requirements that establish a minimum supply of information.

BUSINESS INSIGHT

Accounting Quality

In the bear market that followed the bursting of the dot.com bubble, and amid a series of corporate scandals such as **Enron**, **Tyco**, and **WorldCom**, Congress passed the **Sarbanes-Oxley Act**, often referred to as SOX. SOX sought to rectify perceived problems in accounting, including:

- Weak audit committees
- Non-independent auditors
- Limited management responsibility for accounting
- Deficient internal controls

Increased scrutiny of financial reporting and internal controls has had some success. A report by **Glass, Lewis and Co.**, a corporate-governance research firm, shows that the number of financial restatements by publicly traded companies surged to a record 1,295 in 2005—which is one restatement for each 12 public companies, and more than triple the 2002 total, the year SOX passed. The Glass, Lewis and Co. report concluded that “when so many companies produce inaccurate financial statements, it seriously calls into question the quality of information that investors relied upon to make capital-allocation decisions” (**CFO.Com**, 2006). Bottom line: we must be critical readers of financial reports.

Demand for Information

Demand for financial accounting information extends to numerous users that include:

- Managers and employees
- Investment analysts and information intermediaries
- Creditors and suppliers
- Shareholders and directors
- Customers and strategic partners
- Regulators and tax agencies
- Voters and their representatives

Managers and Employees

For their own well-being and future earnings potential, managers and employees demand accounting information on the financial condition, profitability, and prospects of their companies. Managers and employees also demand comparative financial information on competing companies and other business

opportunities. This permits them to conduct comparative analyses to benchmark company performance and condition.

Managers and employees also demand financial accounting information for use in compensation and bonus contracts that are tied to such numbers. The popularity of employee profit sharing and stock ownership plans has further increased demand for financial information. Other sources of demand include union contracts that link wage negotiations to accounting numbers and pension and benefit plans whose solvency depends on company performance.

Investment Analysts and Information Intermediaries

Investment analysts and other information intermediaries such as financial press writers and business commentators are interested in predicting companies' future performance. Expectations about future profitability and the ability to generate cash impact the price of securities and a company's ability to borrow money at favorable terms. Financial reports reflect information about past performance and current resources available to companies. These reports also provide information on claims on those resources, including suppliers, creditors, lenders, and shareholders. This information allows analysts to make informed assessments about future financial performance and condition so they can provide stock recommendations or write commentaries.

Creditors and Suppliers

Banks and other lenders demand financial accounting information to help determine loan terms, loan amounts, interest rates, and required collateral. Loan agreements often include contractual requirements, called **covenants**, that restrict the borrower's behavior in some fashion. For example, loan covenants might require the loan recipient to maintain minimum levels of working capital, retained earnings, interest coverage, and so forth to safeguard lenders. Covenant violations can yield technical default, enabling the creditor to demand early payment or other compensation.

Suppliers similarly demand financial information to establish credit sales terms and to determine their long-term commitment to supply-chain relations. Both creditors and suppliers use financial information to monitor and adjust their contracts and commitments with a debtor company.

Shareholders and Directors

Shareholders and directors demand financial accounting information to assess the profitability and risks of companies, and to monitor the performance of their managers. Shareholders and others (including investment analysts, brokers, potential investors, etc.) look for information useful in their investment decisions. **Fundamental analysis** uses financial information to estimate company value and to form buy-sell stock strategies.

Both directors and shareholders use accounting information to evaluate managerial performance. Managers similarly use such information to request an increase in compensation and managerial power from directors. Outside directors are crucial to determining who runs the company, and these directors use accounting information to help make leadership decisions.

Customers and Strategic Partners

Customers (both current and potential) demand accounting information to assess a company's ability to provide products or services as agreed and to assess the company's staying power and reliability. Strategic partners wish to estimate the company's profitability to assess the fairness of returns on mutual transactions and strategic alliances.

Regulators and Tax Agencies

Regulators (such as the SEC, the Federal Trade Commission, and the Federal Reserve Bank) and tax agencies demand accounting information for tax policies, antitrust assessments, public protection, price setting, import-export analyses, and various other uses. Timely and reliable information is crucial to effective regulatory policy. Moreover, accounting information is often central to social and economic policy. For example, governments often grant monopoly rights to electric and gas companies serving specific areas in exchange for regulation over prices charged to consumers. These prices are mainly determined from accounting measures.

Voters and their Representatives

Voters and their representatives to national, state, and local governments demand accounting information for policy decisions. The decisions can involve economic, social, taxation, and other initiatives. Voters and their representatives also use accounting information to monitor government spending. We have all heard of the \$1,000 hammer type stories that government watchdog groups uncover while sifting through accounting data. Contributors to nonprofit organizations also demand accounting information to assess the impact of their donations.

Supply of Information

In general, the quantity and quality of accounting information that firms provide are determined by managers' assessment of the benefits and costs of disclosure. Management releases information provided the benefits of disclosing that information outweigh the costs of doing so. Both *regulation* and *bargaining power* affect disclosure costs and benefits and thus play roles in determining the supply of accounting information.

Most areas of the world regulate the minimum levels of accounting disclosures. In the United States, publicly traded firms must file financial accounting information with the Securities Exchange Commission (SEC). The two main compulsory SEC filings are:

- **Form 10-K:** the audited annual report that includes the four financial statements, discussed below, together with explanatory notes and the management's discussion and analysis of financial results.
- **Form 10-Q:** the unaudited quarterly report that includes summary versions of the four financial statements and limited additional disclosures.

Forms 10-K and 10-Q are available electronically from the SEC Website (see Appendix 1A).

The minimum, regulated level of information is not the standard. Both the quantity and quality of information differ across companies and over time. We need only look at several annual reports to see considerable variance in the amount and type of accounting information supplied. For example, differences abound on disclosures for segment operations, product performance reports, and financing activities. Further, some stakeholders possess ample bargaining power to obtain accounting information for themselves. These typically include private lenders and major suppliers and customers.

Benefits of Disclosure

The benefits of supplying accounting information extend to a company's capital, labor, input, and output markets. Companies must compete in these markets. For example, capital markets provide debt and equity financing; the better a company's prospects, the lower is its cost of capital (as reflected in lower interest rates or higher stock prices). The same holds for a company's recruiting efforts in labor markets and its ability to establish superior supplier-customer relations in the input and output markets.

A company's performance in these markets depends on success with its business activities *and* the market's awareness of that success. Companies reap the benefits of disclosure with good news information about their products, processes, management, and so forth. That is, there are real economic incentives for companies to disclose reliable (audited) accounting information enabling them to better compete in capital, labor, input, and output markets.

What inhibits companies from providing false or misleading good news? There are several constraints. An important constraint imposed by stakeholders is that of audit requirements and legal repercussions associated with inaccurate accounting information. Another relates to reputation effects from disclosures as subsequent events either support or refute earlier news.

Costs of Disclosure

The costs of supplying accounting information include its preparation and dissemination, competitive disadvantages, litigation potential, and political costs. Preparation and dissemination costs can be substantial, but much of this cost is already borne by inside managers who need the same information for their own business decisions. The potential for information to yield competitive disadvantages is high. Companies are concerned that disclosures of their activities such as product or segment successes, strategic alliances or pursuits, technological or system innovations, and product or process quality improvements will harm their competitive advantages. Also, companies are frequently sued when disclosures create expectations

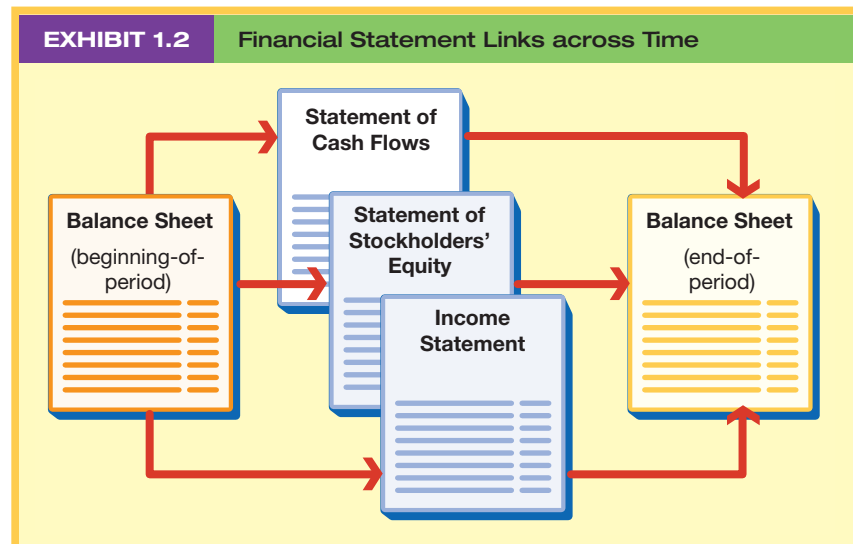
that are not met. Highly visible companies often face political and public pressure, which creates “political costs.” These companies often try to appear as if they do not generate excess profits. For example, government defense contractors, large software conglomerates, and oil companies are favorite targets of public scrutiny. Disclosure costs are higher for companies facing political costs.

A recent rule increased the cost of voluntary financial disclosures for all publicly traded companies. In August 2000, the SEC adopted Regulation FD, or Reg FD for short, to curb the practice of selective disclosure by public companies (called issuers by the SEC) to certain shareholders and financial analysts. In the past, many companies disclosed important information in meetings and conference calls that excluded individual shareholders. The goal of this rule is to even the playing field for all investors. Reg FD reads as follows: “Whenever an issuer discloses any material nonpublic information regarding that issuer, the issuer shall make public disclosure of that information . . . simultaneously, in the case of an intentional disclosure; and . . . promptly, in the case of a non-intentional disclosure.” Reg FD increased disclosure costs and led some companies to curtail the supply of financial information to all users.

FINANCIAL STATEMENTS

Companies use four financial statements to periodically report on business activities. These statements are the: balance sheet, income statement, statement of stockholders’ equity, and statement of cash flows.

Exhibit 1.2 shows how these statements are linked across time. A balance sheet reports on a company’s financial 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 1.2 (period-of-time statements) link the balance sheet from the beginning to the end of a period.



A one-year, or annual, reporting period is common and is called the *accounting*, or *fiscal*, *year*. Of course, firms prepare financial statements more frequently; semi-annual, quarterly, and monthly financial statements are common. *Calendar-year* companies have reporting periods beginning on January 1 and ending on December

31. **Berkshire Hathaway** is a calendar-year company. Some companies choose a fiscal year ending on a date other than December 31, such as when sales and inventory are low. For example, **Best Buy**’s fiscal year-end is always near February 1, after the busy holiday season.

Balance Sheet

A balance sheet reports a company’s financial position at a point in time. The balance sheet reports the company’s *resources (assets)*, namely what the company owns. The balance sheet also reports the *sources* of asset financing. There are two ways a company can finance its assets. It can raise money from shareholders; this is *owner financing*. It can also raise money from banks or other creditors and suppliers; this is *nonowner financing*. This means that both owners and nonowners hold claims on company assets. Owner claims on assets are referred to as *equity* and nonowner claims are referred to as *liabilities* (or debt). Since all financing must be invested in something, we obtain the following basic relation: *investing equals financing*. This equality is called the **accounting equation**, which follows:

LO2 Identify and explain the four financial statements, and define the accounting equation.

$$\begin{array}{l}
 \text{Investing} = \text{Nonowner Financing} + \text{Owner Financing} \\
 \text{Assets} = \text{Liabilities} + \text{Equity}
 \end{array}$$

The accounting equation works for all companies at all points in time.

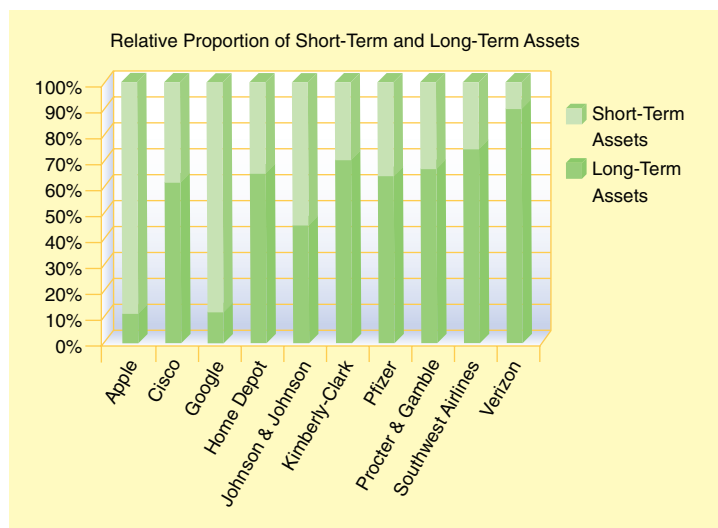
The balance sheet for **Berkshire Hathaway** is in Exhibit 1.3 (condensed). Refer to this balance sheet to verify the following amounts: assets = \$198,325 million, liabilities = \$106,025 million, and equity = \$92,300 million. Assets equal liabilities plus equity, which reflects the accounting equation: investing equals financing.

EXHIBIT 1.3 Balance Sheet (\$ millions)	
BERKSHIRE HATHAWAY Balance Sheet ² December 31, 2005	
Report amounts at a point in time	
Assets	
Cash	\$ 44,660
Noncash assets	153,665
Total assets	<u>\$198,325</u>
Liabilities and equity	
Total liabilities	\$106,025
Equity	
Contributed capital	26,407
Retained earnings	47,717
Other stockholders' equity ³	18,176
Total liabilities and equity	<u>\$198,325</u>

Investing Activities

Balance sheets are organized like the accounting equation. Investing activities are represented by company assets. These assets are financed by a combination of nonowner financing (liabilities) and owner financing (equity).

For simplicity, Berkshire Hathaway's balance sheet in Exhibit 1.3 categorizes assets into cash and noncash assets. Noncash assets consist of several asset categories (Module 2 explains the composition of noncash assets). These categories are listed in order of their nearness to cash. For example, companies own a category of assets called inventories. These are goods that the company intends to sell to its customers. Inventories are converted into cash when they are sold within a short period of time. Hence, they are classified as short-term assets. Companies also report a category called property, plant and equipment. This category includes a company's office buildings or manufacturing facilities. Property, plant and equipment assets will be held for an extended period of time and are, therefore, generally classified as long-term assets.



The relative proportion of short-term and long-term assets is largely determined by a company's business model. This is evident in the graph to the left that depicts the relative proportion of short and long-term assets for several companies that we feature in this book. Companies such as **Apple** and **Google** require little investment in long-term assets. On the other hand, **Verizon** and **Southwest Airlines** require a large investment in long-term assets. Although managers can influence the relative amounts and proportion of assets, their flexibility is somewhat limited by the nature of their industries.

² Financial statement titles often begin with the word *consolidated*. This means that the financial statement includes a parent company and one or more subsidiaries, companies that the parent company owns. We discuss consolidation in Module 7.

³ For Berkshire Hathaway, other stockholders' equity includes accumulated other comprehensive income and minority interests. These and other components of stockholders' equity are discussed in Modules 7 and 9.

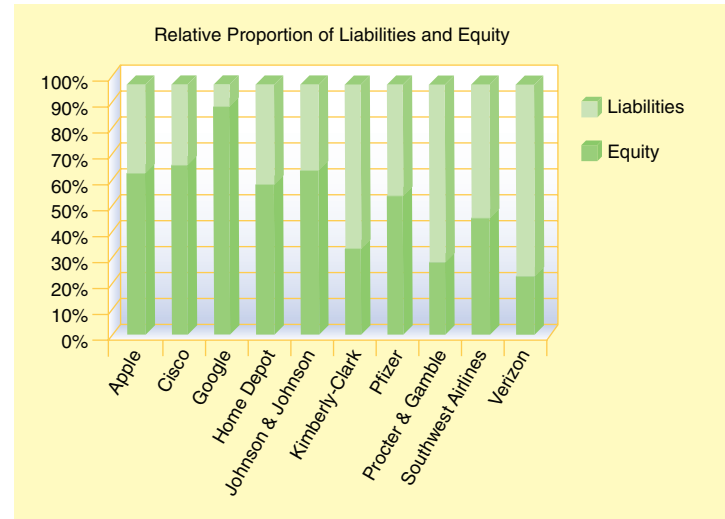
Financing Activities

Assets must be paid for, and funding is provided by a combination of owner and nonowner financing. Owner (or equity) financing includes resources contributed to the company by its owners along with any profit retained by the company. Nonowner (creditor or debt) financing is borrowed money. We distinguish financing sources for an important reason: borrowed money entails a legal obligation to repay amounts owed, and failure to repay amounts borrowed can result in severe consequences for the borrower. Equity financing entails no such legal obligation for repayment.

The relative proportion of nonowner (liabilities) and owner (equity) financing is largely determined by a company's business model. This is evident in the graph to the right; again citing many of the companies we feature as focus companies in this book.

Google is a relatively new company that is expanding into new markets. Its business model is, therefore, more risky than that of a more established company operating in relatively stable markets. Google, therefore, cannot afford to take on additional risk of higher nonowner financing levels. On the other hand, **Proctor and Gamble** competes in consumer goods markets that are largely predictable and stable. It can, therefore, operate with more nonowner financing.

Our discussion of investing and financing activities uses many terms and concepts that we explain later in the book. Our desire here is to provide a sneak preview into the interplay among financial statements, manager behavior, and economics. Some questions that we might have at this early stage regarding the balance sheet follow:



- Berkshire Hathaway reports \$44.7 billion of cash on its 2005 balance sheet, which is 23% of total assets. Many investment-type companies such as Berkshire Hathaway and high-tech companies such as Cisco Systems carry high levels of cash. Why is that? Is there a cost to holding too much cash? Is it costly to carry too little cash?
- The relative proportion of short-term and long-term assets is largely dictated by companies' business models. Why is this the case? Why is the composition of assets on balance sheets for companies in the same industry similar? By what degree can a company's asset composition safely deviate from industry norms?
- What are the trade-offs in financing a company by owner versus nonowner financing? If nonowner financing is less costly, why don't we see companies financed entirely with borrowed money?
- How do shareholders influence the strategic direction of a company? How can long-term creditors influence strategic direction?
- Most assets and liabilities are reported on the balance sheet at their acquisition price, called *historical cost*. Would reporting assets and liabilities at current market values be more informative? What problems might reporting balance sheets using current market value cause?

Review the Berkshire Hathaway balance sheet summarized in Exhibit 1.3 and think about these questions. We provide answers for each of these questions as we progress through the book.

Income Statement

An **income statement** reports on a company's performance over a period of time and lists amounts for revenues (also called sales) and expenses. Revenues less expenses yield the bottom-line net income amount.

Berkshire Hathaway's income statement is in Exhibit 1.4. Refer to its income statement to verify the following: revenues = \$81,663 million, expenses = \$73,135 million, and net income = \$8,528 million. Net income reflects the profit (also called earnings) to owners for that specific period.

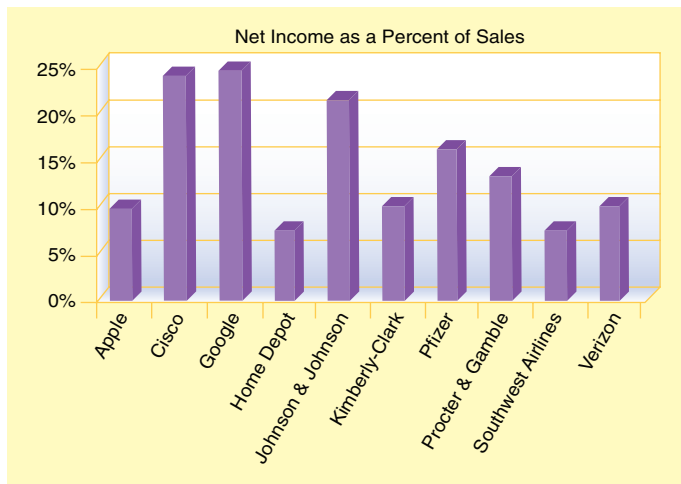
EXHIBIT 1.4 Income Statement (\$ millions)	
BERKSHIRE HATHAWAY Income Statement For Year Ended December 31, 2005	
Revenues	\$81,663
Expenses	<u>73,135</u>
Net income (loss)	<u>\$ 8,528</u>

Manufacturing and merchandising companies typically disclose the cost of goods sold (also called cost of sales) in the income statement. This measure is reported following revenues. It is also common to report the gross profit subtotal, which is revenues less the cost of goods sold. The company's remaining expenses are then reported below gross profit. This income statement layout follows:

Revenues	
– Cost of goods sold	Cost of materials, labor and overhead
= Gross profit	Revenues less cost of goods sold
– Expenses	
= Net income (loss)	

Operating Activities

Operating activities use company resources to produce, promote, and sell its products and services. These activities extend from input markets involving suppliers of materials and labor to a company's output markets involving customers of products and services. Input markets generate most *expenses* (or *costs*) such as inventory, salaries, materials, and logistics. Output markets generate *revenues* (or *sales*) to customers. Output markets also generate some expenses such as marketing and distributing products and services to customers. Net income arises when revenues exceed expenses. A loss occurs when expenses exceed revenues.



Differences exist in the relative profitability of companies across industries. Although effective management can increase the profitability of a company, business models play a large part in determining company profitability within an industry. These differences are highlighted in the graph (to the left) of net income as a percentage of sales for several companies we highlight in this book.

Home Depot operates in a mature industry with little ability to differentiate its products from those of its competitors. Hence, its net income as a percentage of sales is low. **Southwest Airlines** faces a different kind of problem: having competitors that are desperate and trying to survive. Profitability will not return to the transportation industry until weaker competitors are no longer protected by bankruptcy courts. At the other end of the spectrum are **Cisco** and **Google**. Both are dominant in their industries with

products protected by patent laws. Their profitability levels are more akin to that of monopolists.

As a sneak preview, we might consider the following questions regarding the income statement:

- Assume that a company sells a product to a customer who promises to pay in 30 days. Should the seller recognize the sale when it is made or when cash is collected?
- When a company purchases a long-term asset such as a building, its cost is reported on the balance sheet as an asset. Should a company, instead, record the cost of that building as an expense when it is acquired? If not, how should a company report the cost of that asset over the course of its useful life?

- Manufacturers and merchandisers report the cost of a product as an expense when the product sale is recorded. How might we measure the costs of a product that is sold by a merchandiser? By a manufacturer?
- If an asset, such as a building, increases in value, that increase in value is not reported as income until the building is sold, if ever. What concerns arise if we record increases in asset values as part of income, when measurement of that increase is based on appraised values?
- Employees commonly earn wages that are yet to be paid at the end of a particular period. Should their wages be recognized as an expense in the period that the work is performed, or when the wages are paid?
- Companies are not allowed to report profit on transactions relating to their own stock. That is, they don't report income when stock is sold, nor do they report an expense when dividends are paid to shareholders. Why is this the case?

Review the Berkshire Hathaway income statement summarized in Exhibit 1.4 and think about these questions. We provide answers for each of these questions as we progress through the book.

RESEARCH INSIGHT Are Earnings Important?

A recent study asked top finance executives of publicly traded companies to *rank the three most important measures to report to outsiders*. The study reports that:

“[More than 50% of] CFOs state that earnings are the most important financial metric to external constituents . . . this finding could reflect superior informational content in earnings over the other metrics. Alternatively, it could reflect myopic managerial concern about earnings. The emphasis on earnings is noteworthy because cash flows continue to be the measure emphasized in the academic finance literature.”

The study also reports that CFOs view year-over-year earnings to be of critical importance to outsiders. Why is that? The study provides the following insights.

“CFOs note that the first item in a press release is often a comparison of current quarter earnings with four quarters lagged quarterly earnings . . . CFOs also mention that while analysts' forecasts can be guided by management, last year's quarterly earnings number is a benchmark that is harder, if not impossible, to manage after the 10-Q has been filed with the SEC . . . Several executives mention that comparison to seasonally lagged earnings numbers provides a measure of earnings momentum and growth, and therefore is a useful gauge of corporate performance.”

Thus, are earnings important? To the majority of finance chiefs surveyed, the answer is a resounding yes. (Source: Graham, et al., *Journal of Accounting and Economics*, 2005)

Statement of Stockholders' Equity

The **statement of stockholders' equity**, or simply *statement of equity*, reports on changes in key types of equity over a period of time. For each type of equity the statement reports the beginning balance, a summary of the activity in the account during the year, and the ending balance. **Berkshire Hathaway's** statement of stockholders' equity is in Exhibit 1.5. During the recent period, its equity changed due to share issuances and income reinvestment. Berkshire Hathaway classifies these changes into three categories:

- Contributed capital from stockholders' net contributions to the company
- Retained earnings over the life of the company minus all dividends ever paid
- Other (see footnote 3)

Contributed capital represents the cash the company received from the sale of stock to stockholders (also called shareholders), less any funds expended for the repurchase of stock. Retained earnings (also called *earned capital* or *reinvested capital*) represent the cumulative total amount of income that the company has earned and that has been retained in the business and not distributed to shareholders in the form of dividends. The change in retained earnings links consecutive balance sheets via the income statement.

EXHIBIT 1.5 Statement of Equity (\$ millions)				
BERKSHIRE HATHAWAY Statement of Stockholders' Equity For Year Ended December 31, 2005				
	Contributed Capital	Retained Earnings	Other	Total
December 31, 2004	\$26,276	\$39,189	\$21,193	\$86,658
Stock issuance (repurchase)	131			131
Net income (Loss)		8,528		8,528
Dividends		0		0
Other			(3,017)	(3,017)
December 31, 2005	<u>\$26,407</u>	<u>\$47,717</u>	<u>\$18,176</u>	<u>\$92,300</u>

For Berkshire Hathaway, its recent year's retained earnings increases from \$39,189 million to \$47,717 million. This increase of \$8,528 million is explained by net income of \$8,528 million and no payment of dividends. (Ending retained earnings = Beginning retained earnings + Net income - Dividends; we discuss this relation further in Module 2).

Statement of Cash Flows

The **statement of cash flows** reports the change (either an increase or a decrease) in a company's cash balance over a period of time. The statement reports on cash inflows and outflows from operating, investing, and financing activities over a period of time. Berkshire Hathaway's statement of cash flows is in Exhibit 1.6. Its cash balance increased by \$1,233 million in the recent period. Of this increase in cash, operating activities generated an \$9,446 million cash inflow, investing activities reduced cash by \$13,841 million, and financing activities yielded a cash inflow of \$5,628 million.

EXHIBIT 1.6 Statement of Cash Flows (\$ millions)	
BERKSHIRE HATHAWAY Statement of Cash Flows For Year Ended December 31, 2005	
Operating cash flows	\$ 9,446
Investing cash flows	(13,841)
Financing cash flows	5,628
Net increase in cash	1,233
Cash, December 31, 2004	43,427
Cash, December 31, 2005	<u>\$44,660</u>

Berkshire Hathaway's operating cash flow of \$9,446 million does not equal its \$8,528 million net income. Generally, a company's net cash flow for a period does *not* equal its net income for the period. This is due to timing differences between when revenue and expense items are recognized on the income statement and when cash is received and paid. (We discuss this concept further in subsequent modules.)

Both cash flow and net income numbers are important for business decisions. Each is used in security valuation models, and both help users of accounting reports understand and assess a company's past, present, and future business activities.

As a sneak preview, we might consider the following questions regarding the statement of cash flows:

- What is the usefulness of companies providing the statement of cash flows? Do the balance sheet and income statement provide sufficient cash flow information?
- What types of information are disclosed in the statement of cash flows and why are they important?
- What kinds of activities are reported in each of the operating, investing and financing sections of the statement of cash flows? How is this information useful?
- Is it important for a company to report net cash inflows (positive amounts) relating to operating activities over the longer term? What are the implications if operating cash flows are negative for an extended period of time?
- Why is it important to know the composition of a company's investment activities? What kind of information might we look for? Are positive investing cash flows favorable?
- Is it important to know the sources of a company's financing activities? What questions might that information help us answer?
- How might the composition of operating, investing and financing cash flows change over a company's life cycle?
- Is the bottom line increase in cash flow the key number? Why or why not?

Review the Berkshire Hathaway statement of cash flows summarized in Exhibit 1.6 and think about these questions. We provide answers for each of these questions as we progress through the book.

Financial Statement Linkages

The four financial statements are linked within and across periods—see Exhibit 1.2.

- The income statement and the balance sheet are linked via retained earnings. For Berkshire Hathaway, the \$8,528 million increase in retained earnings (reported on the balance sheet) equals its net income (reported on the income statement). Berkshire Hathaway did not pay dividends this year.
- Retained earnings, contributed capital, and other equity balances appear both on the statement of stockholders' equity and the balance sheet.
- The statement of cash flows is linked to the income statement as net income is a component of operating cash flow. The statement of cash flows is also linked to the balance sheet as the change in the balance sheet cash account reflects the net of cash inflows and outflows for the period.

Items that impact one financial statement ripple through the others. Linkages among the four financial statements are an important feature of the accounting system. We discuss this concept further and present a numerical example illustrating these linkages in Module 2.

BUSINESS INSIGHT Warren Buffett on Financial Reports

“When Charlie and I read reports, we have no interest in pictures of personnel, plants or products. References to EBITDA [earnings before interest, taxes, depreciation and amortization] make us shudder—does management think the tooth fairy pays for capital expenditures? We're very suspicious of accounting methodology that is vague or unclear, since too often that means management wishes to hide something. And we don't want to read messages that a public relations department or consultant has turned out. Instead, we expect a company's CEO to explain in his or her own words what's happening.” —[Berkshire Hathaway](#) annual report

Information Beyond Financial Statements

Important financial information about a company is communicated to various decision makers through reports other than the four 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.

MANAGERIAL DECISION

You Are the Product Manager

There is often friction between investors' need for information and a company's desire to safeguard competitive advantages. Assume that you are a key-product manager at your company. Your department has test-marketed a potentially lucrative new product, which it plans to further finance. You are asked for advice on the extent of information to disclose about the new product in the MD&A section of the company's upcoming annual report. What advice do you provide and why? [Answer, p. 1-30]

MID-MODULE REVIEW

The following financial information is from **Allstate Corporation**, a competitor of Berkshire Hathaway's GEICO Insurance, for the year ended December 31, 2005 (\$ millions).

Cash, ending year	\$ 313
Cash flows from operations	5,605
Revenues	35,383
Stockholders' equity	20,186
Cash flows from financing	(555)
Total liabilities	135,886
Expenses	33,618
Noncash assets	155,759
Cash flows from investing	(5,151)
Net income	1,765
Cash, beginning year	414

Required

1. Prepare an income statement, balance sheet, and statement of cash flows for Allstate at December 31, 2005.
2. Compare the balance sheet and income statement of Allstate to those of Berkshire Hathaway in Exhibits 1.3 and 1.4. What differences are observed?

Solution

1.

ALLSTATE CORPORATION Income Statement For Year Ended December 31, 2005	
Revenues	\$35,383
Expenses	33,618
Net income	<u>\$ 1,765</u>

ALLSTATE CORPORATION Balance Sheet December 31, 2005			
Cash asset	\$ 313	Total liabilities	\$135,886
Noncash assets	155,759	Stockholders' equity	20,186
Total assets.	<u>\$156,072</u>	Total liabilities and equity . .	<u>\$156,072</u>

ALLSTATE CORPORATION Statement of Cash Flows For Year Ended December 31, 2005	
Cash flows from operations	\$5,605
Cash flows from investing	(5,151)
Cash flows from financing	(555)
Net increase (decrease) in cash	(101)
Cash, beginning year	414
Cash, ending year	<u>\$ 313</u>

2. Berkshire Hathaway is a larger company; its total assets are \$198,325 million compared to Allstate's assets of \$156,072 million. In percentage terms, Berkshire Hathaway is 27% larger. The income statements of the two companies are markedly different. Berkshire Hathaway reports more than twice as much revenue (\$81,663 million compared to \$35,383 million). The difference in net income is even more drastic; Berkshire Hathaway earned \$8,528 million whereas Allstate reported net income of only \$1,765 million. This is nearly five times more net income! The two companies are not direct competitors in that Berkshire Hathaway has a wide array of companies in its consolidated group, whereas Allstate is mainly a property and casualty insurer.

PROFITABILITY ANALYSIS

This section previews the analysis framework of this book. This framework is used extensively by market professionals who analyze financial reports to evaluate company management and value the company's debt and equity securities. Analysis of financial performance is crucial in assessing prior strategic decisions and evaluating strategic alternatives.

LO3 Explain the basics of profitability analysis.

Return on Net Operating Assets

Suppose we learn that a company reports an operating profit of \$10 million. Is this company performing well? Knowing that a company reports a profit is certainly positive as it indicates that customers value its goods or services and that its revenues exceed expenses. However, we cannot assess how well it is performing. To explain, suppose we learn that this company has \$500 million in operating assets. We now assess the \$10 million in operating profit as low. This is because relative to the size of its asset investment, the company earned a paltry 2% return, computed as \$10 million divided by \$500 million. A 2% return is what a much lower-risk savings account might yield. The important point is that a company's profitability must be assessed with respect to the size of its investment. The metric we used here is known as the *return on net operating assets* (RNOA)—defined as net operating profit after tax for that period, divided by the average net operating assets for that period.

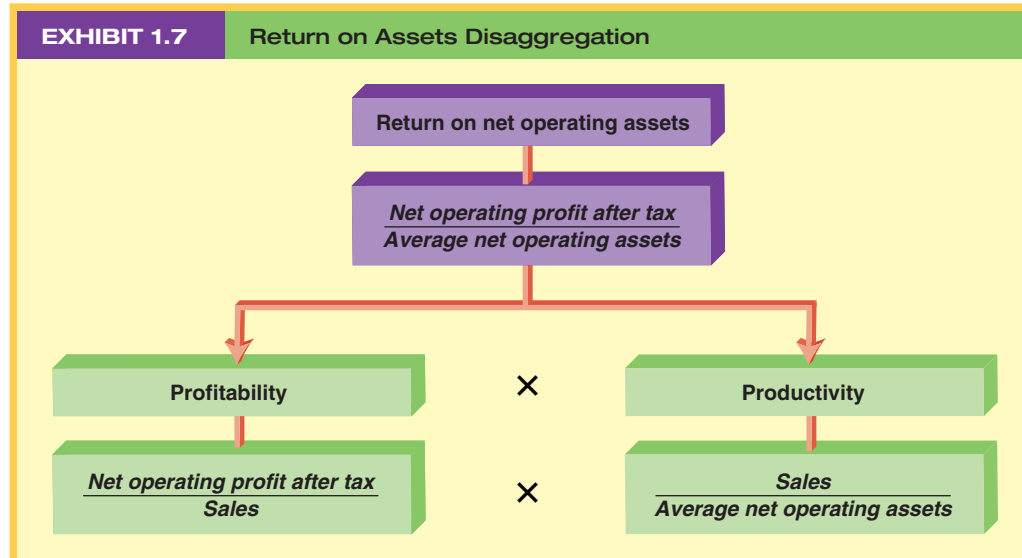
Components of Return on Net Operating Assets

We can separate return on net operating assets into two components: profitability and productivity. Profitability relates net operating profit after tax to sales, called the *net operating profit margin* (NOPM), and reflects the profit earned on each sales dollar. Management wants to earn as much profit as possible from sales.

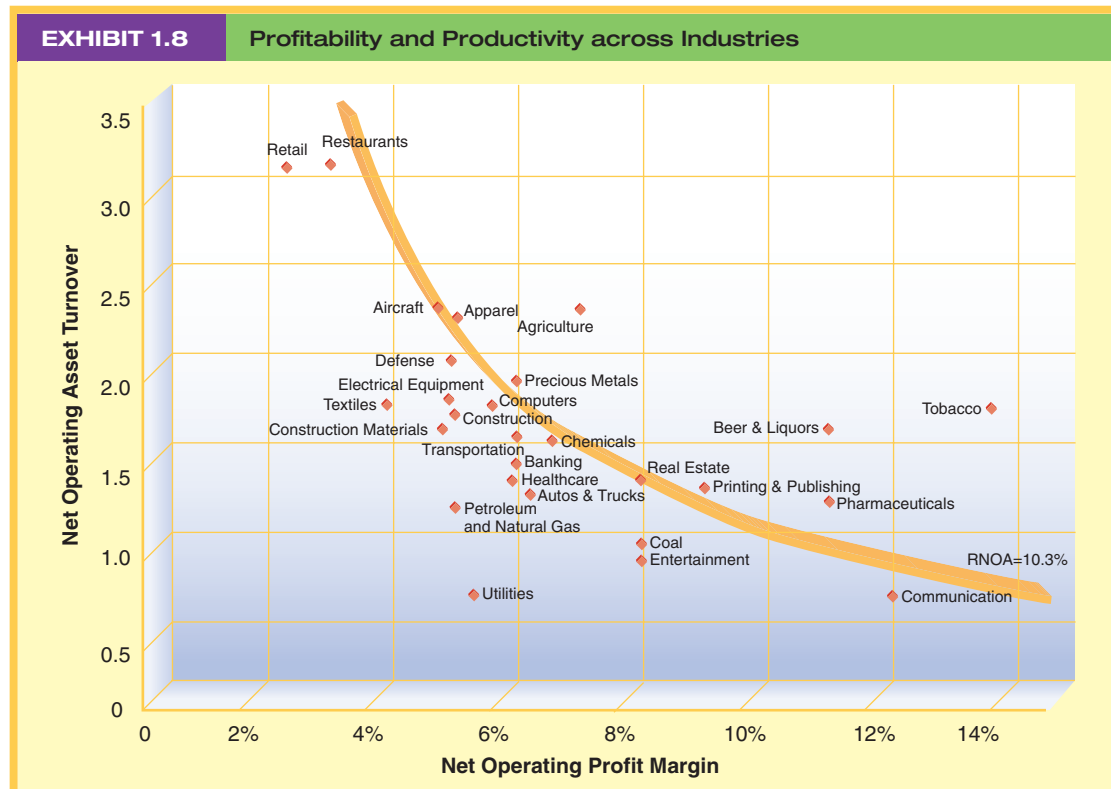
Productivity relates sales to net operating assets. This component, called the *net operating asset turnover* (NOAT), reflects sales generated by each dollar of operating assets. Management wants to maximize

asset productivity, that is, to achieve the highest possible sales level for a given level of operating assets (or to achieve a given level of sales with the smallest level of operating assets).

Exhibit 1.7 depicts the disaggregation of return on net operating assets into these two components. Profitability (NOPM) and productivity (NOAT) are multiplied to yield the return on net operating assets (RNOA).



There are an infinite number of combinations of net operating profit margin and net operating asset turnover that yield the same return on net operating assets. To illustrate, Exhibit 1.8 graphs actual combinations of these two components for many industries over the past 15 years. The solid line represents those profitability and productivity combinations that yield a 10.3% return on net operating assets, which is the median return for all publicly traded companies. Industries such as restaurants and retailers have low profit margins but very high asset turnovers. Asset intensive industries, such as coal and pharmaceuticals, earn a high profit margin but do not turn their assets over as frequently.



Return on Equity

Another important analysis measure is return on equity (ROE), which compares net income to average stockholders' equity. In this case, company earnings are compared to the level of stockholder (not total) investment. We further discuss ROE, RNOA, and their disaggregation in Module 4.

MANAGERIAL DECISION **You Are the Chief Financial Officer**

You are reviewing your company's financial performance for the first six months of the year and are unsatisfied with the results. How can you use return on net operating assets disaggregation to identify areas for improvement? [Answer, p. 1-30]

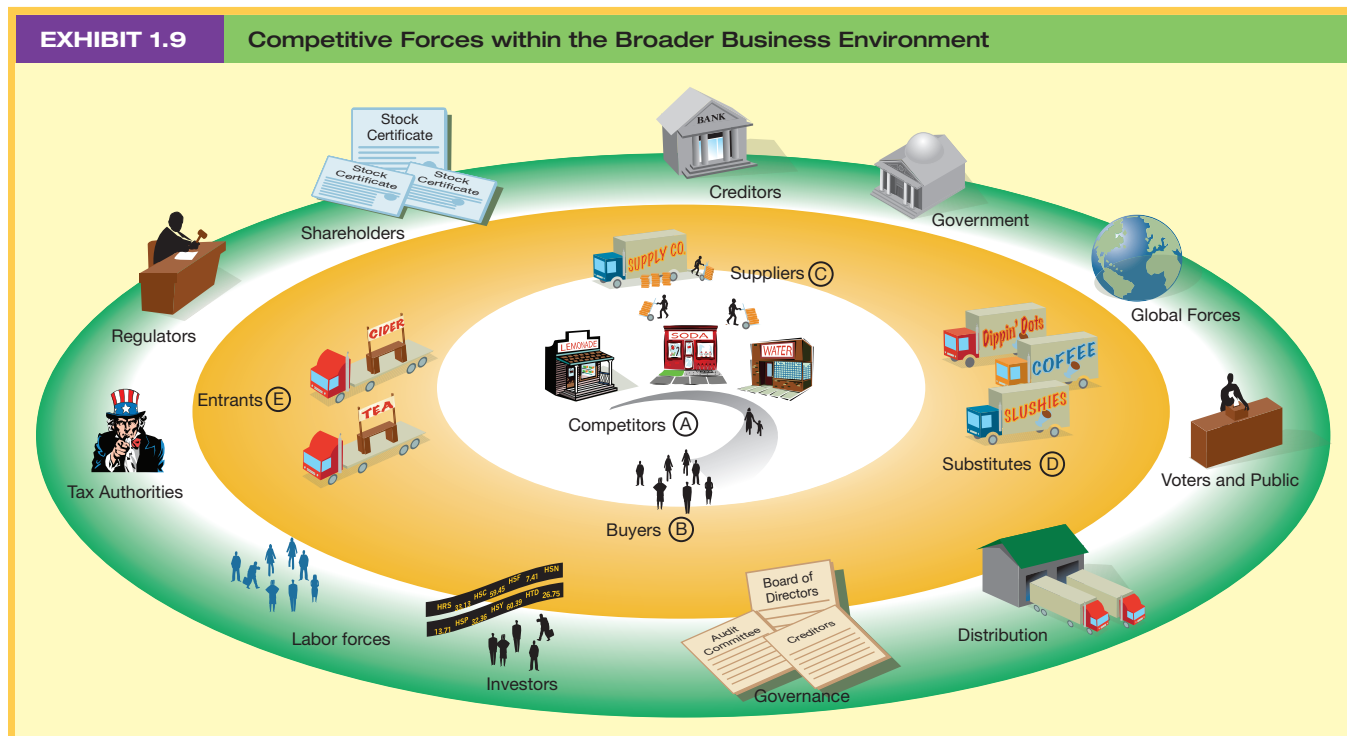
Financial Accounting and Business Analysis

Analysis and interpretation of financial statements must consider the broader business context in which a company operates. This section describes how to systematically consider those broader business forces to enhance our analytical and interpretive skills. We can then better extract insights from financial statements and better estimate future performance and company value.

LO4 Describe business analysis within the context of a competitive environment.

Analyzing the Competitive Environment

Financial statements are influenced by five important forces that confront the company and determine its competitive intensity: (A) industry competition, (B) buyer power, (C) supplier power, (D) product substitutes, and (E) threat of entry (for further discussion, see Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors*, 1980 and 1998). These five forces are depicted graphically in Exhibit 1.9.



The five forces depicted in Exhibit 1.9 are key determinants of profitability.

- (A) **Industry competition** Competition and rivalry raises the cost of doing business as companies must hire and train competitive workers, advertise products, research and develop products, and other related activities.
- (B) **Bargaining power of buyers** Buyers with strong bargaining power can extract price concessions and demand a higher level of service and delayed payment terms; this force reduces both profits from sales and the operating cash flows to sellers.

- Ⓒ **Bargaining power of suppliers** Suppliers with strong bargaining power can demand higher prices and earlier payments, yielding adverse effects on profits and cash flows to buyers.
- Ⓓ **Threat of substitution** As the number of product substitutes increases, sellers have less power to raise prices and/or pass on costs to buyers; accordingly, threat of substitution places downward pressure on profits of sellers.
- Ⓔ **Threat of entry** New market entrants increase competition; to mitigate that threat, companies expend monies on activities such as new technologies, promotion, and human development to erect *barriers to entry* and to create *economies of scale*.

This broader business environment affects the level of profitability that a company can expect to earn. Global economic forces and the quality and cost of labor affect the macroeconomy in which the company operates. Government regulation, borrowing agreements exacted by creditors, and internal governance procedures also affect the range of operating activities in which a company can engage. In addition, strategic plans are influenced by the oversight of equity markets, and investors are loathe to allow companies the freedom to manage for the longer term. Each of these external forces affects a company's strategic planning and expected level of profitability.

The relative strength of companies within their industries, and vis-à-vis suppliers and customers, is an important determinant of both their profitability and the structure of their balance sheets. As competition intensifies, profitability likely declines, and the amount of assets companies need to carry on their balance sheet likely increases. These changes in the income statement and the balance sheet can adversely impact operating performance.

Effect on RNOA and Its Components

Exhibit 1.8 plots operating profit margin (NOPM) and asset turnover (NOAT) for many industries. This graph reveals differences that exist across industries and how those differences are reflected in financial performance metrics.

Individual companies *within* an industry can be plotted in a similar manner. Generally, companies that effectively mitigate competitive forces are able to move toward the upper right area of the graph. That is, they are able to earn greater profit margins, or produce a higher turnover of operating assets, or both. The net result is that they are able to earn a higher RNOA than their peers.

Applying Competitive Analysis

We apply the competitive analysis framework to help interpret the financial results of McLane Company. McLane is a subsidiary of Berkshire Hathaway and was acquired in 2003 as explained in the following note to the Berkshire Hathaway annual report:

On May 23, 2003, Berkshire acquired McLane Company, Inc., ("McLane") a distributor of grocery and food products to retailers, convenience stores and restaurants. Results of McLane's business operations are included in Berkshire's consolidated results beginning on that date. McLane's revenues in 2005 totaled \$24.1 billion compared to \$23.4 billion in 2004 and approximately \$22.0 billion for the full year of 2003. Sales of grocery products increased about 5% in 2005 and were partially offset by lower sales to foodservice customers. McLane's business is marked by high sales volume and very low profit margins. Pretax earnings in 2005 of \$217 million declined \$11 million versus 2004. The gross margin percentage was relatively unchanged between years. However, the resulting increased gross profit was more than offset by higher payroll, fuel and insurance expenses. Approximately 33% of McLane's annual revenues currently derive from sales to Wal-Mart. Loss or curtailment of purchasing by Wal-Mart could have a material adverse impact on revenues and pre-tax earnings of McLane.

McLane is a wholesaler of food products; it purchases food products in finished and semifinished form from agricultural and food-related businesses and resells them to grocery and convenience food stores. The extensive distribution network required in this business entails considerable investment.

Industry Analysis Our business analysis of McLane's financial results includes the following observations:

- **Industry competitors** McLane has many competitors with food products that are difficult to differentiate.

- **Bargaining power of buyers** The note above reveals that 33% of McLane's sales are to Wal-Mart, which has considerable buying power that limits seller profits; also, the food industry is characterized by high turnover and low profit margins, which implies that cost control is key to success.
- **Bargaining power of suppliers** McLane is large (\$24 billion in annual sales), which implies its suppliers are unlikely to exert forces to increase its cost of sales.
- **Threat of substitution** Grocery items are usually not well differentiated; this means the threat of substitution is high, which inhibits its ability to raise selling prices.
- **Threat of entry** High investment costs, such as warehousing and logistics, are a barrier to entry in McLane's business; this means the threat of entry is relatively low.

Our analysis reveals that McLane is a high-volume, low-margin company. Its ability to control costs is crucial to its financial performance, including its ability to fully utilize its assets. Evaluation of McLane's financial statements should focus on that dimension.

Business Analysis Quality analysis depends on an effective business analysis. Before we analyze a single accounting number, we must ask questions about a company's business environment such as the following:

- *Life cycle* At what stage in its life is this company? Is it a startup, experiencing growing pains? Is it strong and mature, reaping the benefits of competitive advantages? Is it nearing the end of its life, trying to milk what it can from stagnant product lines?
- *Outputs* What products does it sell? Are its products new, established, or dated? Do its products have substitutes? How complicated are its products to produce?
- *Buyers* Who are its buyers? Are buyers in good financial condition? Do buyers have substantial purchasing power? Can the seller dictate sales terms to buyers?
- *Inputs* Who are its suppliers? Are there many supply sources? Does the company depend on a few supply sources with potential for high input costs?
- *Competition* In what kind of markets does it operate? Are markets open? Is the market competitive? Does the company have competitive advantages? Can it protect itself from new entrants? At what cost? How must it compete to survive?
- *Financing* Must it seek financing from public markets? Is it going public? Is it seeking to use its stock to acquire another company? Is it in danger of defaulting on debt covenants? Are there incentives to tell an overly optimistic story to attract lower cost financing or to avoid default on debt?
- *Labor* Who are its managers? What are their backgrounds? Can they be trusted? Are they competent? What is the state of employee relations? Is labor unionized?
- *Governance* How effective is its corporate governance? Does it have a strong and independent board of directors? Does a strong audit committee of the board exist, and is it populated with outsiders? Does management have a large portion of its wealth tied to the company's stock?
- *Risk* Is it subject to lawsuits from competitors or shareholders? Is it under investigation by regulators? Has it changed auditors? If so, why? Are its auditors independent? Does it face environmental and/or political risks?

We must assess the broader business context in which a company operates as we read and interpret its financial statements. A review of financial statements, which reflect business activities, cannot be undertaken in a vacuum. It is contextual and can only be effectively undertaken within the framework of a thorough understanding of the broader forces that impact company performance. We should view the above questions as a sneak preview of the types we will ask and answer throughout this book when we read and interpret financial statements.

MODULE-END REVIEW

Following are selected data from [Progressive Corporation's](#) 2005 10-K.

\$ millions	2005
Sales	\$14,303
Net operating profit after tax	1,450
Net income	1,394
Average net operating assets	6,916
Average stockholders' equity	5,631

Required

- Compute Progressive's return on net operating assets. Disaggregate the RNOA into its profitability and productivity components.
- Compute Progressive's return on equity (ROE).
- Consider Exhibit 1.8 that plots industries' RNOA components. Where does Progressive fit on the graph? How does Progressive's profitability and productivity compare to other industries?

Solution

- RNOA = net operating profit after tax / average net operating assets = \$1,450 / \$6,916 = 21.0%. The profitability component is net operating profit after tax / sales = \$1,450 / \$14,303 = 10.1%, and the productivity component is sales / average net operating assets = \$14,303 / \$6,916 = 2.07. Notice that $10.1\% \times 2.07 = 20.9\%$. Thus, the two components, when multiplied yield RNOA (with a minor rounding difference).
- ROE = net income / average stockholders' equity = \$1,394 / \$5,631 = 24.8%.
- Progressive has a very high RNOA. Net operating asset turnover is 2, which is not unusual (most of the industries have turnovers between 1.5 and 2). However, with a 10.1% NOPM, Progressive is more profitable than most industries with the exception of Tobacco, Pharmaceuticals, Communications and Liquor. Thus, Progressive's high RNOA derives from its high profitability and its solid asset productivity.

APPENDIX 1A: Accessing SEC Filings using EDGAR

All publicly traded companies are required to file various reports with the SEC, two of which are the 10-Q (quarterly financial statements) and the 10-K (annual financial statements). The SEC archives these reports in a system called EDGAR, an acronym for electronic data gathering and retrieval. Following is a brief tutorial to access these electronic filings. The SEC's web site is <http://www.sec.gov>.

1. Following is the opening screen. Click on **Search for Company Filings** (highlighted below)



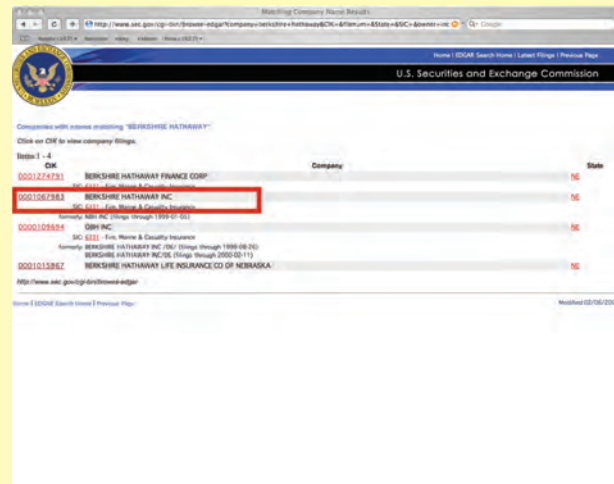
2. Then, click on **Companies & Other Filers**



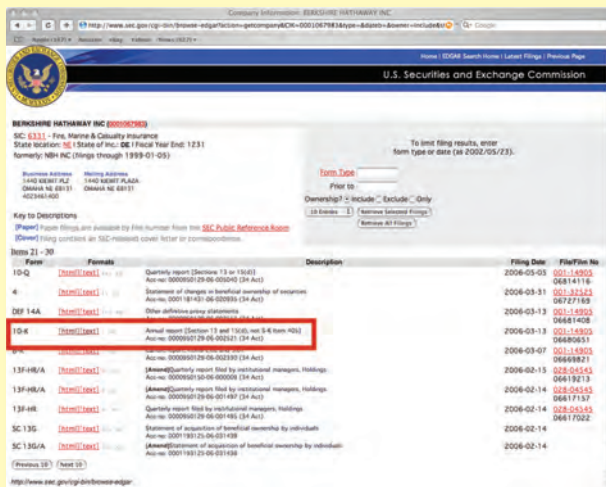
3. In **Company name**, type in the name of the company you are looking for. In this case, we are searching for Berkshire Hathaway. Then click on 'Find Companies.'



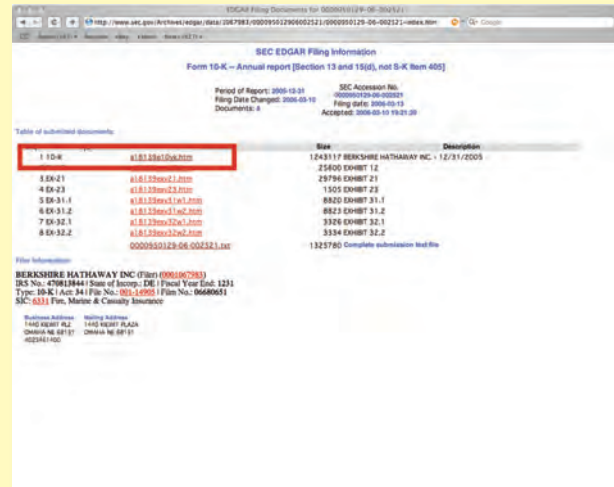
4. Several references to Berkshire appear. Click on the **CIK** (the SEC's numbering system) next to Berkshire Hathaway, Inc.



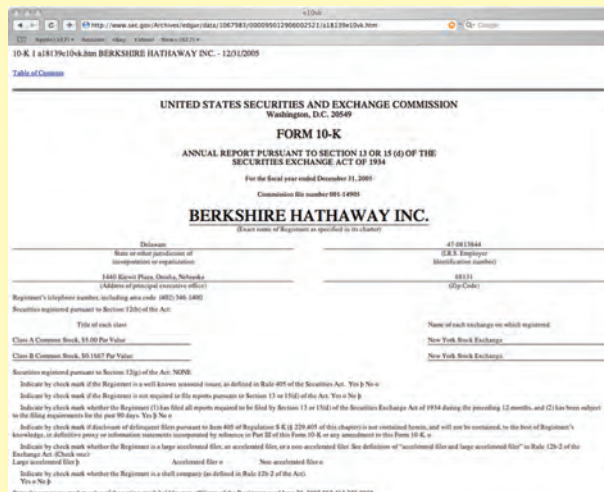
5. Find the form you want to access. In this case we are looking for its 10-K. Click on the **html** link because it's easier to read than the text file.



6. The various exhibits relating to Berkshire Hathaway's 10-K appear. Click on the **10-K** line.



7. The Berkshire Hathaway 10-K will open up. The file is searchable.



APPENDIX 1B: Accounting Principles and Governance

Financial Accounting Environment

LO5 Describe the accounting principles that guide preparation of financial statements.

Information in financial statements is crucial to valuing a company's debt and equity securities. Financial statements information can affect the price the market is willing to pay for the company's equity securities and interest rates attached to its debt securities.

The importance of financial statements means that their reliability is paramount. This includes the crucial role of ethics. To the extent that financial performance and condition are accurately communicated to business decision makers, debt and equity securities are more accurately priced. When securities are mis-priced, resources can be inefficiently allocated both within and across economies. Accurate, reliable financial statements are also important for the effective functioning of many other markets such as labor, input, and output markets.

To illustrate, recall the consequences of a breakdown in the integrity of the financial accounting system at **Enron**. Once it became clear that Enron had not faithfully and accurately reported its financial condition and performance, the market became unwilling to purchase Enron's securities. The value of its debt and equity securities dropped precipitously and the company was unable to obtain cash needed for operating activities. Within months of the disclosure of its financial accounting irregularities, Enron, with revenues of over \$100 billion and total company value of over \$60 billion, the fifth largest U.S. company, was bankrupt!

Further historical evidence of the importance of financial accounting is provided by the Great Depression of the 20th century. This depression was caused, in large part, by the failure of companies to faithfully report their financial condition and performance.

Oversight of Financial Accounting

The stock market crash of 1929 and the ensuing Great Depression led Congress to pass the 1933 Securities Act. This act had two main objectives: (1) to require disclosure of financial and other information about securities being offered for public sale; and (2) to prohibit deceit, misrepresentations, and other fraud in the sale of securities. This act also

required that companies register all securities proposed for public sale and disclose information about the securities being offered, including information about company financial condition and performance. This act became and remains a foundation for contemporary financial reporting.

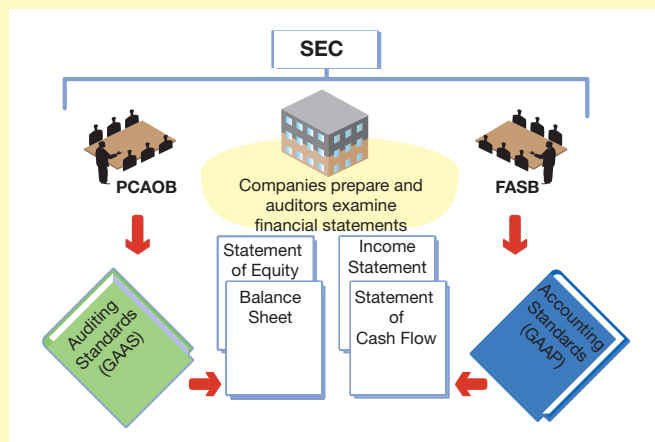
Congress also passed the 1934 Securities Exchange Act, which created the **Securities and Exchange Commission (SEC)** and gave it broad powers to regulate the issuance and trading of securities. The act also provided that companies with more than \$10 million in assets and whose securities are held by more than 500 owners must file annual and other periodic reports, including financial statements that are available for download from the SEC's EDGAR database (www.sec.gov).

The SEC has ultimate authority over U.S. financial reporting, including setting accounting standards for preparing financial statements. Since 1939, however, the SEC has looked to the private

sector to set accounting standards—the SEC retains the right to overrule or revise standards with which it disagrees. One such private sector organization is the American Institute of Certified Public Accountants (AICPA), whose two committees, the Committee on Accounting Procedure (1939–59) and the Accounting Principles Board (1959–73), authored the initial body of accounting standards.

Currently, the **Financial Accounting Standards Board (FASB)** sets U.S. financial accounting standards. The FASB is an independent body overseen by a foundation, whose members include public accounting firms, investment managers, academics, and corporate managers. The FASB has published over 150 accounting standards governing the preparation of financial reports. This is in addition to over 40 standards that were written by predecessor organizations to the FASB, numerous bulletins and interpretations, Emerging Issues Task Force (EITF) statements, AICPA statements of position (SOP), and direct SEC guidance, along with speeches made by high-ranking SEC personnel, all of which form the body of accounting standards governing financial statements. Collectively, these pronouncements, rules and guidance create what is called **Generally Accepted Accounting Principles (GAAP)**.

The standard-setting process is arduous, often lasting up to a decade and involving extensive comment by the public, public officials, accountants, academics, investors, analysts, and corporate preparers of financial reports. To influence the standard-setting process, special interest groups often lobby members of Congress to pressure the SEC and, ultimately, the FASB, on issues about which constituents feel strongly. The reason for this involved process is that amendments to existing standards or the creation of new standards affect the reported financial performance and



condition of companies. Consequently, given the widespread impact of financial accounting, there are considerable economic consequences as a result of accounting changes.

International Accounting Standards and Convergence

A single set of international accounting standards that is accepted in all capital markets throughout the world does not exist. In the U.S., public firms must file financial reports using U.S. generally accepted accounting principles (GAAP). Foreign firms filing with the SEC can use U.S. GAAP, their home country GAAP, or international standards—although if they use their home country GAAP or international standards, foreign issuers must reconcile their numbers to U.S. GAAP.

The International Accounting Standards Board (IASB) oversees development of international accounting standards. In 2002, the FASB and the IASB announced their commitment to minimize differences between U.S. and international accounting standards. Although the two rule-making bodies have achieved consensus on broad philosophical issues, agreement on the detailed wording of standards is more difficult to achieve.

Differences between U.S. and international accounting standards remain. One major advance, however, is that beginning in 2005, European Union companies must use IASB standards rather than their home-country GAAP. Summaries of differences between U.S. and international GAAP are available on the web. One source is the large international public accounting firms (for example, see PWC.com and search IFRS and GAAP).

Choices in Financial Accounting

Some people mistakenly assume that financial accounting is an exact discipline—that is, companies select the one proper accounting method to account for a transaction, and then follow the rules. The reality is that GAAP allows companies choices in preparing financial statements. The choice of methods often yields financial statements that are markedly different from one another in terms of reported income, assets, liabilities, and equity amounts.

People often are surprised that financial statements comprise numerous estimates. For example, companies must estimate the amounts that will eventually be collected from customers, the length of time that buildings and equipment will be productive, the value impairments of assets, the future costs of warranty claims, and the eventual payouts on pension plans.

Recent Accounting Scandals	
Company	Allegations
Adelphia Communications (ADELQ)	Founding Rigas family collected \$3.1 billion in off-balance-sheet loans backed by Adelphia; overstated results by inflating capital expenses and hiding debt.
TWX Time Warner (TWX)	As the ad market faltered and AOL's purchase of Time Warner loomed, AOL inflated sales by booking revenue for barter deals and ads it sold for third parties. These questionable revenues boosted growth rates and sealed the deal. AOL also boosted sales via "round-trip" deals with advertisers and suppliers.
Bristol-Myers Squibb (BMY)	Inflated its 2001 revenue by \$1.5 billion by "channel stuffing," or forcing wholesalers to accept more inventory than they could sell to get inventory off Bristol-Myers' books.
Enron	Created profits and hid debt totaling over \$1 billion by improperly using off-the-books partnerships; manipulated the Texas power market; bribed foreign governments to win contracts abroad; manipulated California energy market.
Global Crossing	Engaged in network capacity "swaps" with other carriers to inflate revenue; shredded documents related to accounting practices.
Halliburton (HAL)	Improperly booked \$100 million in annual construction-cost overruns before customers agreed to pay for them.
Qwest Communications International (Q)	Inflated revenue using network capacity "swaps" and improper accounting for long-term deals.
Tyco (TYC)	Ex-CEO L. Dennis Kozlowski indicted for tax evasion; Kozlowski and former CFO Mark H. Swartz, convicted of taking unauthorized loans from the company.
WorldCom	Overstated cash flow by booking \$11 billion in operating expenses as capital costs; loaned founder Bernard Ebbers \$400 million off-the-books.
Xerox (XRX)	Falsified financial results for five years, over-reported income by \$1.5 billion.

Accounting standard setters walk a fine line regarding choice in accounting. On one hand, they are concerned that choice in preparing financial statements will lead to abuse by those seeking to gain by influencing decisions of

financial statement users. On the other hand, standard setters are concerned that companies are too diverse for a “one size fits all” financial accounting system.

For example, **Enron** exemplifies the problems that accompany rigid accounting standards. A set of accounting standards relating to special purpose entities (SPEs) provided preparers with guidelines under which those entities were or were not to be consolidated. Unfortunately, once the SPE guidelines were set, some people worked diligently to structure SPE transactions so as to just miss the consolidation requirements and achieve *off-balance-sheet* financing. This is just one example of how, with rigid standards, companies can adhere to the letter of the rule, but not its intent. In such situations, the financial statements are not fairly presented.

For most of its existence, the FASB has promulgated standards that were quite complicated and replete with guidelines. This invited abuse of the type embodied by the Enron scandal. In recent years, the pendulum has begun to swing away from such rigidity. Now, once financial statements are prepared, company management is required to step back from the details and make a judgment on whether the statements taken as a whole ‘fairly present’ the financial condition of the company.

Moreover, since the enactment of the **Sarbanes-Oxley Act**, the SEC requires the chief executive officer (CEO) of the company and its chief financial officer (CFO) to personally sign a statement attesting to the accuracy and completeness of the financial statements. This requirement is an important step in restoring confidence in the integrity of financial accounting. The statements signed by both the CEO and CFO contain the following statements:

- Both the CEO and CFO have personally reviewed the annual report
- There are no untrue statements of a material fact that would make the statements misleading
- Financial statements fairly present in all material respects the financial condition of the company
- All material facts are disclosed to the company’s auditors and board of directors
- No changes to its system of internal controls are made unless properly communicated

The Sarbanes-Oxley Act also imposed fines and potential jail time for executives. Presumably, the prospect of personal losses is designed to make these executives more vigilant in monitoring the financial accounting system.

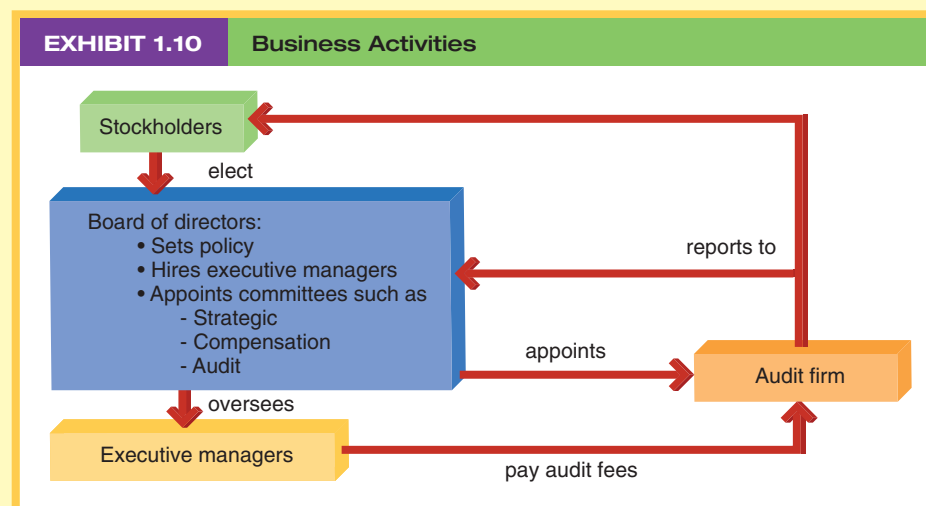
Regulatory and Legal Environment

Even though key executives must personally attest to the completeness and accuracy of company financial statements, markets demand further assurances from outside parties to achieve the level of confidence necessary to warrant investment, credit, and other business decisions. The regulatory and legal environment provides further assurance that financial statements are complete and accurate.

Audit Committee

Law requires each publicly traded company to have a board of directors, where stockholders elect each director. This board represents the company owners and oversees management. The board also hires the company’s executive management and regularly reviews company operations.

The board of directors usually establishes several subcommittees to focus on particular governance tasks such as compensation, strategic plans, and financial management. Exhibit 1.10 illustrates a typical organization of a company’s governance structure. Corporate governance refers to the checks and balances that monitor company and manager activities. Governance committees are commonplace. One of these, the audit committee, oversees the financial accounting system.



The audit committee must consist solely of outside directors, and cannot include the CEO. As part of its oversight of the financial accounting system, the audit committee focuses on **internal controls**, which are the policies and procedures used to protect assets, ensure reliable accounting, promote efficient operations, and urge adherence to company policies.

Statement of Management Responsibility

Following passage of the Sarbanes-Oxley Act, the SEC issued a ruling requiring companies “to include in their annual reports a report of management on the company’s internal control over financial reporting.” Many companies incorporate the rule’s requirements by reference in their disclosures. Others, like **Home Depot** in Exhibit 1.11 make explicit reference to the rule’s provisions.

EXHIBIT 1.11 Responsibility for Financial Reporting

Management’s Responsibility Financial Statements

The financial statements presented in this Annual Report have been prepared with integrity and objectivity and are the responsibility of the management of The Home Depot, Inc. These financial statements have been prepared in conformity with U.S. generally accepted accounting principles and properly reflect certain estimates and judgments based upon the best available information.

The financial statements of the Company have been audited by KPMG LLP, an independent registered public accounting firm. Their accompanying report is based upon an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States).

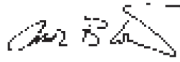
The Audit Committee of the Board of Directors, consisting solely of outside directors, meets five times a year with the independent registered public accounting firm, the internal auditors and representatives of management to discuss auditing and financial reporting matters. In addition, a telephonic meeting is held prior to each quarterly earnings release. The Audit Committee retains the independent registered public accounting firm and regularly reviews the internal accounting controls, the activities of the independent registered public accounting firm and internal auditors and the financial condition of the Company. Both the Company’s independent registered public accounting firm and the internal auditors have free access to the Audit Committee.

Management’s Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a–15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our evaluation, our management concluded that our internal control over financial reporting was effective as of January 30, 2005. Our management’s assessment of the effectiveness of our internal control over financial reporting as of January 30, 2005 has been audited by KPMG LLP, an independent registered public accounting firm, as stated in its report which is included herein.



Robert L. Nardelli
Chairman, President &
Chief Executive Officer



Carol B. Tomé
Executive Vice President &
Chief Financial Officer



Kelly H. Barrett
Vice President
Corporate Controller

The statement of responsibility contains several assertions by management:

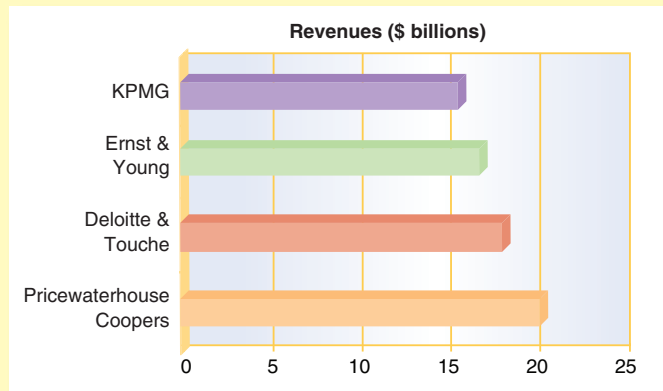
1. Financial statements are prepared by management, which assumes responsibility for them
2. Financial statements are prepared in conformity with GAAP
3. Financial statements are audited by an external auditing firm
4. Board of directors has an audit committee to oversee the financial accounting system and the system of internal controls
5. Management is responsible for establishing and maintaining adequate internal control over financial reporting.

It is important to remember that management prepares financial statements—not the auditors who are hired to express an opinion on those statements. Moreover, remember that management’s interests may or may not be aligned with those of other stakeholders.

Audit Report

Financial statements for each publicly traded company must be audited by an independent audit firm. There are four large, international auditing firms that are authorized by the SEC to provide auditing services for companies that issue securities to the public:

1. **Deloitte & Touche LLP**
2. **Ernst & Young LLP**
3. **KPMG LLP**
4. **PricewaterhouseCoopers LLP**



These four firms provide opinions for the majority of financial statements filed by publicly traded U.S. companies. There also are a number of regional accounting firms that provide audit services to both publicly traded and nontraded private companies.

A company's Board of Directors hires the auditors to review and express an opinion on its financial statements. The audit opinion expressed by Deloitte & Touche, LLP on the financial statements of **Berkshire Hathaway** is reproduced in Exhibit 1.12.

EXHIBIT 1.12

Audit Report for Berkshire Hathaway

To the Board of Directors and Shareholders, Berkshire Hathaway Inc.

We have audited the accompanying consolidated balance sheets of Berkshire Hathaway Inc. and subsidiaries (the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of earnings, cash flows and changes in shareholders' equity and comprehensive income for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Berkshire Hathaway Inc. and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 2, 2006 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

DELOITTE & TOUCHE LLP
Omaha, Nebraska
March 2, 2006

The basic ‘clean’ audit report is consistent across companies and includes these assertions:

- Financial statements *present fairly, in all material respects* a company’s financial condition, in conformity with GAAP.
- Financial statements are management’s responsibility. Auditor responsibility is to express an opinion on those statements.
- Auditing involves a sampling of transactions, not investigation of each transaction.
- Audit opinion provides *reasonable assurance* that the statements are free of *material* misstatements, not a guarantee.
- Auditors review accounting policies used by management and the estimates used in preparing the statements.

Unless all of these conditions are met, the auditor cannot issue a clean opinion. Instead, the auditor issues a “qualified” opinion and states the reasons a clean opinion cannot be issued. Financial report readers should scrutinize with care both the qualified audit opinion and the financial statements themselves.

The audit opinion is not based on a test of each transaction. Auditors usually develop statistical samples and infer test results to other transactions. The audit report is not a guarantee that no misstatements exist. Auditors only provide reasonable assurance that the statements are free of material misstatements. Their use of the word reasonable is deliberate, as they do not want to be held to an absolute standard should problems be subsequently uncovered. The word material is used in the sense that an item must be of sufficient magnitude to change the perceptions or decisions of the financial statement user (such as a decision to purchase stock or extend credit).

The requirement of auditor independence is the cornerstone of effective auditing and is subject to debate because the company pays the auditor’s fees. Regulators have questioned the perceived lack of independence of auditing firms and the degree to which declining independence compromises the ability of auditing firms to challenge a client’s dubious accounting.

The Sarbanes-Oxley Act contained several provisions designed to encourage auditor independence:

1. It established the Public Company Accounting Oversight Board to oversee the development of audit standards and to monitor the effectiveness of auditors,
2. It prohibits auditors from offering certain types of consulting services, and requires audit partners to rotate clients every five years, and
3. It requires audit committees to consist of independent members.

BUSINESS INSIGHT Warren Buffett on Audit Committees

“Audit committees can’t audit. Only a company’s outside auditor can determine whether the earnings that a management purports to have made are suspect. Reforms that ignore this reality and that instead focus on the structure and charter of the audit committee will accomplish little.

As we’ve discussed, far too many managers have fudged their company’s numbers in recent years, using both accounting and operational techniques that are typically legal but that nevertheless materially mislead investors. Frequently, auditors knew about these deceptions. Too often, however, they remained silent. The key job of the audit committee is simply to get the auditors to divulge what they know.

To do this job, the committee must make sure that the auditors worry more about misleading its members than about offending management. In recent years auditors have not felt that way. They have instead generally viewed the CEO, rather than the shareholders or directors, as their client. That has been a natural result of day-to-day working relationships and also of the auditors’ understanding that, no matter what the board says, the CEO and CFO pay their fees and determine whether they are retained for both auditing and other work. The rules that have been recently instituted won’t materially change this reality. What will break this cozy relationship is audit committees unequivocally putting auditors on the spot, making them understand they will become liable for major monetary penalties if they don’t come forth with what they know or suspect.”—Warren Buffett, [Berkshire Hathaway](#) annual report

SEC Enforcement Actions

Companies whose securities are issued to the public must file reports with the SEC (see www.sec.gov). One of these reports is the 10-K, which includes the annual financial statements (quarterly statements are filed under report 10-Q). The 10-K report provides more information than the company’s glossy annual report, which is partly a marketing document (although the basic financial statements are identical). You should use the 10-K because of its additional information.

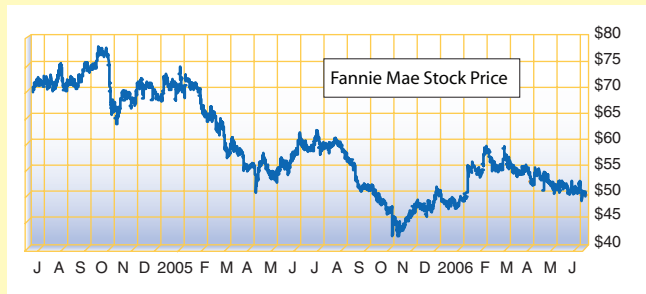
The SEC has ultimate authority to accept or reject financial statements that companies submit. Should the SEC reject a company's financial statements, the company must restate and refile them. Restatements are time-consuming, publicly known, and restating companies typically see their stock market value slide. For example, in 2006, the SEC required **Fannie Mae** to restate its financial statements. The SEC commenced litigation, and the following excerpts come from the criminal complaint:

The Federal National Mortgage Association engaged in a financial fraud involving multiple violations of Generally Accepted Accounting Principles ("GAAP") in connection with the preparation of its annual and quarterly financial statements. These violations had the effect, among other things, of falsely portraying stable earnings growth and reduced income statement volatility and, for year-ended 1998, of maximizing bonuses and achieving forecasted earnings. Between 1998 and 2004, Fannie Mae, a shareholder-owned government sponsored enterprise, misstated its results of operations and issued materially false and misleading financial statements in various reports and in filings with the Commission.

The Company's accounting was inconsistent with GAAP. Additionally, the Company's reported financial results were smoothed through misapplications of GAAP. These practices were not disclosed to investors.

As a direct result of these violations, and other errors, Fannie Mae expects to restate its historical financial statements for the years ended December 31, 2003 and 2002, and for the quarters ended June 30, 2004 and March 31, 2004. This restatement will result in at least a \$1.1 billion reduction of previously reported net income.

The Commission's investigation uncovered numerous transactions over several years by which Fannie Mae management intentionally smoothed out gyrations in its earnings to show investors it was a low-risk company. In addition,



the SEC charged that the company's accounting policies were created to shape the company's books in a way that made it appear that the company had reached earnings targets, thus triggering the maximum possible bonus payout for executives.

Following litigation of the above-referenced complaint, Fannie Mae fired its senior management team, including its CEO and CFO. It also agreed to pay a \$400 million penalty, restate its previously issued financial reports, reform its accounting policies, and institute stricter internal controls over its accounting procedures. Fannie Mae's stock (FNM) lost a third of its market value during the proceedings—see margin graph. The SEC's power to require restatement, with its con-

sequent damage to company reputation and company stock price, is a major deterrent to those desiring to bias their financial accounts to achieve a particular goal.

Courts

Courts provide remedies to individuals or companies that suffer damages as a result of material misstatements in financial statements. Typical court actions involve shareholders who sue the company and its auditors, alleging that the company disclosed, and the auditors attested to, false and misleading financial statements. The number of such shareholder suits has declined in the past few years. Nonetheless, shareholder suits are chronically in the news. Stanford Law School's Securities Class Action Clearinghouse commented that "Two factors are likely responsible for the decline. First, lawsuits arising from the dramatic boom and bust of U.S. equities in the late 1990s and early 2000s are now largely behind us. Second, improved governance in the wake of the **Enron** and **WorldCom** frauds likely reduced the actual incidence of fraud." The SEC and the New York District Attorney successfully brought suit against **Adelphia Communications Corporation** and its owners on behalf of the U.S. Government and numerous investors, creditors, employees and others affiliated with the company. The press release announcing the settlement read, in part:

Washington, D.C., April 25, 2005—The Securities and Exchange Commission today announced that it and the United States Attorney's Office for the Southern District of New York (USAO) reached an agreement to settle a civil enforcement action and resolve criminal charges against Adelphia Communications Corporation, its founder John J. Rigas, and his three sons, Timothy J. Rigas, Michael J. Rigas and James P. Rigas, in one of the most extensive financial frauds ever to take place at a public company.

In its complaint, the Commission charged that Adelphia, at the direction of the individual defendants: (1) fraudulently excluded billions of dollars in liabilities from its consolidated financial statements by hiding them on the books of off-balance sheet affiliates; (2) falsified operating statistics and inflated earnings to meet Wall Street estimates; and (3) concealed rampant self-dealing by the Rigas family, including the undisclosed use of corporate funds for purchases of Adelphia stock and luxury condominiums.

Mark K. Schonfeld, Director of the SEC's Northeast Regional Office, said, "This settlement agreement presents a strong, coordinated approach by the SEC and the U.S. Attorney's Office to resolving one of the most complicated and egregious financial frauds committed at a public company. The

settlement provides an expedient and effective way to provide victims of Adelphia's fraud with a substantial recovery while at the same time enabling Adelphia to emerge from Chapter 11 bankruptcy."

The settlement terms of this action, and related criminal actions against the Rigas family, resulted in the following:

- Rigas family members forfeited in excess of \$1.5 billion in assets derived from the fraud; the funds were used, in part, to establish a fund for the fraud victims.
- Rigas family members were barred from acting as officers or directors of a public company.
- John Rigas, the 80-year-old founder of Adelphia Communications, was sentenced to 15 years in prison.
- Timothy Rigas, the ex-finance chief, was sentenced to 20 years.

GUIDANCE ANSWERS

MANAGERIAL DECISION

You Are the Product Manager

As a manager, you must balance two conflicting objectives—namely, mandatory disclosure requirements and your company's need to protect its competitive advantages. You must comply with all minimum required disclosure rules. 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 inform investors and others about your company's successful investments. Still, there are many stakeholders impacted by your disclosure decision and each must be given due consideration.

MANAGERIAL DECISION

You Are the Chief Financial Officer

Financial performance is typically measured by return on net operating assets, which can be disaggregated into the net operating profit margin (net operating profit after tax/sales) and the net operating asset turnover (sales/average net operating assets). This disaggregation might lead you to review factors affecting profitability (gross margins and expense control) and to assess how effectively your company is utilizing its assets (the turnover rates). Finding ways to increase profitability for a given level of investment or to reduce the amount of invested capital while not adversely impacting profitability contributes to improved financial performance.

Superscript ^{A(B)} denotes assignments based on Appendix 1A (1B).

DISCUSSION QUESTIONS

- Q1-1.** A firm's planning activities motivate and shape three types of business activities. List the three activities. Describe how financial accounting reports can provide useful information for each activity. How can subsequent financial accounting reports be used to evaluate the success of each of the activities?
- 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? Explain the information conveyed in the balance sheet.
- Q1-5.** Does an income statement report on a period of time or at a point in time? Explain the information conveyed in the income statement.
- Q1-6.** Does a statement of cash flows report on a period of time or at a point in time? Explain the information and activities conveyed in the statement of cash flows.
- Q1-7.** Explain how a company's four primary financial statements are linked.
- Q1-8.** Financial statements are used by several interested stakeholders. List three or more potential external users of financial statements. Explain how each constituent on your list might use financial statement information in their decision making process.
- Q1-9.** What ethical issues might managers face in dealing with confidential information?
- Q1-10.^A** 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 the auditor use in expressing its opinion and what responsibilities does it assume?

Procter & Gamble
(PG)

- Q1-11.^B Business decision makers external to the company increasingly demand more financial information from companies. Discuss the reasons why companies have traditionally opposed the efforts of regulatory agencies like the SEC to require more disclosure.
- Q1-12.^B What are generally accepted accounting principles and what organizations presently establish them?
- Enron Q1-13.^B Corporate governance has received considerable attention since the collapse of Enron and other accounting-related scandals. What is meant by corporate governance? What are the primary means by which sound corporate governance is achieved?
- Q1-14.^B What is the primary function of the auditor? In your own words, describe what an audit opinion says.
- Q1-15. Describe a decision that requires financial accounting information, other than a stock investment decision. How is financial accounting information useful in making this decision?
- Q1-16. Users of financial information are vitally concerned with the company's strategic direction. Despite their understanding of this need for information, companies are reluctant to supply it. Why? In particular, what costs are companies concerned about?
- Q1-17. One of Warren Buffett's acquisition criteria is to invest in businesses "earning good return on equity." The return on equity (ROE) formula uses both net income and stockholders' equity. Why is it important to relate net income to stockholders' equity? Why isn't it sufficient to merely concentrate on companies with the highest net income?
- Q1-18. One of Warren Buffett's acquisition criteria is to invest in businesses "earning good return on equity, while employing little or no debt." Why is Buffett concerned about debt?

MINI EXERCISES

M1-19. Relating Financing and Investing Activities (LO2)
 Dell, Inc. (DELL) In a recent year, the total assets of Dell, Inc. equal \$15,470 million and its equity is \$4,873 million. What is the amount of its liabilities? Does Dell receive more financing from its owners or nonowners? What percentage of financing is provided by Dell's owners?

M1-20. Relating Financing and Investing Activities (LO2)
 Ford Motor Company (F) In a recent year, the total assets of Ford Motor Company equal \$315,920 million and its liabilities equal \$304,269 million. What is the amount of Ford's equity? Does Ford receive more financing from its owners or nonowners. What percentage of financing is provided by its owners?

M1-21. Applying the Accounting Equation and Computing Financing Proportions (LO2)
 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? Discuss why the proportion of owner financing might differ across these three businesses.

	(\$ millions)	Assets	=	Liabilities	+	Equity
Hewlett-Packard (HPQ)		\$74,708		\$ 36,962		\$ (a)
General Mills (GIS)		\$18,227		\$ (b)		\$4,175
General Motors (GM)		\$ (c)		\$365,057		\$6,814

M1-22.^A Identifying Key Numbers from Financial Statements (LO2)
 Starbucks (SBUX) Access the October 2006 10-K for Starbucks Corporation at the SEC's EDGAR database for financial reports (www.sec.gov). What did Starbucks report for total assets, liabilities, and equity at October 1, 2006? Confirm that the accounting equation holds. What percent of Starbucks' assets is financed by nonowners?

M1-23.^A Verifying Linkages Between Financial Statements (LO2)
 E. I. DuPont de Nemours (DD) Access the 2005 10-K for DuPont at the SEC's EDGAR database of financial reports (www.sec.gov). Using its December 31, 2005, consolidated statement of stockholders' equity, prepare a table to reconcile the opening and ending balances of its retained (reinvested) earnings for 2005 by showing the activity in the account during the year.

M1-24. Identifying Financial Statement Line Items and Accounts (LO2)
 Several line items and account titles are listed below. For each, indicate in which of the following financial statement(s) we 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 capital expenditures
- f. Retained earnings
- g. Cash inflow for stock issued
- h. Cash outflow for dividends
- i. Net income

M1-25. Identifying Ethical Issues and Accounting Choices (LO5)

Assume that you are a technology services provider and you must decide on 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. According to the contract, you will be paid only when the client “accepts” the installation. Although you have not yet received your client’s 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?

M1-26.^B Understanding Internal Controls and their Importance (LO5)

The **Sarbanes-Oxley Act** legislation requires companies to report on the effectiveness of their internal controls. The SEC administers the Sarbanes-Oxley Act, and defines internal controls as follows:

“A process designed by, or under the supervision of, the registrant’s principal executive and principal financial officers . . . to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.”

Why do you think Congress believes internal controls are such an important area to monitor and report on?

EXERCISES

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

Determine the missing amounts on lines (a), (b), and (c) below. Which of these companies is more owner-financed? Which of these companies is more nonowner-financed?

(\$ millions)	Assets	=	Liabilities	+	Equity	
a. Motorola, Inc.	\$31,152	=	\$?		\$11,239	Motorola, Inc. (MOT)
b. Kraft Foods	\$?	=	\$31,268		\$25,832	Kraft Foods (KFT)
c. Merck & Co.	\$47,561	=	\$29,361		\$?	Merck & Co. (MRK)

E1-28. Applying the Accounting Equation and Assessing Financial Statement Linkages (LO2)

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 Intel’s total equity at year-end? **Intel (INTC)**
- 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 JetBlue’s equity at the end of the year? **JetBlue (JBLU)**
- 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 beginning and ending amounts for Walt Disney’s equity? **The Walt Disney Company (DIS)**

E1-29. Specifying Financial Information Users and Uses (LO1)

Financial statements have a wide audience of interested stakeholders. Identify two or more financial statement users that are external to the company. For each user on your list, specify two questions that could be addressed with financial statement information.

E1-30. Applying Financial Statement Relations to Compute Dividends (LO2)

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

Colgate-Palmolive (CL)

(\$ millions)	2005	2004
Retained earnings	8,968.1	8,223.9

During 2005, Colgate-Palmolive reported net income of \$1,351.4 million. What amount of dividends, if any, did Colgate-Palmolive pay to its shareholders in 2005? What percent of its net income did Colgate-Palmolive pay out in 2005?

Briggs & Stratton
(BGG)

E1-31. Computing and Interpreting Financial Statement Ratios (LO3)
Following are selected ratios of **Briggs & Stratton** (manufacturer of engines) for 2005 and 2004.

RNOA Component	2005	2004
Profitability (Net operating profit after tax / Sales)	4.67%	7.82%
Productivity (Sales / Average net operating assets)	2.08	1.77

- Was the company profitable in 2005? What evidence do you have of this?
- Is the change in productivity (net operating asset turnover) a positive development? Explain.
- Compute the company's return on net operating assets (RNOA) for 2005 (show computations).

Nordstrom, Inc.
(JWN)

E1-32. Computing Return on Net Operating Assets and Applying the Accounting Equation (LO3)
Nordstrom, Inc., reports net operating profit after tax of \$477.2 million for its fiscal year ended January 2006. At the beginning of that fiscal year, Nordstrom had \$2,777.3 million in net operating assets. By fiscal year-end 2006, total net operating assets had grown to \$2,973.1 million. What is Nordstrom's return on net operating assets (RNOA)?

E1-33. Discussing Accounting in Society (LO1)
Financial accounting plays an important role in modern society and business.

- Identify two or more external stakeholders that are interested in a company's financial statements and what their particular interests are.
- What are *generally accepted accounting principles*? What organizations have primary responsibility for the formulation of GAAP?
- 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?

Starbucks (SBUX)

E1-34. Computing Return on Equity (LO3)
Starbucks reports net income for 2006 of \$564 million. Its stockholders' equity is \$2,229 million and \$2,090 million for 2006 and 2005, respectively.

- Compute its return on equity for 2006.
- Starbucks repurchased over \$850 million of its common stock in 2006. How did this repurchase affect Starbucks' ROE?
- Why do you think a company like Starbucks repurchases its own stock?

PROBLEMS

Staples (SPLS)

P1-35. Computing Return on Equity and Return on Net Operating Assets (LO3)
The following table contains financial statement information for **Staples, Inc.**

(\$ millions)	2006	2005	2004	2003
Net operating profit after tax	\$ 853,632	\$ 731,817	\$ 518,887	\$ 443,737
Net income	834,409	708,388	490,211	446,000
Net operating assets	4,367,221	4,202,136	3,486,208	3,618,429
Stockholders' equity	4,425,471	4,115,196	3,662,900	2,658,892

- Required**
- Compute the return on equity (ROE) for 2004 through 2006. What trend is observed? How does Staples' ROE compare with the approximately 12% average ROE for publicly traded companies?
 - Compute the return on net operating assets (RNOA) for 2004 through 2006. What trends are observed? How does Staples' RNOA compare with the approximate 10% average RNOA for publicly traded companies?
 - What factors might allow a company like Staples to reap above-average returns?

General Mills, Inc.
(GIS)

P1-36. Formulating Financial Statements from Raw Data (LO2)
Following is selected financial information from **General Mills, Inc.**, for its fiscal year ended May 30, 2004 (\$ millions).

Cash and cash equivalents	\$ 751
Net cash provided by operating activities	1,461
Net sales	11,070
Stockholders' equity	5,547
Cost of sales	6,584
Net cash used by financing activities	(943)
Total liabilities	12,901
Total expenses	3,431
Noncash assets	17,697
Net cash used by investing activities	(470)
Net income	1,055
Cash and cash equivalents beginning year	703

Required

Prepare the income statement, balance sheet, and statement of cash flows for General Mills, Inc.

P1-37. Formulating Financial Statements from Raw Data (LO2)

Following is selected financial information from **Abercrombie & Fitch** for its fiscal year ended January 31, 2005 (\$ millions).

Abercrombie & Fitch (ANF)

Cash and equivalents	\$ 350
Cash provided by operating activities	426
Sales	2,021
Stockholders' equity	669
Cost of goods sold	1,111
Cash used for financing activities	(412)
Total liabilities	679
Expenses	694
Noncash assets	998
Cash provided by investing activities	280
Net income	216
Cash and cash equivalents beginning year	56

Required

Prepare the income statement, balance sheet, and statement of cash flows for Abercrombie & Fitch.

P1-38. Formulating Financial Statements from Raw Data (LO2)

Following is selected financial information from **Cisco Systems, Inc.**, for the year ended July 30, 2005 (\$ millions).

Cisco Systems, Inc. (CSCO)

Cash and cash equivalents	\$ 4,742
Cash provided by operating activities	7,568
Sales	24,801
Stockholders' equity	23,184
Cost of goods sold	8,130
Cash used in financing activities	(9,162)
Total liabilities	10,699
Expenses	10,930
Noncash assets	29,141
Cash provided by investing activities	2,614
Net income	5,741
Cash and cash equivalents beginning year	3,722

Required

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

P1-39. Formulating a Statement of Stockholders' Equity from Raw Data (LO2)

Crocker Corporation began calendar-year 2005 with stockholders' equity of \$100,000, consisting of contributed capital of \$70,000 and retained earnings of \$30,000. During 2005, it issued additional stock for total cash proceeds of \$30,000. It also reported \$50,000 of net income, and paid \$25,000 as a cash dividend to shareholders.

Required

Prepare the 2005 statement of stockholders' equity for Crocker Corporation.

P1-40. Formulating a Statement of Stockholders' Equity from Raw Data (LO2)

EA Systems, Inc., reports the following selected information at December 31, 2005 (\$ millions).

Contributed capital, December 31, 2004 and 2005	\$ 550
Retained earnings, December 31, 2004	2,437
Cash dividends, 2005	281
Net income, 2005	859

Required

Use this information to prepare the statement of stockholders' equity for EA Systems, Inc., for 2005.

P1-41. Computing, Analyzing, and Interpreting Return on Equity (LO3)

Following are summary financial statement data for both **Kimberly-Clark** and **Procter & Gamble** (industry competitors) for 2004 and 2005.

Kimberly-Clark (KMB)
Procter & Gamble (PG)

Kimberly-Clark Corporation (KMB)		
(\$ millions)	Stockholders' Equity	Net Income
2004	\$6,630	\$1,800
2005	5,558	1,568

Procter & Gamble Company (PG)		
(\$ millions)	Stockholders' Equity	Net Income
2004	\$18,190	\$6,156
2005	18,475	6,923

Required

- Compute the return on equity (net income/average stockholders' equity) for 2005.
- Which company reports a higher return on equity for 2005? Both companies used cash to repurchase large amounts of common stock in 2005. How do these repurchases affect return on equity? Why might a company wish to repurchase its own common stock?

P1-42. Conducting Business Analysis (LO4)

Refer to the information in P1-41 to answer the following requirements.

Procter & Gamble (PG)

Required

- Discuss the possible reasons for Procter & Gamble's higher ROE in terms of its relative position in the competitive environment. (*Hint:* Review Porter's five forces analysis.)
- Drawing on the analysis of part *a*, assess the competitive strength of Procter & Gamble.

P1-43. Computing, Analyzing, and Interpreting Return on Equity (LO3)

Nokia manufactures, markets, and sells phones and other electronics. Total stockholders' equity for Nokia is €14,576 in 2005 and €14,871 in 2004. In 2005, Nokia reported net income of €3,582 on sales of €34,191.

Nokia (NOK)

Required

- What is Nokia's return on equity for 2005?
- What are total expenses for Nokia in 2005?
- Nokia used cash to repurchase a large amount of its common stock in 2004. What motivations might Nokia have for repurchasing its common stock?

P1-44. Comparing Abercrombie & Fitch and TJX Companies (LO3)

Following are selected financial statement data from **Abercrombie & Fitch** (ANF—upscale clothing retailer) and **TJX Companies** (TJX—value priced clothing retailer including TJ Maxx)—both dated the end of January 2006.

Abercrombie & Fitch (ANF) and TJX Companies (TJX)

(\$ millions)	ANF	TJX
Sales	\$2,784.7	\$16,057.9
Net operating profit after tax	352.8	675.3
Net operating assets—2006	584.0	2,548.2
Net operating assets—2005	669.3	2,321.2

Required

- a. Compute the return on net operating assets for both companies for the year end January 2006.
- b. Disaggregate the RNOAs for both companies into the net operating profit margin and the net operating asset turnover.
- c. What differences are observed? Evaluate these differences in light of the two companies' business models. Which company has better financial performance?

P1-45. Computing, Analyzing, and Interpreting Return on Net Operating Assets and its Components (LO3)

McDonald's Corporation (MCD) reported 2005 net operating profit after tax of \$2,614 million on net sales of \$20,460 million. The December 31, 2005, balance sheet of MCD reports the following.

McDonald's Corporation (MCD)

(\$ millions)	2005	2004
Net operating assets	\$23,497	\$22,083

Required

- a. What is MCD's return on net operating assets? Given that the average RNOA for fast-food restaurants is about 5.5%, how does MCD compare on RNOA? Explain why MCD's RNOA might be so different from the average fast-food restaurant.
- b. Decompose MCD's RNOA into its net operating profit margin and its net operating asset turnover.
- c. Suggest specific actions that **McDonald's** might take to improve (1) its net operating profit margin, and (2) its net operating asset turnover.

P1-46. Disaggregating Return on Net Operating Assets Over Time (LO3)

Following are selected financial statement data from **3M Company** for 2002 through 2005.

3M Company (MMM)

(\$ millions)	2005	2004	2003	2002
Net sales	\$21,167	\$20,011	\$18,232	\$16,332
Net operating profit after tax	3,256	2,976	2,413	1,980
Net operating assets	12,209	12,972	10,604	9,132

Required

- a. Compute **3M Company's** return on net operating assets for 2003 through 2005. What trends are observed?
- b. Disaggregate 3M's RNOA into the net operating profit margin and the net operating asset turnover for 2003 through 2005.
- c. Which RNOA component appears to be driving the trend observed in part a? Explain.

P1-47.^A Reading and Interpreting Audit Opinions (LO5)

Apple, Inc.'s 2005 financial statements include the following audit report from **KPMG LLP**

Apple, Inc. (AAPL)

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
 The Board of Directors and Shareholders
 Apple, Inc.:

We have audited the accompanying consolidated balance sheets of Apple, Inc. and subsidiaries (the Company) as of September 24, 2005 and September 25, 2004, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the years in the three-year period ended September 24, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

Continued

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of September 24, 2005 and September 25, 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended September 24, 2005, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of September 24, 2005, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated November 29, 2005 expressed an unqualified opinion on management's assessment of and the effective operation of internal control over financial reporting.

As discussed in Note 1 to the consolidated financial statements, the Company changed its method of accounting for asset retirement obligations and for financial instruments with characteristics of both liabilities and equity in 2003.

fs/ KPMG LLP

Mountain View, California
November 29, 2005

Required

- To whom is the report addressed? Why?
- In your own words, briefly describe the audit process. What steps do auditors take to determine whether a company's financial statements are free from material misstatement?
- What is the nature of KPMG's opinion? What do you believe the word *fairly* means? Is KPMG providing a guarantee to Apple's financial statement users?
- What other opinion is KPMG rendering? Why is this opinion important?
- What do you believe is the purpose of the last paragraph of KPMG's audit report?

P1-48. Reading and Interpreting CEO Certifications (LO5)

Apple, Inc. (AAPL)

Following is the CEO Certification required by the Sarbanes-Oxley Act and signed by Apple CEO Steve Jobs. Apple's Chief Financial Officer signed a similar form.

CERTIFICATIONS

I, Steven P. Jobs, certify that:

- I have reviewed this annual report on Form 10-K of Apple, Inc.;
- Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the registrant) and have:
 - Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

Continued

