To my daughters, Joanne and Stacey
—PDE

To my students and my loving family
—JJW

To my wife Ellie and children, Grace and Christian
—RFH

To my husband Brittan and children Loic, Cindy, Maclean, Quinn and Kay
—MLM

Cambridge Business Publishers


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he combined skills and expertise of Easton, Wild, Halsey, and McAnally create the ideal team to author the first new financial accounting textbook for MBAs in more than a generation. Their collective experience in award-winning teaching, consulting, and research in the area of financial accounting and analysis provides a powerful foundation for this innovative textbook.

**Peter D. Easton** is an expert in accounting and valuation and holds the Notre Dame Alumni Chair in Accountancy in the Mendoza College of Business. Professor Easton’s expertise is widely recognized by the academic research community and by the legal community. Professor Easton frequently serves as a consultant on accounting and valuation issues in federal and state courts.

Professor Easton holds undergraduate degrees from the University of Adelaide and the University of South Australia. He holds a graduate degree from the University of New England and a PhD in Business Administration (majoring in accounting and finance) from the University of California, Berkeley.

Professor Easton’s research on corporate valuation has been published in the *Journal of Accounting and Economics*, *Journal of Accounting Research*, *The Accounting Review*, *Contemporary Accounting Research*, *Review of Accounting Studies*, and *Journal of Business Finance and Accounting*. Professor Easton has served as an associate editor for 11 leading accounting journals and he is currently an associate editor for the *Journal of Accounting Research*, *Journal of Business Finance and Accounting*, and *Journal of Accounting, Auditing, and Finance*. He is an editor of the *Review of Accounting Studies*.

Professor Easton has held appointments at the University of Chicago, the University of California at Berkeley, Ohio State University, Macquarie University, the Australian Graduate School of Management, the University of Melbourne, Tilburg University, National University of Singapore, Seoul National University, and Nyenrode University. He is the recipient of numerous awards for excellence in teaching and in research. Professor Easton regularly teaches accounting analysis and security valuation to MBAs. In addition, Professor Easton has taught managerial accounting at the graduate level.

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Professor Wild is an active member of the American Accounting Association and its sections. He has served on several committees of these organizations, including the Outstanding Accounting Educator Award, Wildman Award, National Program Advisory, Publications, and Research Committees. Professor Wild is author of several best-selling books. His research articles on financial accounting and analysis appear in *The Accounting Review*, *Journal of Accounting Research*, *Journal of Accounting and Economics*, *Contemporary Accounting Research*, *Journal of Accounting, Auditing & Finance*, *Journal of Accounting and Public Policy*, *Journal of Business Finance and Accounting*, *Auditing: A Journal of Theory and Practice*, and other accounting and business journals. He is past associate editor of *Contemporary Accounting Research* and has served on editorial boards of several respected journals, including *The Accounting Review* and the *Journal of Accounting and Public Policy*. 

**ABOUT THE AUTHORS**
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Professor Halsey teaches courses in financial and managerial accounting at both the graduate and undergraduate levels, including a popular course in financial statement analysis for second year MBA students. He has also taught numerous executive education courses for large multinational companies through Babson’s school of Executive Education as well as for a number of stock brokerage firms in the Boston area. He is regarded as an innovative teacher and has been recognized for outstanding teaching at both the University of Wisconsin and Babson College.

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At Texas A&M, Professor McAnally teaches financial reporting, analysis, and valuation in the full-time and Executive MBA programs. Through the Mays Center for Executive Development, she works with corporate clients including Halliburton, AT&T, and Baker Hughes. She has also taught at University of Calgary, IMADEC (in Austria) and at the Indian School of Business, in Hyderabad. She has received numerous faculty-determined and student-initiated teaching awards at the MBA and executive levels. Those awards include the Beazley Award, the Trammell Foundation Award, the MBA Teaching Award, the MBA Association Distinguished Faculty Award, the Award for Outstanding and Memorable Faculty Member, and the Distinguished Achievement Award.

Professor McAnally’s research interests include accounting and disclosure in regulated environments, executive compensation, and accounting for risk. She has published articles in the leading academic journals including Journal of Accounting and Economics, Journal of Accounting Research, The Accounting Review, Review of Accounting Studies, and Contemporary Accounting Research. Professor McAnally received the Mays Business School Research Achievement Award in 2005. She was Associate Editor at Accounting Horizons and served on the editorial board of Contemporary Accounting Research and was Guest Editor for the MBA-teaching volume of Issues in Accounting Education (2012). She is active in the American Accounting Association.
Welcome to the Sixth Edition of *Financial Accounting for MBAs*. Our main goal in writing this book was to satisfy the needs of today’s business manager by providing the most contemporary, relevant, engaging, and user-oriented textbook available. This book is the product of extensive market research including focus groups, market surveys, class tests, manuscript reviews, and interviews with faculty across the country. We are grateful to students and faculty who used the First through Fifth Editions and whose feedback greatly benefited this Sixth Edition.

**TARGET AUDIENCE**

*Financial Accounting for MBAs* is intended for use in full-time, part-time, executive, and evening MBA programs that include a financial accounting course as part of the curriculum, and one in which managerial decision making and analysis are emphasized. This book easily accommodates mini-courses lasting several days as well as extended courses lasting a full semester.

**INNOVATIVE APPROACH**

*Financial Accounting for MBAs* is managerially oriented and focuses on the most salient aspects of accounting. It helps MBA students learn how to read, analyze, and interpret financial accounting data to make informed business decisions. This textbook makes financial accounting engaging, relevant, and contemporary. To that end, it consistently incorporates real company data, both in the body of each module and throughout assignment material.

**FLEXIBLE STRUCTURE**

The MBA curricula, instructor preferences, and course lengths vary across colleges. Accordingly and to the extent possible, the 12 modules that make up *Financial Accounting for MBAs* were designed independently of one another. This modular presentation enables each college and instructor to “customize” the book to best fit the needs of their students. Our introduction and discussion of financial statements constitute Modules 1, 2, and 3. Module 4 presents the analysis of financial statements with an emphasis on analysis of operating profitability. Modules 5 through 10 highlight major financial accounting topics including assets, liabilities, equity, and off-balance-sheet financing. Module 11 explains forecasting financial statements and Module 12 introduces simple valuation models. At the end of each module, we present an ongoing analysis project that can be used as a guide for an independent project. Like the rest of the book, the project is independent across the various modules. At the end of the book, we include several useful resources. Appendix A contains compound interest tables and formulas. Appendix B details the process for preparing and analyzing the statement of cash flow. Appendix C is an illustrative case that applies the techniques described in Modules 1 through 12 to an actual company, Kimberly-Clark. Appendix C can be used, in conjunction with the module-end project questions, by students required to prepare a company analysis. Appendix D is a chart of accounts used in the book.

**Transaction Analysis and Statement Preparation**

Instructors differ in their coverage of accounting mechanics. Some focus on the effects of transactions on financial statements using the balance sheet equation format. Others include coverage of journal entries and T-accounts. We accommodate both teaching styles in this Sixth Edition. Specifically, Module 2 provides an expanded discussion of the effects of transactions using our innovative financial statement effects template. Emphasis is on the analysis of Apple’s summary transactions, which concludes with the preparation of its financial statements. Module 3, which is entirely optional, allows an instructor to drill down and focus on accounting mechanics: journal entries and T-accounts. It illustrates accounting for numerous transactions, including those involving accounting adjustments. It concludes with the preparation of a trial balance and the financial statements. This detailed transaction analysis uses the same financial statement effects template, with journal entries and T-accounts highlighted in the margin. Thus, these two modules accommodate the spectrum of teaching styles— instructors can elect to use either or both modules to suit their preferences, and their students are not deprived of any information as a result of that selection.
Flexibility for Courses of Varying Lengths

Many instructors have approached us to ask about suggested class structures based on courses of varying length. To that end, we provide the following table of possible course designs:

<table>
<thead>
<tr>
<th>Module</th>
<th>15 Week Semester-Course</th>
<th>10 Week Quarter-Course</th>
<th>6 Week Mini-Course</th>
<th>1 Week Intensive-Course</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Financial Accounting for MBAs</td>
<td>Week 1</td>
<td>Week 1</td>
<td>Week 1</td>
<td>Day 1 (Module 1 and either Module 2 or Module 3)</td>
</tr>
<tr>
<td>2. Introducing Financial Statements and Transaction Analysis</td>
<td>Week 2</td>
<td>Week 2</td>
<td>Week 2</td>
<td></td>
</tr>
<tr>
<td>3. Accounting Adjustments and Constructing Financial Statements (optional)</td>
<td>Week 2</td>
<td>Week 2</td>
<td>Week 2</td>
<td></td>
</tr>
<tr>
<td>4. Analyzing and Interpreting Financial Statements</td>
<td>Weeks 3 and 4</td>
<td>Week 3</td>
<td>Week 3</td>
<td>Day 2</td>
</tr>
<tr>
<td>5. Reporting and Analyzing Operating Income</td>
<td>Week 5</td>
<td>Week 4</td>
<td>Skim</td>
<td>Skim</td>
</tr>
<tr>
<td>6. Reporting and Analyzing Operating Assets</td>
<td>Week 6</td>
<td>Week 5</td>
<td>Week 4</td>
<td>Day 3</td>
</tr>
<tr>
<td>7. Reporting and Analyzing Nonowner Financing</td>
<td>Week 7</td>
<td>Week 6</td>
<td>Week 5</td>
<td>Day 4</td>
</tr>
<tr>
<td>8. Reporting and Analyzing Owner Financing</td>
<td>Week 8</td>
<td>Week 7</td>
<td>Week 6</td>
<td>Day 5</td>
</tr>
<tr>
<td>9. Reporting and Analyzing Intercorporate Investments</td>
<td>Week 9</td>
<td>Optional</td>
<td>Optional</td>
<td>Optional</td>
</tr>
<tr>
<td>10. Reporting and Analyzing Off-Balance-Sheet Financing</td>
<td>Weeks 10 and 11</td>
<td>Week 8</td>
<td>Optional</td>
<td>Optional</td>
</tr>
<tr>
<td>11. Forecasting Financial Statements</td>
<td>Weeks 12 and 13</td>
<td>Week 9</td>
<td>Optional</td>
<td>Optional</td>
</tr>
<tr>
<td>12. Analyzing and Valuing Equity Securities</td>
<td>Weeks 13 and 14</td>
<td>Week 10</td>
<td>Optional</td>
<td>Optional</td>
</tr>
</tbody>
</table>

Managerial Emphasis

Tomorrow’s MBA graduates must be skilled in using financial statements to make business decisions. These skills often require application of ratio analyses, benchmarking, forecasting, valuation, and other aspects of financial statement analysis for decision making. Further, tomorrow’s MBA graduates must have the skills to go beyond basic financial statements and to interpret and apply nonfinancial statement disclosures, such as footnotes and supplementary reports. This book, therefore, emphasizes real company data, including detailed footnote and other management disclosures, and shows how to use this information to make managerial inferences and decisions. This approach makes financial accounting interesting and relevant for all MBA students.

As MBA instructors, we recognize that the core MBA financial accounting course is not directed toward accounting majors. Financial Accounting for MBAs embraces this reality. This book highlights financial reporting, analysis, interpretation, and decision making. We incorporate the following financial statement effects template to train MBA students in understanding the economic ramifications of transactions and their impact on all key financial statements. This analytical tool is a great resource for MBA students in learning accounting and applying it to their future courses and careers. Each transaction is identified in the “Transaction” column. Then, the dollar amounts (positive or negative) of the financial statement effects are recorded in the appropriate balance sheet or income statement columns. The template also reflects the statement of cash flow effects (via the cash column) and the statement of stockholders’ equity effects (via the contributed capital and earned capital columns). The earned capital account is immediately updated to reflect any income or loss arising from each transaction (denoted by the arrow line from net income to earned capital). This template is instructive as it reveals the financial impacts of transactions, and it provides insights into the effects of accounting choices.
INNOVATIVE PEDAGOGY

Financial Accounting for MBAs includes special features specifically designed for the MBA student.

Focus Companies for Each Module

Each module’s content is explained through the accounting and reporting activities of real companies. Each module incorporates a “focus company” for special emphasis and demonstration. The enhanced instructional value of focus companies comes from the way they engage MBA students in real analysis and interpretation. Focus companies were selected based on the industries that MBA students typically enter upon graduation.

| MODULE 1 | Berkshire Hathaway | MODULE 8 | IBM |
| MODULE 2 | Apple | MODULE 9 | Google |
| MODULE 3 | Apple | MODULE 10 | Southwest Airlines |
| MODULE 4 | Walmart | MODULE 11 | Procter & Gamble |
| MODULE 5 | Pfizer | MODULE 12 | Nike |
| MODULE 6 | Cisco | APPENDIX B | Starbucks |
| MODULE 7 | Verizon | APPENDIX C | Kimberly-Clark |

Real Company Data Throughout

Market research and reviewer feedback tell us that one of instructors’ greatest frustrations with other MBA textbooks is their lack of real company data. We have gone to great lengths to incorporate real company data throughout each module to reinforce important concepts and engage MBA students. We engage nonaccounting MBA students specializing in finance, taxation, marketing, management, real estate, operations, and so forth, with companies and scenarios that are relevant to them. For representative examples, SEE PAGES 2-34, 4-7, 5-8, 5-15, 6-10, 7-16, 8-5, 9-26, 10-20, and 11-9.

Footnotes and Other Management Disclosures

Analyzed on their own, financial statements reveal only part of a corporation’s economic story. Information essential for a complete analysis of a company’s financial position must be gleaned from the footnotes and other disclosures provided by the company. Consequently, we incorporate footnotes and other disclosures generously throughout the text and assignments. For representative examples, SEE PAGES 7-7, 7-9, 8-12, 8-27, and 10-6.

Industry-Level Data

We repeatedly emphasize that financial analysis cannot be performed in a vacuum—appropriate benchmarks are critical to a complete understanding of a company’s financial performance and position. To this point, we provide graphics that capture industry-level data including many of the ratios we discuss and compute in the modules. For representative examples, SEE PAGES 4-15, 4-19, 6-12, and 7-25.

Decision Making Orientation

One primary goal of a MBA financial accounting course is to teach students the skills needed to apply their accounting knowledge to solving real business problems and making informed business decisions. With that goal in mind, Managerial Decision boxes in each module encourage students to apply the material presented to solving actual business scenarios. For representative examples, SEE PAGES 2-35, 4-14, 7-23, 8-9, 9-16, and 10-7.
Mid-Module and Module-End Reviews

Financial accounting can be challenging—especially for MBA students lacking business experience or previous exposure to business courses. To reinforce concepts presented in each module and to ensure student comprehension, we include mid-module and module-end reviews that require students to recall and apply the financial accounting techniques and concepts described in each module. For representative examples, SEE PAGES 4-8, 7-11, 8-14, 9-16, and 10-11.

Experiential Learning

Students retain information longer if they can apply the lessons learned from the module content. To meet this need for experiential learning, we conclude each module with a hands-on analysis project. A series of questions guides students’ inquiry and helps students synthesize the material in the module and integrate material across modules. For representative examples, SEE PAGES 1-42, 4-58, and 9-55.

Excellent, Class-Tested Assignment Materials

Excellent assignment material is a must-have component of any successful textbook (and class). We went to great lengths to create the best assignments possible from contemporary financial statements. In keeping with the rest of the book, we used real company data extensively. We also ensured that assignments reflect our belief that MBA students should be trained in analyzing accounting information to make business decisions, as opposed to working on mechanical bookkeeping tasks. There are six categories of assignments: Discussion Questions, Mini Exercises, Exercises, Problems, IFRS Applications, and Management Applications. For representative examples, SEE PAGES 4-37, 6-45, and 9-41.

SIXTH EDITION CHANGES

Based on classroom use and reviewer feedback, a number of substantive changes have been made in the sixth edition to further enhance the MBA students’ experiences:

- Updated Financial Data: We have updated all Focus Company financial statements and disclosures to reflect each company’s latest available filings. We also explain the SEC’s EDGAR financial statement retrieval software and how to download excel spreadsheets of financial statements from 10-K filings.

- Updated Assignments: We have updated all assignments using real data to reflect each company’s latest available filings and have added many new assignments that also utilize real financial data and footnotes. We have expanded the IFRS Applications to include more companies from Canada and Australia.

- Ongoing Analysis Project: We have added a project component to each module. See the description above in Experiential Learning.

- Analyzing Cash Flows: To help students better understand cash flows, we have included new sections on the analysis of cash flows in Appendix B, including a discussion of the cash flow cycle and interpretation of cash flow patterns.

- International Financial Reporting Standards (IFRS): We have updated the IFRS Insight boxes and IFRS Alert boxes on the similarities and differences between U.S. GAAP and IFRS. Each module concludes with a Global Accounting section and an expanded IFRS assignments section, which brings in reports and disclosures from around the globe.

- New Focus Companies: We have changed a number of the focus companies: Module 4 now uses Walmart, Module 7 focuses on IBM, Module 10 uses Southwest Airlines, and Module 12 highlights Nike.

- Accounting Quality: We augmented the section on accounting quality in Module 5. It describes measures of accounting quality and factors that mitigate accounting quality. We also provide a check list of items in financial statements that should be reviewed when analyzing financial statements.

- Intercorporate Investments: Consistent with recent changes in accounting standards, we have revised Module 9 (formerly Module 7) to emphasize investors’ control of securities and deemphasize the percentage of ownership as the determining factor in selecting the method used for financial reporting.

- Credit Ratings: This edition expands discussion of credit ratings. This includes trends in credit ratings, current credit rating statistics, and rating procedures implemented by companies such as Moody’s and Standard and Poor’s.

- Noncontrolling Interest: We added expanded discussion of noncontrolling interest, how it is reported in financial statements, and the interpretation of its disclosure. The book distinguishes the ROE disaggregation with and without controlling interest and explains how to handle noncontrolling interest for analysis, forecasting, and equity valuation. In Module 9, we also expand our discussion of consolidation to illustrate the allocation of consolidated net income to the noncontrolling interest and to the controlling (parent) interest.

- Revised Forecasting Module: We have expanded our discussion of the forecasting of revenues and expenses to distinguish between forecasting using publicly-available databases and forecasting with
proprietary databases. For the latter, we continue to utilize analyst reports and spreadsheets provided to us by Morgan Stanley.

- **Enhanced R&D Analysis:** We have developed a new discussion of R&D costs in Module 5 focusing on the analysis and interpretation of R&D.

- **Expanded analysis of allowance accounts:** We have developed a new appendix to Module 6 to illustrate the accounting for sales returns and analysis. We also present a discussion of the analysis of the allowance accounts in Schedule II (Valuation and Qualifying Accounts) of the 10-K or similar disclosures in other types of annual reports.

- **Pension Accounting:** We have expanded our discussion of analysis of pension disclosures, including the change that many companies now immediately recognize actuarial gains and losses in operating results.

- **New Regulations:** We highlight pending and proposed accounting standards and their likely effects, if passed. These include the proposed standard on Revenue Recognition. This edition also reflects all accounting standards in effect since our last edition, including the new business combination and consolidation standard and goodwill impairment testing.

### COMPANION CASEBOOK

**Cases in Financial Reporting, 7th edition** by Ellen Engel (University of Chicago), D. Eric Hirst (University of Texas – Austin), and Mary Lea McAnally (Texas A&M University). This book comprises 27 cases and is a perfect companion book for faculty interested in exposing students to a wide range of real financial statements. The cases are current and cover companies from Canada, France, Austria, the Netherlands, the UK, India, as well as from the U.S. Many of the U.S. companies are major multinationals. Each case deals with a specific financial accounting topic within the context of one (or more) company’s financial statements. Each case contains financial statement information and a set of directed questions pertaining to one or two specific financial accounting issues. This is a separate, saleable casebook (ISBN 978-1-934319-79-6). Contact your sales representative to receive a desk copy or email customerservice@cambridgepub.com.

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### SUPPLEMENT PACKAGE

#### For Instructors

- **Solutions Manual:** Created by the authors, the Solutions Manual contains complete solutions to all the assignments in the textbook.
- **PowerPoint:** Created by the authors, the PowerPoint slides outline key elements of each module.
- **Test Bank:** Written by the authors, the test bank includes multiple-choice items, matching questions, short essay questions, and problems.
- **Computerized Test Bank:** This computerized version of the test bank enables you to add and edit questions; create up to 99 versions of each test; attach graphic files to questions; import and export ASCII files; and select questions based on type or learning objective. It provides password protection for saved tests and question databases and is able to run on a network.
- **Website:** All instructor materials are accessible via the book’s Website (password protected) along with other useful links and information. www.cambridgepub.com

#### For Students

- **Student Solutions Manual:** Created by the authors, the student solutions manual contains all solutions to the even-numbered assignment materials in the textbook. This is a restricted item that is only available to students after their instructor has authorized its purchase. ISBN 978-1-61853-120-9
- **Website:** Useful links are available to students free of charge on the book’s Website.
ACKNOWLEDGMENTS

All six editions of this book benefited greatly from the valuable feedback of focus group attendees, reviewers, students, and colleagues. We are extremely grateful to them for their help in making this project a success.

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Learning Objectives

LO1 Identify and discuss the users and suppliers of financial statement information. (p. 1-5)
LO2 Identify and explain the four financial statements, and define the accounting equation. (p. 1-9)
LO3 Explain and apply the basics of profitability analysis. (p. 1-19)
LO4 Describe business analysis within the context of a competitive environment. (p. 1-20)
LO5 Describe the accounting principles and regulations that frame financial statements. (p. 1-26)

Berkshire Hathaway

Berkshire Hathaway owns numerous businesses that pursue diverse activities. The legendary Warren Buffett, the “Sage of Omaha,” manages the company. 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 (and large 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 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 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 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 a prior period’s Berkshire Hathaway annual report:

Three suggestions for investors: First, beware of companies displaying weak accounting. . . . 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.

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 earnings projections, growth expectations, and return on equity 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 accounting information serves many purposes. To understand this, imagine that we are a specific user of accounting information. For example, imagine we are a stock investor—how might we use accounting information to identify a stock to buy? Imagine we are a bond trader—how might we use accounting information to assess whether a company is able to repay its debt? Imagine we are a manager—how might we use accounting information to decide whether to acquire another company or divest a current division? Imagine we are an equity or credit analyst—how might we use accounting to assess and communicate an investment appraisal or credit report?

This book explains the concepts, preparation, and application of financial accounting information and, importantly, how decision makers use such information. In general, managers use financial accounting information to make operating, investing, and financing decisions. Investors and analysts use financial accounting information to help decide whether to buy or sell stock. Lenders and rating agencies use accounting information to help decide on a company’s creditworthiness and lending terms. Regulators use accounting information to enact social and economic policies and to monitor compliance with laws. Legal institutions use accounting information to assess fines and reparations in litigation. Other decision makers rely on accounting information for purposes ranging from determining demands in labor union negotiations to levying damages for environmental abuses.

This module begins with an overview of the information environment that companies face, and it discusses the demand for and supply of financial information. We then review financial statements and explain what they convey about a company. Profitability is described next and is used as a focus of much of our application of accounting information. We conclude the module with an introduction to business analysis, which is an important part of drawing inferences from financial statements. We include (in the appendix) a discussion of the regulatory environment that defines current financial reporting for companies.

The remainder of the book can be broken into four parts—see figure at top of next page. Part 1 consists of Modules 1, 2, and 3 and offers an introduction of accounting fundamentals and the business environment. Part 2 consists of Module 4, which introduces analysis of financial statements. Although an aim of this book is to help us understand the application of financial statements, it is important that we understand their preparation. Thus, Part 3, which consists of Modules 5 through 10, describes the accounting for assets, liabilities, and equity; Appendix B covers accounting for cash flows. Part 4 consists of Modules 11 and 12, which explain the forecasting of accounting numbers and the valuation of common stock; Appendix C applies many of the analysis tools introduced in this book.
REPORTING ON BUSINESS ACTIVITIES

To effectively manage a company or infer whether it is well managed, we must understand the company’s business activities. Financial statements help us understand these business activities. These statements report on a company’s performance and financial condition, and reveal executive management’s privileged information and insights.

Financial statements satisfy the needs of different users. The functioning of the accounting information system involves application of accounting standards to produce financial statements. 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 information system as users of financial reports 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. Companies conduct all these activities while confronting business forces, including market constraints and competitive pressures. Financial statements provide crucial input for strategic planning. They also provide 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 (purplish) 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 user experience to its customers through its innovative hardware, software, peripherals, and services. The Company’s business strategy leverages its unique ability to design and develop its own operating systems, hardware, application software, and services to provide its customers new products and solutions with superior ease-of-use, seamless integration, and innovative design. The Company believes continual investment in research and development, marketing and advertising is critical to the development and sale of innovative products and technologies. As part of its strategy, the Company continues to expand its platform for the discovery and delivery of third-party digital content and applications through the iTunes Store . . . The Company also supports a community for the development of third-party software and hardware products and digital content that complement the Company’s offerings. The Company’s strategy also includes expanding its distribution network to effectively reach more customers and provide them with a high-quality sales and post-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 insight into the success of a company’s strategic plan, and are an important input to the planning process. These statements highlight portions of the strategic plan that proved profitable and, thus, warrant additional capital investment. They also reveal areas that are less effective, and provide information to help managers develop 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 begins again. Understanding a company’s strategic plan helps focus our analysis of financial statements by placing them in proper context.

FINANCIAL STATEMENTS: DEMAND AND SUPPLY

Demand for financial statements 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. Supply of financial statements is driven by companies’ wish to lower their costs of financing and less obvious costs such as political, contracting, and labor. Managers decide how much financial information to supply by 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.

Demand for Information

The following broad classes of users demand financial accounting information:

- Managers and employees
- Investment analysts and information intermediaries
- Creditors and suppliers
- Stockholders 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 as well as comparative financial information on competing companies and business opportunities. This permits them to benchmark their company’s 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 about claims on those resources, including claims by suppliers, creditors, lenders, and stockholders. 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 demand financial information to establish credit 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 company.

Stockholders and Directors
Stockholders and directors demand financial accounting information to assess the profitability and risks of companies. Stockholders and others (such as investment analysts, brokers, and potential investors) search 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 stockholders 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 antitrust assessments, public protection, price setting, import-export analyses, and setting tax policies. Timely and reliable information is crucial to effective
regulatory policy, and 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.

**IFRS INSIGHT Development of International Standards**

The accounting standards explained in this book are consistent with generally accepted accounting principles (GAAP) primarily developed by the Financial Accounting Standards Board (FASB). A similar organization, the International Accounting Standards Board (IASB), develops a global set of International Financial Reporting Standards (IFRS) for preparation of financial statements. To increase comparability of financial statements and reduce reporting complexity, the Securities Exchange Commission (SEC), the FASB, and the IASB are committed to a process of convergence to one set of world accounting standards. As we progress through the book, we will provide IFRS Insight boxes like this to identify differences between GAAP and IFRS.

**Supply of Information**

In general, the quantity and quality of accounting information that companies supply are determined by managers’ assessment of the benefits and costs of disclosure. Managers release 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 and 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, with explanatory notes and the management’s discussion and analysis (MD&A) 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 (which must be filed within 60 [90] days of the year-end for larger [smaller] companies) and 10-Q (which must be filed within 40 [45] days of the quarter-end for larger [smaller] companies, except for the fourth quarter when it is part of the 10-K) 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 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 companies have often already incurred those costs because managers need similar 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.

The SEC adopted Regulation Fair Disclosure (FD), or Reg FD for short, to curb the practice of selective disclosure by public companies (called *issuers* by the SEC) to certain stockholders and financial analysts. In the past, many companies disclosed important information in meetings and conference calls that excluded individual stockholders. 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 the cost of voluntary financial disclosure and led some companies to curtail the supply of financial information to all users.

**International Accounting Standards and Convergence**

The International Accounting Standards Board (IASB) oversees the development of accounting standards for a vast number of countries outside the United States. More than 100 countries, including those in the European Union, require use of International Financial Reporting Standards (IFRS) developed by the IASB. For many years, IASB and the FASB operated as independent standard-setting bodies. In the early 2000s, pressure mounted for these two standard-setting organizations to collaborate and create one set of internationally acceptable standards. At a joint meeting in 2002, the FASB and the IASB each acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting.

The original intent of the two boards was to create one set of standards that companies across the globe would adopt. However, resistance from U.S. companies, investors, and legislators thwarted that effort. Instead, a new approach has emerged and has the support of the SEC staff. Under this method, labeled the *endorsement method*, FASB would remain the U.S. standard setter and endorse new IFRS into the U.S. financial reporting system. Additionally, the FASB will consider how to conform current U.S. standards to existing IFRS. During 2013, FASB and IASB made progress on projects concerning revenue recognition, financial instruments, and leases. At present, the two boards have the following projects on their agendas: loan impairment, insurance contracts, and investment entities.

On July 13, 2012, the staff of the SEC’s Office of the Chief Accountant published a report on an IFRS Work Plan. The report did not include a final policy decision, or even a recommendation, as to whether or how IFRS should be incorporated into the U.S. financial reporting system. Thus, as of early 2014, there is no formal plan for U.S. companies to transition to IFRS. For now, the endorsement
method prevails. Interestingly, foreign companies that are listed on U.S. stock exchanges are permitted to file IFRS financial statements and many do.

Are financial statements prepared under IFRS substantially different from those prepared under U.S. GAAP? At a broad level, the answer is no. Both are prepared using accrual accounting and utilize similar conceptual frameworks. Both require the same set of financial statements: a balance sheet, an income statement, a statement of cash flows, a statement of stockholders’ equity, and a set of explanatory footnotes. That does not mean that no differences exist. However, the differences are typically technical in nature, and do not differ on broad principles discussed in this book.

At the end of each module, we summarize key differences between U.S. GAAP and IFRS. Also, there are a variety of sources that provide more detailed and technical analysis of similarities and differences between U.S. GAAP and IFRS. The FASB, the IASB, and each of the “Big 4” accounting firms also maintain Websites devoted to this issue. Search under IFRS and PwC, KPMG, EY and Deloitte. The two standard-setting bodies also provide useful information, see: FASB (www.fasb.org) and IASB (www.iasb.org).

**BUSINESS INSIGHT** Accounting Quality

In the bear market that followed the bursting of the dot.com bubble in the early 2000s, 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 and 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). Bottom line: we must be critical readers of financial reports.

**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; semiannual, 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, Target’s fiscal year ends on the Saturday nearest January 31, 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 stockholders; 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:

\[
\text{Investing} = \text{Nonowner Financing} + \text{Owner Financing}
\]

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 = $427,452 million; liabilities = $235,864 million; and equity = $191,588 million. Assets equal liabilities plus equity, which reflects the accounting equation: investing equals financing.

**Investing Activities**

Balance sheets are organized like the accounting equation. Investing activities are represented by the company’s 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, which typically occurs within a short period of time. Hence, they are classified as short-term assets. Companies also report a category of assets 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 side that depicts the relative proportion of short- and long-term assets for several companies that we feature in this book. Companies such as Cisco and Google require little investment in long-term assets. On the other hand, Procter & Gamble and McDonald’s 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.

### 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 between these two financing sources for a reason: borrowed money entails a legal obligation to repay amounts owed, and failure to do so 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 side, again citing many of the companies we feature as focus companies in this book. Google’s and Apple’s revenues and expenses are more volatile, which means that these companies face greater operating risk than do more established companies that operate in relatively stable markets. On the other hand, Caterpillar’s cash flows are relatively stable. They can 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 $46,992 million of cash on its 2012 balance sheet, which is 11% 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 stockholders 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 fair values be more informative? What problems might fair-value reporting 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.

**IFRS INSIGHT** Balance Sheet Presentation and IFRS

Balance sheets prepared under IFRS often classify accounts in reverse order of liquidity (lack of nearness to cash), which is the opposite of what U.S. companies do. For example, intangible assets are typically listed first and cash is listed last among assets. Also, equity is often listed before liabilities, where liabilities are again listed in order of decreasing liquidity. These choices reflect convention and not IFRS requirements.

**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 = $162,463 million; expenses = $147,151 million; and net income = $15,312 million. Net income reflects the profit (also called earnings) to owners for that specific period.

**EXHIBIT 1.4 Income Statement ($ millions)**

<table>
<thead>
<tr>
<th>BERKSHIRE HATHAWAY</th>
<th>Income Statement</th>
<th>For Year Ended December 31, 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$162,463</td>
<td></td>
</tr>
<tr>
<td>Expenses</td>
<td>$147,151</td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>$15,312</td>
<td></td>
</tr>
<tr>
<td>Less: Earnings attributable to noncontrolling interest</td>
<td>488</td>
<td></td>
</tr>
<tr>
<td>Net income attributable to Berkshire Hathaway stockholders</td>
<td>$14,824</td>
<td></td>
</tr>
</tbody>
</table>

**ANALYSIS INSIGHT** Earnings Attributable to Noncontrolling Interest

The income statement shows net income separated into two parts: one portion attributable to noncontrolling interest and a second portion attributable to Berkshire Hathaway stockholders. When you buy stock in Berkshire Hathaway, you are a stockholder of that company. Berkshire Hathaway owns stock in other companies, and the companies that Berkshire Hathaway (the parent) owns are called subsidiaries. Most of Berkshire Hathaway’s subsidiaries are owned entirely (100%) by Berkshire Hathaway. These are called “wholly-owned subsidiaries.” However, some Berkshire Hathaway subsidiaries are owned jointly by Berkshire Hathaway and other outside stockholders. If Berkshire Hathaway owns more than 50% of the common stock of a given subsidiary, Berkshire has de facto control over the operating, investing, and financing activities of the subsidiary. In this case, Berkshire Hathaway includes all of the revenues and all of the expenses of such a subsidiary in its own consolidated income statement. Then, Berkshire Hathaway separates the total consolidated net income into the portion that it owns (income attributable to Berkshire Hathaway stockholders) and the portion owned by outside stockholders (income attributable to noncontrolling interest). The portion is determined by the percent of outstanding common stock that Berkshire Hathaway owns. If Berkshire Hathaway owns 60% of the stock, 60% of the subsidiary’s income is attributable to Berkshire Hathaway stockholders and 40% is attributable to the noncontrolling interest. So, which income number should we use in an analysis of Berkshire Hathaway? Because analysis is usually performed from the standpoint of a stockholder of Berkshire Hathaway, we focus on the net income attributable to Berkshire Hathaway stockholders.
Manufacturing and merchandising companies typically include an additional expense account, called cost of goods sold (or cost of sales), in the income statement following revenues. It is also common to report a subtotal called gross profit (or gross margin), which is revenues less cost of goods sold. The company’s remaining expenses are then reported below gross profit. This income statement layout follows:

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. These differences are illustrated in the graph (to the side) of net income as a percentage of sales for several companies.

Target operates in a mature industry with little ability to differentiate its merchandise from competitors. Hence, its income as a percent 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 Apple, Google, and Intel. All three 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 stockholders. 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.
## Statement of Stockholders’ Equity

The **Statement of Stockholders’ 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 four categories:

- **Contributed capital**, the stockholders’ net contributions to the company
- **Retained earnings**, net income over the life of the company minus all dividends ever paid
- **Other**, consists of amounts that we explain later in the book
- **Noncontrolling interest**, the equity of outside stockholders

### EXHIBIT 1.5 Statement of Equity ($ millions)

<table>
<thead>
<tr>
<th></th>
<th>Contributed Capital</th>
<th>Retained Earnings</th>
<th>Other Equity</th>
<th>Noncontrolling Interest</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 2011</td>
<td>$37,815</td>
<td>$109,448</td>
<td>$17,587</td>
<td>$4,111</td>
<td>$168,961</td>
</tr>
<tr>
<td>Stock issuance (repurchase) ...</td>
<td>118</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income .................</td>
<td>14,824&lt;sup&gt;a&lt;/sup&gt;</td>
<td>488&lt;sup&gt;b&lt;/sup&gt;</td>
<td></td>
<td></td>
<td>15,312</td>
</tr>
<tr>
<td>Dividends ..................</td>
<td>(0)</td>
<td></td>
<td></td>
<td></td>
<td>(0)</td>
</tr>
<tr>
<td>Other ......................</td>
<td>(695)</td>
<td>9,846</td>
<td>(658)</td>
<td></td>
<td>8,493</td>
</tr>
<tr>
<td>December 31, 2012 ............</td>
<td>$37,238</td>
<td>$124,272</td>
<td>$26,137</td>
<td>$3,941</td>
<td>$191,588</td>
</tr>
</tbody>
</table>

<sup>a</sup> This is income attributable to Berkshire Hathaway stockholders, see Exhibit 1.4

<sup>b</sup> This is income attributable to noncontrolling interest, see Exhibit 1.4

Exhibit 1.5 reconciles the activity in each of the equity accounts from the balance sheet in Exhibit 1.3. We briefly discuss each of these accounts here and explain the accounts in depth in Module 8.

- **Contributed capital** represents assets the company received from issuing stock to stockholders (also called shareholders). The balance of this account at the beginning of the year was $37,815 million. During the year, Berkshire Hathaway sold additional shares for $118 million and recorded miscellaneous adjustments of $(695) million to yield a year-end balance of $37,238 million.

- **Retained earnings** (also called **earned capital** or **reinvested capital**) represent the cumulative total amount of income that the company has ever earned and that has been retained in the business; that is, not distributed to stockholders in the form of dividends. The change in retained earnings links consecutive balance sheets via the income statement: Ending retained earnings = Beginning retained earnings + Net income for the period − Dividends for the period. For Berkshire Hathaway, its retained earnings increases from $109,448 million to $124,272 million. This increase of $14,824 million is explained by its net income of $14,824 million as Berkshire Hathaway paid no dividends in 2012.

- **Other equity** for Berkshire Hathaway consists of **accumulated other comprehensive income (AOCI)** and **Treasury stock (TS)**. We defer discussion of AOCI to Module 8. For now, view AOCI
as income that has not been reflected in the income statement and is, therefore, excluded from retained earnings. Treasury stock is the cost of the shares that Berkshire Hathaway has repurchased and not reissued. It can be seen as the opposite of contributed capital. Treasury stock decreases equity when shares are repurchased (hence, the negative sign).

- **Noncontrolling interest** represents the equity of noncontrolling stockholders who own stock in Berkshire Hathaway’s subsidiaries. As with equity for Berkshire Hathaway’s stockholders, the equity of noncontrolling interest increases by income attributable to noncontrolling interest and decreases by any dividends paid or losses attributable to the noncontrolling interest (there were none in 2012). We defer discussion of this account to Modules 8 and 9.

### RESEARCH INSIGHT Are Earnings Important?

A 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 change in 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 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 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 $9,693 million in the recent period: operating activities generated a $20,950 million cash inflow, investing activities reduced cash by $10,574 million, and financing activities yielded a cash outflow of $683 million.

<table>
<thead>
<tr>
<th>EXHIBIT 1.6</th>
<th>Statement of Cash Flows ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>BERKSHIRE HATHAWAY</td>
</tr>
<tr>
<td></td>
<td>Statement of Cash Flows</td>
</tr>
<tr>
<td></td>
<td>For Year Ended December 31, 2012</td>
</tr>
<tr>
<td>Operating cash flows</td>
<td>$20,950</td>
</tr>
<tr>
<td>Investing cash flows</td>
<td>(10,574)</td>
</tr>
<tr>
<td>Financing cash flows</td>
<td>(683)*</td>
</tr>
<tr>
<td>Net increase in cash</td>
<td>9,693</td>
</tr>
<tr>
<td>Cash, December 31, 2011</td>
<td>37,299</td>
</tr>
<tr>
<td>Cash, December 31, 2012</td>
<td>$46,992</td>
</tr>
</tbody>
</table>

* Includes $(123) relating to foreign currency exchange rate changes.

Berkshire Hathaway’s operating cash flow of $20,950 million does not equal its $14,824 million net income. Generally, a company’s net cash flow for a period does not equal its net income for the pe-
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 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—consider the following:

- The income statement and the balance sheet are linked via retained earnings. For Berkshire Hathaway, the $14,824 million increase in retained earnings (reported on the balance sheet) equals its net income (reported on the income statement) (see Exhibit 1.5). Berkshire Hathaway did not pay dividends in 2012.
- 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 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.

**Information Beyond Financial Statements**

Important financial information about a company is communicated to various decision makers through means other than the four financial statements. These 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.
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 can yield 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. Following are examples of how some managers are alleged to have abused the latitude available in reporting financial results.

<table>
<thead>
<tr>
<th>Company</th>
<th>Allegations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adelphia Communications (ADELQ)</td>
<td>Founding Rigas family collected $3.1 billion in off-balance-sheet loans backed by Adelphia; it overstated results by inflating capital expenses and hiding debt.</td>
</tr>
<tr>
<td>Time Warner (TWX)</td>
<td>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.</td>
</tr>
<tr>
<td>Enron</td>
<td>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.</td>
</tr>
<tr>
<td>Global Crossing (GLBC)</td>
<td>Engaged in network capacity “swaps” with other carriers to inflate revenue; shredded documents related to accounting practices.</td>
</tr>
<tr>
<td>Qwest Communications International (Q)</td>
<td>Inflated revenue using network capacity “swaps” and improper accounting for long-term deals.</td>
</tr>
<tr>
<td>Tyco (TYC)</td>
<td>Ex-CEO L. Dennis Kozlowski indicted for tax evasion; Kozlowski and former CFO Mark H. Swartz, convicted of taking unauthorized loans from the company.</td>
</tr>
<tr>
<td>WorldCom</td>
<td>Overstated cash flow by booking $11 billion in operating expenses as capital costs; loaned founder Bernard Ebbers $400 million off-the-books.</td>
</tr>
<tr>
<td>Autonomy Corp.</td>
<td>Engaged in aggressive revenue recognition (“round-trip transactions”) where it bought goods from customers and failed to fully record costs; its overstated results allegedly led Hewlett-Packard to overpay when acquiring Autonomy stock.</td>
</tr>
</tbody>
</table>

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.

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 narrowly avoid 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
The following financial information is from AXA Equitable Life Insurance Company, a competitor of Berkshire Hathaway’s GEICO Insurance, for the year ended December 31, 2012 ($ millions).

<table>
<thead>
<tr>
<th>Financial Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash, ending year</td>
<td>$3,162</td>
</tr>
<tr>
<td>Cash flows from operations</td>
<td>$(780)</td>
</tr>
<tr>
<td>Revenues</td>
<td>$9,160</td>
</tr>
<tr>
<td>Net income attributable to AXA stockholders</td>
<td>$121</td>
</tr>
<tr>
<td>AXA stockholders’ equity</td>
<td>$15,436</td>
</tr>
<tr>
<td>Cash flows from financing</td>
<td>$3,407</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$158,913</td>
</tr>
<tr>
<td>Expenses</td>
<td>$8,944</td>
</tr>
<tr>
<td>Noncash assets</td>
<td>$173,681</td>
</tr>
<tr>
<td>Cash flows from investing</td>
<td>$(2,692)</td>
</tr>
<tr>
<td>Net income</td>
<td>$216</td>
</tr>
<tr>
<td>Noncontrolling interest (equity)</td>
<td>$2,494</td>
</tr>
<tr>
<td>Cash, beginning year</td>
<td>$3,227</td>
</tr>
</tbody>
</table>

**Required**

2. Compare the balance sheet and income statement of AXA to those of Berkshire Hathaway in Exhibits 1.3 and 1.4. What differences do we observe?

*The solution is on page 1-43.*
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.

**Return on Assets**

Suppose we learn that a company reports a profit of $10 million. Does the $10 million profit indicate that the company is 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 without considering the context. To explain, suppose we learn that this company has $500 million in assets. We now assess the $10 million profit as low 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 on assets is what a much lower-risk investment in government-backed bonds might yield. The important point is that a company’s profitability must be assessed with respect to the size of its investment. One common metric is the *return on assets* (ROA)—defined as net income for that period divided by the average assets for that period.

**Components of Return on Assets**

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

Productivity relates sales to assets. This component, called *asset turnover* (AT), reflects sales generated by each dollar of assets. Management wants to maximize asset productivity, that is, to achieve the highest possible sales level for a given level of assets (or to achieve a given level of sales with the smallest level of assets).

Exhibit 1.7 depicts the disaggregation of return on assets into these two components. Profitability (PM) and productivity (AT) are multiplied to yield the return on assets (ROA). Average assets are commonly defined as (beginning-year assets + ending-year assets)/2.

![Exhibit 1.7: Return on Assets Disaggregation](image)

There are an infinite number of combinations of profit margin and asset turnover that yield the same return on assets. To illustrate, Exhibit 1.8 graphs actual combinations of these two components for companies that we highlight in this book (each is identified by its ticker symbol). Retailers, such as Home Depot (HD), Target (TGT), and Starbucks (SBUX) are characterized by relatively low profit margins and a high turnover of their assets. The business models for other companies such as 3M (MMM), Johnson & Johnson (JNJ), and McDonald’s (MCD) require a larger investment in assets. These
companies must earn a higher profit margin to yield an acceptable ROA. We might be surprised to see technology companies such as Apple (AAPL), Google (GOOG), and Cisco (CSCO) in the group with high asset investments. Technology companies typically maintain a high level of cash and short-term investments on their balance sheets, which allows them to respond quickly to opportunities. The solid line represents those profitability and productivity combinations that yield a 10.5% return on assets.

**Exhibit 1.8 Profitability and Productivity Across Companies**

### Return on Equity

Another important analysis measure is return on equity (ROE), which is defined as net income attributable to the parent company’s stockholders divided by average stockholders’ equity, where average equity is commonly defined as (beginning-year equity attributable to the parent company’s stockholders + ending-year equity attributable to the parent company’s stockholders)/2. In this case, company earnings are compared to the level of stockholder (not total) investment. ROE reflects the return to stockholders, which is different from the return for the entire company (ROA).

**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 disaggregate return on assets to identify areas for improvement? [Answer, p. 1-32]

### Financial Statements 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 analysis and interpretation. This business analysis can sharpen our insights and help us better estimate future performance and company value.

### 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 and are key determinants of profitability.

A. **Industry competition** Competition and rivalry raise the cost of doing business as companies must hire and train competitive workers, advertise products, research and develop products, and engage in 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.

C. **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.

D. **Threat of substitution** As the number of product substitutes increases, sellers have less power to raise prices and/or pass costs on to buyers; accordingly, threat of substitution places downward pressure on profits of sellers.

E. **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.

The broader business environment affects the level of profitability that a company can expect to achieve. 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 in an effort to generate more profit. Such changes are revealed in the income statement and the balance sheet.

### 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 several years ago. Berkshire describes McLane’s business in the following note to the Berkshire Hathaway 2012 annual report:
McLane Company—McLane Company, Inc. ("McLane") provides wholesale distribution and logistics services in all 50 states and internationally in Brazil to customers that include convenience stores, discount retailers, wholesale clubs, drug stores, military bases, quick service restaurants, and casual dining restaurants. Prior to Berkshire’s acquisition in 2003, McLane was an integral part of the Wal-Mart Stores, Inc. ("Wal-Mart") distribution network. McLane continues to provide wholesale distribution services to Wal-Mart, which accounts for approximately 28% of McLane’s revenues. McLane’s business model is based on a high volume of sales, rapid inventory turnover, and tight expense control.

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. 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 28% 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 ($37 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.

**Analyzing the Broader Business Environment**

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 start-up, 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 stockholders? Is it under investigation by regulators? Has it changed auditors? If so, why? 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.

Analyzing Competitive Advantage

The goal of our analysis is to identify sustainable operating income and cash flow. This is true whether our analysis is focused on valuation of equity securities as a current or prospective investor, or on a company’s ability to repay its debt as a current or prospective creditor, or on trying to grow company value as part of management. This analysis is much deeper than merely eliminating transitory (nonrecurring) items from financial statements. It is an attempt to answer one of the following two questions:

1. Is the company’s competitive advantage sustainable?
2. If the company has no competitive advantage, does its management have a plan to develop a sustainable competitive advantage that can be implemented in an acceptable period of time and with a reasonable amount of investment?

Answers to these questions impact forecasts of the company’s future performance.

Companies increase market value when they earn a return on investment that exceeds the usual level of return (we discuss valuation of equity securities in Module 12). It is very difficult, however, to sustain such excess returns given a competitive environment and ever-shortening product life cycles. We already discussed the nature of a competitive environment as advanced by Professor Michael Porter, who also identified cost leadership and differentiation as potential strategies to achieve sustainable competitive advantage (see Porter, Competitive Advantage: Creating and Sustaining Superior Performance, The Free Press, 1985). Our aim is to identify the source of competitive advantage and to investigate the extent to which it is sustainable, that is, whether it can be competed away.

Patents and other protections of intellectual property create barriers to entry that allow a company to achieve a comparative advantage and excess returns. These legal barriers typically have a finite life, however, and a company must maintain a pipeline of innovations that offer replacements for intellectual property that loses patent protection. The pharmaceutical industry is one example and analysts focus on pending patent expirations and the replacements.

In the absence of legal protection, companies utilize other strategies to achieve sustainable competitive advantage. Product differentiation is one strategy, and, if the company is able to effectively differentiate its product so that there are limited or no substitutes, it can charge a premium price to yield excess returns. Typically, differentiation is achieved from technological innovation that produces products and services with attributes valued by customers and not easily replicated by competitors. Differentiation along the dimensions of product design, marketing, distribution, and after-sale customer support are examples. Such differentiation has costs such as research and development, advertising, and other marketing expenses. Our analysis of such strategies focuses on the cost of achieving such differentiation vis-à-vis the price premium extracted from the market. We also focus on the extent competitors can develop an effective response, thus, creating price pressure and reducing returns. Commentary in the Management Discussion and Analysis (MD&A) section of the 10-K can provide useful insights along with financial press articles, actions and plans of competitors, and consumers of the company’s products or services.

Another approach to achieve excess returns is to become a cost leader. Cost leadership can result from a number of factors, including access to low-cost raw materials or labor (while maintaining quality), manufacturing or service efficiency in the form of cost-efficient processes and manufacturing
scale efficiencies, greater bargaining power with suppliers, sophisticated IT systems that permit timely collection of key information, and other avenues. Companies that view themselves as cost leaders frequently highlight the areas in which they excel in the MD&A. Our analysis focuses on the degree such cost efficiencies are likely to persist.

In the absence of a competitive advantage, our analysis focuses on the likelihood that a company develops such an advantage. Management often discusses strategy with stockholders and equity analysts, which are recorded in conference calls that are readily available or reported in the financial press. In the case of a turnaround situation, our focus is on viability of the plan, that is, can it be achieved at an acceptable cost given the current state of the industry. Moreover, our focus is long term. Companies can often achieve short-term gains at long-term cost, such as by selling off profitable segments. Such actions do not create long-term value.

Our increasingly competitive environment has led to an increasing number of failures. Two-thirds of the original Fortune 500 disappeared within three decades and only 71 survive today (see Stangler and Arbesman, *What Does FORTUNE 500 Turnover Mean?* Ewing Marion Kauffman Foundation, 2012). Creating a sustainable competitive advantage that yields excess returns is difficult and we are wary of forecasted excess returns for an extended period. Through a critical and thorough investigation of financial statements, its footnotes, the MD&A, and all publicly available information, we can identify drivers of a company’s competitive advantage. We then test the sustainability and validity of those drivers. This is an important step in assessing competitive advantage.

**GLOBAL ACCOUNTING**

As we discussed earlier, the United States is among only a few economically developed countries (such as India, Singapore, and Taiwan) that do not use IFRS (a list is at [http://www.iasplus.com/en/resources/use-of-ifrs/#totals](http://www.iasplus.com/en/resources/use-of-ifrs/#totals)). While laws and enforcement mechanisms vary across countries, the demand and supply of accounting information are governed by global economic forces. Thus, it is not surprising that IFRS and U.S. GAAP both prescribe the same set of financial statements. While account titles and note details differ, the underlying principles are the same. That is, U.S. GAAP and IFRS both capture, aggregate, summarize, and report economic activities on an accrual basis.

Given the global economy and liquid transnational capital markets, along with the fact that many non-U.S. companies file IFRS financial statements with the SEC, it is critical that we be conversant with both U.S. GAAP and IFRS. For this purpose, the final section of each module includes a summary of notable differences between these two systems of accounting for topics covered in that module. Also, each module has assignments that examine IFRS companies and their financial statements. By using a wide array of financial information, we will speak the language of accounting in at least two dialects.

**MODULE-END REVIEW**

Following are selected data from *Progressive Corporation*’s 2012 10-K.

<table>
<thead>
<tr>
<th>$ millions</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$17,084</td>
</tr>
<tr>
<td>Net income</td>
<td>902</td>
</tr>
<tr>
<td>Average assets</td>
<td>22,270</td>
</tr>
<tr>
<td>Average stockholders’ equity</td>
<td>5,907</td>
</tr>
</tbody>
</table>

**Required**

- Compute Progressive’s return on assets. Disaggregate the ROA into its profitability and productivity components.
- Compute Progressive’s return on equity (ROE).

The solution is on page 1-44.
**APPENDIX 1A: Accessing SEC Filings**

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). Following is a brief tutorial to access these electronic filings. The SEC’s Website is [http://www.sec.gov](http://www.sec.gov).

1. Following is the opening screen. Click on “Company Filings” (highlighted below).

2. In **Company name**, type in the name of the company we are looking for. In this case, we are searching for Berkshire Hathaway. Then click search.

3. Click CIK (Central Index Key), state, country, or SIC (Standard Industrial Classification).

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

5. Enter the form number under “filing type” that we want to access. Click the Search button. In this case we are looking for the 10-K.

6. Click on the document link for the year that we want to access.
APPENDIX 1B: Accounting Principles and Governance

Financial Accounting Environment

Information in financial statements is crucial to valuing a company’s debt and equity securities. Financial statement 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 mispriced, 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 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 provides 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 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 primarily to the private sector to set accounting standards. 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 nearly 170 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. 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. 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.

**Audits and Corporate Governance**

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. To that end, companies engage external auditors to provide an opinion about financial statements. Further, companies implement a system of checks and balances that monitor managers’ actions, which is called corporate governance.

**Audit Report**

Financial statements for each publicly traded company must be audited by an independent audit firm. There are a number of large auditing firms that are authorized by the SEC to provide auditing services for companies that issue securities to the public: PricewaterhouseCoopers, KPMG, Ernst & Young, Deloitte, McGladrey, Grant Thornton, and BDO, to name a few. These firms provide opinions about financial statements for the large majority of publicly traded U.S. 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 1.10.

The basic “clean” audit report is consistent across companies and includes these assertions:

- 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.
EXHIBIT 1.10  Audit Report for Berkshire Hathaway

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

We have audited the accompanying consolidated balance sheets of Berkshire Hathaway Inc. and subsidiaries (the “Company”) as of December 31, 2012 and 2011, and the related consolidated statements of earnings, comprehensive income, changes in shareholders’ equity, and cash flows for each of the three years in the period ended December 31, 2012. We also have audited the Company’s internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company’s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the Company’s internal control over financial reporting 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 and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company’s internal control over financial reporting is a process designed by, or under the supervision of, the company’s principal executive and principal financial officers, or persons performing similar functions, and effected by the company’s board of directors, management, and other personnel 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. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Berkshire Hathaway Inc. and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

DELOITTE & TOUCHE LLP

Omaha, Nebraska
March 1, 2013
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.

Financial statements *present fairly, in all material respects* a company’s financial condition, in conformity with GAAP.

If the auditor cannot make all of these assertions, 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. Instead, auditors usually develop statistical samples to make inferences about the larger set of 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** (PCAOB) 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.

**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. Governance committees are commonplace. One of these, the audit committee, oversees the financial accounting system. Exhibit 1.11 illustrates a typical organization of a company’s governance structure.

![Exhibit 1.11 Business Activities](image)

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.
Regulatory and Legal Environment

The regulatory and legal environment provides further assurance that financial statements are complete and accurate.

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 on 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). We prefer to use the 10-K because of its additional information.

The SEC critically reviews all of the financial reports that companies submit. If irregularities are found, the SEC has the authority to bring enforcement actions against companies that it feels are misrepresenting their financial condition (remember the phrase in the audit opinion that requires companies to “present fairly, in all material respects, the financial position of . . . ”). One such action was brought against Dell Inc. and its executives. Following are excerpts from the SEC’s complaint:

The Securities and Exchange Commission today charged Dell Inc. with failing to disclose material information to investors and using fraudulent accounting to make it falsely appear that the company was consistently meeting Wall Street earnings targets and reducing its operating expenses.

The SEC alleges that Dell did not disclose to investors large exclusivity payments the company received from Intel Corporation not to use central processing units (CPUs) manufactured by Intel’s main rival. It was these payments rather than the company’s management and operations that allowed Dell to meet its earnings targets. After Intel cut these payments, Dell again misled investors by not disclosing the true reason behind the company’s decreased profitability . . .

The SEC’s complaint, filed in federal district court in Washington, D.C., alleges that Dell Inc., Michael Dell, Rollins, and Schneider misrepresented the basis for the company’s ability to consistently meet or exceed consensus analyst EPS estimates from fiscal year 2002 through fiscal year 2006. Without the Intel payments, Dell would have missed the EPS consensus in every quarter during this period . . .

The SEC’s complaint further alleges that Dell’s most senior former accounting personnel, including Schneider, Dunning, and Jackson engaged in improper accounting by maintaining a series of “cookie jar” reserves that it used to cover shortfalls in operating results from FY 2002 to FY 2005. Dell’s fraudulent accounting made it appear that it was consistently meeting Wall Street earnings targets and reducing its operating expenses through the company’s management and operations.

According to the SEC’s complaint, Intel made exclusivity payments to Dell in order for Dell not to use CPUs manufactured by its rival—Advance Micro Devices, Inc. (AMD). These exclusivity payments grew from 10 percent of Dell’s operating income in FY 2003 to 38 percent in FY 2006, and peaked at 76 percent in the first quarter of FY 2007. The SEC alleges that Dell Inc., Michael Dell, Rollins, and Schneider failed to disclose the basis for the company’s sharp drop in its operating results in its second quarter of fiscal 2007 as Intel cut its payments after Dell announced its intention to begin using AMD CPUs. In dollar terms, the reduction in Intel exclusivity payments was equivalent to 75 percent of the decline in Dell’s operating income. Michael Dell, Rollins, and Schneider had been warned in the past that Intel would cut its funding if Dell added AMD as a vendor. Nevertheless, in Dell’s second quarter FY 2007 earnings call, they told investors that the sharp drop in the company’s operating results was attributable to Dell pricing too aggressively in the face of slowing demand and to component costs declining less than expected.

The SEC’s complaint further alleges that the reserve manipulations allowed Dell to materially misstate its earnings and its operating expenses as a percentage of revenue—an important financial metric that the Company itself highlighted—for over three years. The manipulations also enabled Dell to misstate materially the trend and amount of operating income of its EMEA segment, an important business unit that Dell also highlighted, from the third quarter of FY 2003 through the first quarter of FY 2005.

While not admitting to wrongdoing, Dell agreed to pay a penalty of $100 million to settle the SEC’s charges. The SEC’s oversight and powers of prosecution are an important check to help insure that companies’ reports to investors “present fairly, in all material respects” the companies’ financial condition.
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 book 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

Courts

Courts provide remedies to individuals and companies that suffer damages as a result of material misstatements in financial statements. Typical court actions involve stockholders who sue the company and its auditors, alleging that the company disclosed, and the auditors attested to, false and misleading financial statements. Stockholder lawsuits are chronically in the news, although the number of such suits has declined in recent years. 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 corporate governance in the wake of the Enron and WorldCom frauds likely reduced the actual incidence of fraud.” Nevertheless, courts continue to wield considerable power. For example, 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; he applied for a Presidential pardon in January 2009 but was denied.
- Timothy Rigas, the ex-finance chief, was sentenced to 20 years and is currently serving time at a federal correctional complex in North Carolina.
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 often measured by return on assets, which can be disaggregated into the profit margin (profit after tax/sales) and the asset turnover (sales/average 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 statements can provide useful information for each activity. How can subsequent financial statements 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. Access the 2012 10-K for Procter & Gamble at the SEC’s 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?

Q1-11. 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. What are generally accepted accounting principles and what organizations presently establish them?

Q1-13. 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. 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 statement information, other than a stock investment decision. How is financial statement information useful in making this decision?

Q1-16. Users of financial statement 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)
In a recent year, the total assets of Dell Inc. equal $47,540 million and its equity is $10,701 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)
In a recent year, the total assets of Best Buy equal $16,787 million and its liabilities equal $13,072 million. What is the amount of Best Buy’s equity? Does Best Buy 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.

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>Assets =</th>
<th>Liabilities +</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hewlett-Packard</td>
<td>$108,768</td>
<td>= $85,935</td>
<td>+ $ (a)</td>
</tr>
<tr>
<td>General Mills</td>
<td>$22,658</td>
<td>= $ (b)</td>
<td>+ $ 8,096</td>
</tr>
<tr>
<td>Target</td>
<td>$ (c)</td>
<td>= $31,605</td>
<td>+ $16,558</td>
</tr>
</tbody>
</table>

M1-22. Identifying Key Numbers from Financial Statements (LO2)
Access the September 30, 2012, 10-K for Starbucks Corporation at the SEC’s database for financial reports (www.sec.gov). What did Starbucks report for total assets, liabilities, and equity at September 30, 2012? Confirm that the accounting equation holds. What percent of Starbucks’ assets is financed by nonowners?

M1-23. Verifying Linkages Between Financial Statements (LO2)
Access the 2012 10-K for DuPont at the SEC’s database of financial reports (www.sec.gov). Using its December 31, 2012, consolidated statement of stockholders’ equity, prepare a table to reconcile the opening and ending balances of its retained (reinvested) earnings for 2012 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 \( \text{(LO5)} \)
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. Understanding Internal Controls and Their Importance \( \text{(LO5)} \)
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 would Congress believe that internal controls are such an important area to monitor and report on?

EXERCISES

E1-27. Composition of Accounts on the Balance Sheet \( \text{(LO2)} \)
Answer the following questions about the Target balance sheet.

- Briefly describe the types of assets that Target is likely to include in its inventory.
- What kinds of assets would Target likely include in its Property and Equipment?
- Target reports about two-thirds of its total assets as long-term. Given Target’s business model, why do we see it report a relatively high proportion of long-term assets?

E1-28. Applying the Accounting Equation and Assessing Financial Statement Linkages \( \text{(LO2)} \)
Answer the following questions. \( \text{(Hint: Apply the accounting equation.)} \)

- Intel had assets equal to $84,351 million and liabilities equal to $33,148 million for a recent year-end. What was Intel’s total equity at year-end? Why would we expect a company like Intel to report a relatively high proportion of equity vis-à-vis liabilities?
- At the beginning of a recent year, JetBlue’s assets were $7,071 million and its equity was $1,757 million. During the year, assets decreased $1 million and liabilities decreased $132 million. What was JetBlue’s equity at the end of the year?
- What balance sheet account provides the link between the balance sheet and the income statement? Briefly describe how this linkage works.

E1-29. Specifying Financial Information Users and Uses \( \text{(LO1)} \)
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 \( \text{(LO2)} \)
Colgate-Palmolive reports the following dollar balances in its retained earnings account.

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>2012</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>$16,953</td>
<td>$15,649</td>
</tr>
</tbody>
</table>

During 2012, Colgate-Palmolive reported net income of $2,472 million. What amount of dividends, if any, did Colgate-Palmolive pay to its stockholders in 2012? What percent of its net income did Colgate-Palmolive pay out as dividends in 2012?
Following are selected ratios of Colgate-Palmolive for 2012 and 2011.

<table>
<thead>
<tr>
<th>Return on Assets (ROA) Component</th>
<th>2012</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profitability (Net income/Sales)</td>
<td>14%</td>
<td>15%</td>
</tr>
<tr>
<td>Productivity (Sales/Average net assets)</td>
<td>1.3</td>
<td>1.4</td>
</tr>
</tbody>
</table>

a. Was the company profitable in 2012? What evidence do you have of this?
b. Is the change in productivity (asset turnover) a positive development? Explain.
c. Compute the company’s return on assets (ROA) for 2012 (show computations).

E1-32. Computing Return on Assets and Applying the Accounting Equation **(LO3)**
Nordstrom, Inc., reports net income of $735 million for its fiscal year ended February 2013. At the beginning of that fiscal year, Nordstrom had $8,491 million in total assets. By fiscal year-end 2013, total assets had decreased to $8,089 million. What is Nordstrom’s return on assets (ROA)?

Financial statement information plays an important role in modern society and business.

a. Identify two or more external stakeholders that are interested in a company’s financial statements and what their particular interests are.
b. What are generally accepted accounting principles? What organizations have primary responsibility for the formulation of GAAP?
c. What role does financial statement information play in the allocation of society’s financial resources?
d. What are three aspects of the accounting environment that can create ethical pressure on management?

E1-34. Computing Return on Equity **(LO3)**
Starbucks reports net income for 2012 of $1,383.8 million. Its stockholders’ equity is $4,387.3 million and $5,114.5 million for 2011 and 2012, respectively.

a. Compute its return on equity for 2012.
b. Starbucks repurchased over $501 million of its common stock in 2012. How did this repurchase affect Starbucks’ ROE?
c. Why do you think a company like Starbucks repurchases its own stock?

PROBLEMS

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

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>Total Assets</th>
<th>Net Income</th>
<th>Sales</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>$203,105</td>
<td>$16,999</td>
<td>$469,162</td>
<td>$81,738</td>
</tr>
<tr>
<td>2012</td>
<td>193,406</td>
<td>15,699</td>
<td>446,950</td>
<td>75,761</td>
</tr>
<tr>
<td>2011</td>
<td>180,782</td>
<td>16,389</td>
<td>421,849</td>
<td>71,247</td>
</tr>
</tbody>
</table>

Required

a. Compute the return on equity (ROE) for 2012 and 2013. What trend, if any, is evident? How does Wal-Mart’s ROE compare with the approximately 21.5% median ROE for companies in the Dow Jones Industrial average for 2012?
b. Compute the return on assets (ROA) for 2012 and 2013. What trends, if any, are evident? How does Wal-Mart’s ROA compare with the approximate 6.7% median ROA for companies in the Dow Jones Industrial average for 2012?
c. What factors might allow a company like Wal-Mart to reap above-average returns?
Following is selected financial information from **General Mills, Inc.**, for its fiscal year ended May 26, 2013 ($ millions).

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$17,774.1</td>
</tr>
<tr>
<td>Cash from operating activities</td>
<td>2,926.0</td>
</tr>
<tr>
<td>Cash, beginning year</td>
<td>471.2</td>
</tr>
<tr>
<td>Stockholders' equity</td>
<td>8,096.0</td>
</tr>
<tr>
<td>Noncash assets</td>
<td>21,916.6</td>
</tr>
<tr>
<td>Cash from financing activities*</td>
<td>(1,140.4)</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>11,350.2</td>
</tr>
<tr>
<td>Total expenses (other than cost of goods sold)</td>
<td>4,568.7</td>
</tr>
<tr>
<td>Cash, ending year</td>
<td>741.4</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>14,562.0</td>
</tr>
<tr>
<td>Cash from investing activities</td>
<td>(1,515.4)</td>
</tr>
</tbody>
</table>

* Cash from financing activities includes the effects of foreign exchange rate fluctuations.

**Required**

a. Prepare the income statement, the balance sheet, and the statement of cash flows for General Mills for the fiscal year ended May 26, 2013.

b. Do the negative amounts for cash from investing activities and cash from financing activities concern us? Explain.

c. Using the statements prepared for part a, compute the following ratios (for this part only, use the year-end balance instead of the average for assets and stockholders’ equity):
   i. Profit margin
   ii. Asset turnover
   iii. Return on assets
   iv. Return on equity

---

Following is selected financial information from **Abercrombie & Fitch** for its fiscal year ended February 2, 2013 ($ millions).

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noncash assets</td>
<td>$2,343</td>
</tr>
<tr>
<td>Total expenses (other than cost of goods sold)</td>
<td>2,580</td>
</tr>
<tr>
<td>Cash from investing activities</td>
<td>(247)</td>
</tr>
<tr>
<td>Cash, ending year</td>
<td>644</td>
</tr>
<tr>
<td>Revenue</td>
<td>4,511</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>1,169</td>
</tr>
<tr>
<td>Cash from operating activities</td>
<td>684</td>
</tr>
<tr>
<td>Cash from financing activities*</td>
<td>(377)</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>1,694</td>
</tr>
<tr>
<td>Cash, beginning year</td>
<td>584</td>
</tr>
<tr>
<td>Stockholders’ equity</td>
<td>1,818</td>
</tr>
</tbody>
</table>

* Cash from financing activities includes the effects of foreign exchange rate fluctuations.

**Required**

a. Prepare the income statement, the balance sheet, and the statement of cash flows for Abercrombie & Fitch for the fiscal year ended February 2, 2013.

b. Do the negative amounts for cash from investing activities and cash from financing activities concern us? Explain.

c. Using the statements prepared for part a, compute the following ratios (for this part only, use the year-end balance instead of the average for assets and stockholders’ equity):
   i. Profit margin
   ii. Asset turnover
   iii. Return on assets
   iv. Return on equity
P1-38. **Formulating Financial Statements from Raw Data** *(LO2, 3)*

Following is selected financial information from **Cisco Systems, Inc.**, for the year ended July 27, 2013 ($ millions).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash, ending year</td>
<td>$ 7,925</td>
</tr>
<tr>
<td>Cash from operating activities</td>
<td>12,894</td>
</tr>
<tr>
<td>Sales</td>
<td>48,607</td>
</tr>
<tr>
<td>Stockholders’ equity</td>
<td>59,128</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>19,167</td>
</tr>
<tr>
<td>Cash from financing activities</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>42,063</td>
</tr>
<tr>
<td>Total expenses (other than cost of goods sold)</td>
<td>19,457</td>
</tr>
<tr>
<td>Noncash assets</td>
<td>93,266</td>
</tr>
<tr>
<td>Cash from investing activities</td>
<td>(11,768)</td>
</tr>
<tr>
<td>Net income</td>
<td>9,983</td>
</tr>
<tr>
<td>Cash, beginning year</td>
<td>9,799</td>
</tr>
</tbody>
</table>

**Required**


* b. Do the negative amounts for cash from investing activities and cash from financing activities concern us? Explain.

* c. Using the statements prepared for part a, compute the following ratios (for this part only, use the year-end balance instead of the average for assets and stockholders’ equity):
  * i. Profit margin
  * ii. Asset turnover
  * iii. Return on assets
  * iv. Return on equity

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

Crocker Corporation began calendar-year 2013 with stockholders’ equity of $150,000, consisting of contributed capital of $120,000 and retained earnings of $30,000. During 2013, 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 stockholders.

**Required**

Prepare the 2013 statement of stockholders’ equity for Crocker Corporation.

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

**Gap, Inc.**, reports the following selected information at February 2, 2013 ($ millions).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributed capital, February 2, 2013</td>
<td>$ 2,919</td>
</tr>
<tr>
<td>Treasury stock, February 2, 2013</td>
<td>(13,465)</td>
</tr>
<tr>
<td>Retained earnings, February 2, 2013</td>
<td>13,259</td>
</tr>
<tr>
<td>Accumulated other comprehensive income, February 2, 2013</td>
<td>181</td>
</tr>
</tbody>
</table>

During fiscal year 2013, Gap reported the following:

1. Issuance of stock ................................ $ 3
2. Repurchase of stock ................................ 705
3. Net income ........................................ 1,135
4. Cash dividends ..................................... 240
5. Other comprehensive income (loss) ............ (48)

**Required**

Use this information to prepare the statement of stockholders’ equity for Gap, Inc., for fiscal year 2013.
P1-41. Computing, Analyzing, and Interpreting Return on Equity and Return on Assets (LO3)
Following are summary financial statement data for Kimberly-Clark for 2010 through 2012.

<table>
<thead>
<tr>
<th>KIMBERLY-CLARK CORPORATION (KMB)</th>
<th>2012</th>
<th>2011</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$21,063</td>
<td>$20,846</td>
<td>$19,746</td>
</tr>
<tr>
<td>Net income</td>
<td>1,750</td>
<td>1,591</td>
<td>1,843</td>
</tr>
<tr>
<td>Total assets</td>
<td>19,873</td>
<td>19,373</td>
<td>19,864</td>
</tr>
<tr>
<td>Equity</td>
<td>4,985</td>
<td>5,249</td>
<td>5,917</td>
</tr>
</tbody>
</table>

**Required**

a. Compute the return on assets and return on equity for 2011 and 2012 (use average assets and average equity), together with the components of ROA (profit margin and asset turnover). What trends do we observe?

b. Which component appears to be driving the change in ROA over this time period?

c. KMB repurchased a large amount of its common shares in recent years at a cost of almost $4.9 billion. How did this repurchase affect its return on equity?

P1-42. Computing, Analyzing, and Interpreting Return on Equity and Return on Assets (LO3)

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>2013</th>
<th>2012</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$11,762</td>
<td>$10,497</td>
<td>$9,310</td>
</tr>
<tr>
<td>Net income</td>
<td>735</td>
<td>683</td>
<td>613</td>
</tr>
<tr>
<td>Total assets</td>
<td>8,089</td>
<td>8,491</td>
<td>7,462</td>
</tr>
<tr>
<td>Equity</td>
<td>1,913</td>
<td>1,956</td>
<td>2,021</td>
</tr>
</tbody>
</table>

**Required**

a. Compute return on assets and return on equity for each year 2012 and 2013 (use average assets and average equity), together with the components of ROA (profit margin and asset turnover). What trends, if any, do we observe?

b. Which component, if any, appears to be driving the change in ROA over this time period?

P1-43. Computing, Analyzing, and Interpreting Return on Equity (LO3)
Canadian Tire Corporation, Limited operates retail stores in Canada that sell general merchandise, clothing, and sporting goods. Total stockholders’ equity for Canadian Tire, (in Canadian dollars), is $4,763.6 in 2012 and $4,409.0 in 2011. In 2012, Canadian Tire reported net income of $499.2 on sales of $11,427.2.

**Required**

a. What is Canadian Tire’s return on equity for 2012?

b. What are total expenses for Canadian Tire for 2012?

c. Canadian Tire used cash to repurchase a large amount of its common stock during the period 2009 through 2012. What motivations might Canadian Tire 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 2013.

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>Company</th>
<th>Total Assets</th>
<th>Net Income</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>TJX Companies Inc.</td>
<td>$8,282</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>2013</td>
<td>TJX Companies Inc.</td>
<td>9,512</td>
<td>$1,907</td>
<td>$25,878</td>
</tr>
<tr>
<td>2012</td>
<td>Abercrombie &amp; Fitch</td>
<td>3,117</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>2013</td>
<td>Abercrombie &amp; Fitch</td>
<td>2,987</td>
<td>237</td>
<td>4,511</td>
</tr>
</tbody>
</table>

**Required**

a. Compute the return on assets for both companies for the year ended 2013.

b. Disaggregate the ROAs for both companies into the profit margin and 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 and Interpreting Return on Assets and Its Components (LO3)**

McDonald’s Corporation (MCD) reported the following balance sheet and income statement data for 2010 through 2012.

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>Total Assets</th>
<th>Net Income</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>$31,975.2</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>2011</td>
<td>32,989.9</td>
<td>$5,503.1</td>
<td>$27,006.0</td>
</tr>
<tr>
<td>2012</td>
<td>35,386.5</td>
<td>5,464.8</td>
<td>27,567.0</td>
</tr>
</tbody>
</table>

**Required**

a. What is MCD’s return on assets for 2011 and 2012? Disaggregate MCD’s ROA into its net profit margin and its asset turnover.

b. What factor is mainly responsible for the change in MCD’s ROA over this period?

P1-46. **Disaggregating Return on Assets over Multiple Periods (LO3)**

Following are selected financial statement data from 3M Company for 2009 through 2012.

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>Total Assets</th>
<th>Net Income</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>$27,250</td>
<td>$3,193</td>
<td>$23,123</td>
</tr>
<tr>
<td>2010</td>
<td>30,156</td>
<td>4,085</td>
<td>26,662</td>
</tr>
<tr>
<td>2011</td>
<td>31,616</td>
<td>4,283</td>
<td>29,611</td>
</tr>
<tr>
<td>2012</td>
<td>33,876</td>
<td>4,444</td>
<td>29,904</td>
</tr>
</tbody>
</table>

**Required**

a. Compute 3M Company’s return on assets for 2010 through 2012. Disaggregate 3M’s ROA into the profit margin and asset turnover for 2010 through 2012. What trends do we observe?

b. Which ROA component appears to be driving the trend observed in part a? Explain.

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

Apple Inc.’s 2012 financial statements include the following audit report from Ernst & Young LLP.

---

**Report of Ernst & Young LLP, Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders of Apple Inc.

We have audited the accompanying consolidated balance sheets of Apple Inc. as of September 29, 2012 and September 24, 2011, and the related consolidated statements of operations, shareholders’ equity and cash flows for each of the three years in the period ended September 29, 2012. 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, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Apple Inc. at September 29, 2012 and September 24, 2011, and the consolidated results of its operations and its cash flows for each of the three years in the period ended September 29, 2012, 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), Apple Inc.’s internal control over financial reporting as of September 29, 2012, based on criteria established in Internal Control—Integrated Framework issued by the committee of Sponsoring Organizations of the Treadway Commission and our report dated October 31, 2012 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

San Jose, California
October 31, 2012
Required

a. To whom is the report addressed? Why?

b. 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?

c. What is the nature of Ernst & Young’s opinion? What do you believe the word fairly means? Is Ernst & Young providing a guarantee to Apple’s financial statement users?

d. What other opinion is Ernst & Young rendering? Why is this opinion important?

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

Following is the CEO Certification required by the Sarbanes-Oxley Act and signed by Apple CEO Timothy D. Cook. Apple’s Chief Financial Officer signed a similar form.

CERTIFICATIONS

I, Timothy D. Cook, certify that:

1. I have reviewed this annual report on Form 10-K of Apple Inc.;

2. 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;

3. 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;

4. 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:

   (a) 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;

   (b) 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;

   (c) 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

   (d) 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

5. The registrant’s other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of the registrant’s board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize, and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Date: October 31, 2012

By: /s/ TIMOTHY D. COOK

Timothy D. Cook
Chief Executive Officer
Required

a. Summarize the assertions that Timothy D. Cook made in this certification.
b. Why did Congress feel it important that CEOs and CFOs sign such certifications?
c. What potential liability do you believe the CEO and CFO are assuming by signing such certifications?

P1-49. Assessing Corporate Governance and Its Effects (LO5)

Review the corporate governance section of General Electric’s Website http://www.ge.com. Find and click on: “investor relations”; then, find and click on: “governance” and open the “Governance Principles” PDF.

Required

a. In your words, briefly describe GE’s governance structure.
b. What is the main purpose of its governance structure?

IFRS APPLICATIONS

I1-50. Applying the Accounting Equation and Computing Financing Proportions (LO2)

The following table contains fiscal 2012 information for three companies that use IFRS. Apply 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 companies.

<table>
<thead>
<tr>
<th>(Amounts in millions)</th>
<th>Assets</th>
<th>Liabilities +</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>OMV Group (Austria)</td>
<td>€ 13,888</td>
<td>€ 6,034</td>
<td>(a)</td>
</tr>
<tr>
<td>Ericsson (Sweden)</td>
<td>SEK 274,996</td>
<td></td>
<td>(b) SEK 138,483</td>
</tr>
<tr>
<td>BAE Systems (UK)</td>
<td>£18,500</td>
<td></td>
<td>£3,774</td>
</tr>
</tbody>
</table>

I1-51. Computing Return on Equity and Return on Assets (LO3)

The following table contains financial statement information for AstraZeneca, which is a global biopharmaceutical company focused on discovery, development, manufacturing and commercialization of medicines and is headquartered in London, UK.

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>Total Assets</th>
<th>Net Income</th>
<th>Sales</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>$56,127</td>
<td>$8,106</td>
<td>$33,269</td>
<td>$23,410</td>
</tr>
<tr>
<td>2011</td>
<td>52,830</td>
<td>9,470</td>
<td>33,591</td>
<td>23,472</td>
</tr>
<tr>
<td>2012</td>
<td>53,534</td>
<td>6,405</td>
<td>27,973</td>
<td>23,952</td>
</tr>
</tbody>
</table>

Required

a. Compute the return on equity (ROE) for 2011 and 2012. What trend, if any, is evident? How does AstraZeneca’s ROE compare with the approximately 21.5% median ROE for companies in the Dow Jones Industrial average for 2012?
b. Compute the return on assets (ROA) for 2011 and 2012. What trends, if any, are evident? How does AstraZeneca’s ROA compare with the approximate 6.7% median ROA for companies in the Dow Jones Industrial average for 2012?
c. What factors might allow a company like AstraZeneca to reap above-average returns?

I1-52. Computing and Interpreting Return on Assets and Its Components (LO3)

Tesco PLC, which is one of the world’s largest retailers and is headquartered in Cheshunt, U.K., reported the following balance sheet and income statement data for 2011 through 2013.

<table>
<thead>
<tr>
<th>(£ millions)</th>
<th>Total Assets</th>
<th>Net Income</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>£12,039</td>
<td>£2,671</td>
<td>£60,455</td>
</tr>
<tr>
<td>2012</td>
<td>12,863</td>
<td>2,814</td>
<td>63,916</td>
</tr>
<tr>
<td>2013</td>
<td>13,096</td>
<td>120</td>
<td>64,826</td>
</tr>
</tbody>
</table>
Required
a. What is Tesco’s return on assets for 2012 and 2013?
b. Disaggregate Tesco’s ROA metrics from part a into profit margin and asset turnover.
c. What factor is mainly responsible for the change in Tesco’s ROA over this period?

MANAGEMENT APPLICATIONS

MA1-53. Strategic Financing (LO2)
You and your management team are working to develop the strategic direction of your company for the next three years. One issue you are discussing is how to finance the projected increases in operating assets. Your options are to rely more heavily on operating creditors, borrow the funds, or to sell additional stock in your company. Discuss the pros and cons of each source of financing.

MA1-54. Statement Analysis (LO3)
You are evaluating your company’s recent operating performance and are trying to decide on the relative weights you should put on the income statement, the balance sheet, and the statement of cash flows. Discuss the information each of these statements provides and its role in evaluating operating performance.

MA1-55. Analyst Relations (LO2)
Your investor relations department reports to you that stockholders and financial analysts evaluate the quality of a company’s financial reports based on their “transparency,” namely the clarity and completeness of the company’s financial disclosures. Discuss the trade-offs of providing more or less transparent financial reports.

MA1-56. Ethics and Governance: Management Communications (LO5)
The Business Insight box on page 1-14 quotes Warren Buffett on the use of accounting jargon. Many companies publicly describe their performance using terms such as “EBITDA” or “earnings purged of various expenses” because they believe these terms more effectively reflect their companies’ performance than GAAP-defined terms such as net income. What ethical issues might arise from the use of such terms and what challenges does their use present for the governance of the company by stockholders and directors?

MA1-57. Ethics and Governance: Auditor Independence (LO5)
The SEC has been concerned with the “independence” of external auditing firms. It is especially concerned about how large non-audit (such as consulting) fees might impact how aggressively auditing firms pursue accounting issues they uncover in their audits. Congress recently passed legislation that prohibits accounting firms from providing both consulting and auditing services to the same client. How might consulting fees affect auditor independence? What other conflicts of interest might exist for auditors? How do these conflicts impact the governance process?

ONGOING PROJECT
An important part of learning is application. To learn accounting, we must practice the skills taught and apply those skills to real world problems. To that end, we have designed a project to reinforce the lessons in each module and apply that to real companies. The goal of this project is to complete a comprehensive analysis of two (or more) companies in the same industry. We will then create a set of forecasted financial statements and a valuation of the companies’ equity. This is essentially what financial analysts and many creditors do. We might not aspire to be an analyst or creditor, but by completing a project of this magnitude, we will have mastered financial reporting at a sufficient level to be able to step into any role in an organization. The goal of Module 1’s assignment is to obtain and begin to explore the financial reports for two publicly traded companies that compete with each other.

- Select two publicly traded companies that compete with each other. They must be publicly traded as private company financial statements will not be publicly available. While the two companies do not need to be head-to-head competitors, their main lines of business should broadly overlap.
- Download the annual reports for each company and peruse them. At this stage, choose companies that are profitable (net income is positive) and that have positive retained earnings and stockholders’ equity. Select companies whose financial statements are not overly complicated. (Probably avoid the automotive, banking, insurance, and financial services industries. Automotive
companies have recently reported large losses, which complicates the analysis. Banking, insurance, and financial services have operations that differ drastically from the usual industrial companies common in practice. While these companies can be analyzed, they present challenges for the beginning analyst.

- Use the SEC EDGAR Website to locate the recent Form 10-K (or other annual report such as 20-F or 40-F). Download a spreadsheet version of financial statements. Use Appendix 1A as a guide.
- Use the annual report and the financial statements along with any online sites to assess the companies' business environment. Use Porter’s Five Forces or a SWOT analysis to briefly analyze the competitive landscape for the two companies. (Originated by Albert S Humphrey, SWOT Analysis provides a useful way to assess an organization’s Strengths, Weaknesses, Opportunities, and Threats.) Our aim is to understand the competitive position of each company so that we can assess their financial statements in a broader business context.
- Explore the financial statements and familiarize yourself with the company basics. The following give an indication of some questions that guide us as we look for answers.
  - What accounting standards are used, U.S. GAAP, IFRS, or other?
  - What is the date of the most recent fiscal year-end?
  - Determine the relative proportion of short-term and long-term assets.
  - Determine the relative proportion of liabilities and equity.
  - Calculate the return on assets (ROA) for the most recent year.
  - Disaggregate ROA into the two component parts as shown in Exhibit 1.7. Compare the numbers/ratios for each company.
  - Find the companies’ audit reports. Who are the auditors? Are any concerns raised in the reports?
  - Do the audit reports differ significantly from the one for Berkshire Hathaway in this module?

SOLUTIONS TO REVIEW PROBLEMS

Mid-Module Review

Solution

1. AXA EQUITABLE LIFE INSURANCE COMPANY

<table>
<thead>
<tr>
<th>Income Statement</th>
<th>For Year Ended December 31, 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$ 9,160</td>
</tr>
<tr>
<td>Expenses</td>
<td>8,944</td>
</tr>
<tr>
<td>Net income</td>
<td>216</td>
</tr>
<tr>
<td>Net income attributable to noncontrolling interest</td>
<td>95</td>
</tr>
<tr>
<td>Net income attributable to AXA stockholders</td>
<td>$ 121</td>
</tr>
</tbody>
</table>

AXA EQUITABLE LIFE INSURANCE COMPANY

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>December 31, 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 3,162</td>
</tr>
<tr>
<td>Noncash assets</td>
<td>173,681</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$158,913</td>
</tr>
<tr>
<td>Equity</td>
<td></td>
</tr>
<tr>
<td>AXA stockholders’ equity</td>
<td>15,436</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>2,494</td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td>$17,930</td>
</tr>
<tr>
<td>Total assets</td>
<td>$176,843</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>$176,843</td>
</tr>
</tbody>
</table>
## AXA EQUITABLE LIFE INSURANCE COMPANY

### Statement of Cash Flows
For Year Ended December 31, 2012

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flows from operations</td>
<td>$(780)</td>
</tr>
<tr>
<td>Cash flows from investing</td>
<td>$(2,692)</td>
</tr>
<tr>
<td>Cash flows from financing</td>
<td>3,407</td>
</tr>
<tr>
<td>Net increase (decrease) in cash</td>
<td>$(65)</td>
</tr>
<tr>
<td>Cash, beginning year</td>
<td>3,227</td>
</tr>
<tr>
<td>Cash, ending year</td>
<td>$3,162</td>
</tr>
</tbody>
</table>

2. Berkshire Hathaway is a larger company; its total assets are $427,452 million compared to AXA’s assets of $176,843 million. The income statements of the two companies are markedly different. Berkshire Hathaway reports nearly eighteen times as much revenue ($162,463 million compared to $9,160 million). The difference in net income attributable to the parent stockholders is also large; Berkshire Hathaway earned $14,824 million whereas AXA reported net income of only $121 million.

### Module-End Review

**Solution**

a. **ROA** = Net income/Average assets = $902/$22,270 = 4.1%.
   
   The profitability component is Net income/Sales = $902/$17,084 = 5.3%, and the productivity component is Sales/Average assets = $17,084/$22,270 = 0.77. Notice that 5.3% × 0.77 = 4.1%. Thus, the two components, when multiplied, yield ROA.

b. **ROE** = Net income/Average stockholders’ equity = $902/$5,907 = 15.3%.