Harvard Business School Case Selections (Reprint)

哈佛商学案例精选集
（英文影印版）

商务基础系列
Business Fundamentals Series

解读财务报表（第二版）

Reading Financial Reports (Second Edition)

William J. Bruns, Jr. 小威廉·J·布伦斯
Julie H. Hertenstein 朱莉·H·赫滕斯坦 等 编写
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INTRODUCTION

Welcome to the Business Fundamentals series from Harvard Business School Publishing!

The readings in this collection were developed for the MBA and executive programs of Harvard Business School. These programs rely heavily on the case method of instruction, in which students analyze and discuss firsthand accounts of actual management situations. Students also learn the fundamentals of what managers do: how they measure performance, make choices, and organize their activities. At Harvard Business School, the fundamentals are often taught through background notes, which describe business processes, management techniques, and industries.

The collections in this series are not meant to be comprehensive, but to present the fundamentals of business. Each collection contains several notes, and perhaps an article or two, that provide a framework for understanding a particular business topic or function.

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The Business Fundamentals collections are designed for both individual study and facilitated training. If you want to use this collection for self-study, we've provided a summary, outline, learning objectives, and questions for each reading to help you get started. If these readings are part of a training program in your company, you will find them to be a rich resource for discussion and group work.

You can search for related materials on our Web site: www.hbsp.harvard.edu. We hope that your learning experience will be a rich one.

Reading Financial Reports

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THE ACCOUNTING FRAMEWORK, FINANCIAL STATEMENTS, AND SOME ACCOUNTING CONCEPTS

(W.J. Bruns, Jr. / #9-193-028 / 12 p)

Summary

This note introduces managers to the accounting framework, describes the basic financial statements and how they classify financial information, and briefly explains eleven accounting concepts.

Outline

The Basic Accounting Framework

- Assets
- Equities
- Assets = Equities
- Classifications of Assets and Equities

Basic Financial Statements

- The Balance Sheet
- The Statement of Income
- The Statement of Cash Flows

Accounting Concepts

Learning Objectives

After reading the note and completing the following exercises, managers should be able to:

- Understand what kind of information each basic financial statement (balance sheet, income statement, and cash flow statement) is meant to provide.
- Become familiar with the format and vocabulary of their company's financial statements.
- Recognize how several basic accounting concepts are reflected in financial statements.

Questions and Ideas to Consider

Distribute copies of your firm's most recent annual report. (If an annual report is not available, try to obtain copies of the company's latest financial statements, or use the statements provided in the exhibits.)

1. As you read the section on "The Balance Sheet" (pp. 5-7), match each definition with the corresponding item on your firm's balance sheet.

   a) According to the balance sheet, what are your company's largest assets or group of assets? Which assets changed the most from the previous year? Do you know why? What significance might this change have for your department?

   b) What are your company's largest liabilities? Which liabilities changed the most from the previous year? Do you know why? What impact might this change have on your department?

2. As you read the section on "The Statement of Income" (p. 7), match each definition with the corresponding item on your company's income statement.

   a) Is cost of goods sold explained in a footnote? If not, briefly list what contributes to your company's cost of goods sold.

   b) How does your company present operating expenses? What are the major components of its operating expenses?

   c) Has cost of goods sold or SG&A increased as a percentage of revenue compared to last year? Why or why not?

3. As you read the section on "The Statement of Cash Flows" (pp. 7-8), match each definition with the corresponding item on your firm's statement of cash flows.

   a) What are the biggest sources of cash?

   b) What are the biggest uses of cash?

   c) What accounts for the greatest change in cash (i.e., operations, investing activities, or financing activities)?

The Accounting Framework, Financial Statements, and Some Accounting Concepts

Providing information for decisions about the deployment and use of resources in an organization and in the economy is one of the top objectives of accounting and accountants. Over many years, certain formats and procedures for presenting accounting information have come into wide use. Financial statements are based on a framework appropriately called *The Accounting Framework.*

The Basic Accounting Framework

The accounting framework rests on two premises. The first is the idea that it is possible to distinguish an *accounting entity*—the person or organization for which a set of accounts is kept—from other persons or organizations that are associated with it. The second premise is that for any accounting entity, the resources available will be exactly equal to the resources provided by creditors and owners. This second assumption is usually called *the accounting equation* and is written

$$Assets = Equities$$

The accounting processes of observing, measuring, and reporting are always carried out with an eye to maintaining this fundamental equality of assets and equities.

Assets

In general, assets may be thought of as all things of value that the organization has a right to use. They consist of financial resources, equipment and other physical resources, and other resources having value to the entity. Most business organizations have a wide variety of assets, which they may classify according to common characteristics. Some prevalent financial assets include cash and cash balances in banks, amounts owed to the organization by customers, and marketable securities held by the firm. Operating assets often include land, buildings, equipment used in carrying out the activities of the organization, and inventories of unsold products. Other assets might include such intellectual property as copyrights or patents, conveying exclusive rights to profit from the use of property or process.

Professor William J. Bruns prepared this note as the basis for class discussion.

Equities

The equities in an organization represent claims on its resources or assets. In a crude way, the equities reveal the suppliers of an organization's resources. Some parties provide resources and expect to be repaid; these are creditors. Others contribute resources and thereby become participants; these are owners. Equities of nonowners would include amounts owed to employees or suppliers, amounts owed on short-term loans, and loans represented by other debts of one kind or another. Owners share in both the risks and whatever profits accrue. The equities of owners include the amount of resources that they contributed originally as well as some portion of the earnings that have not been withdrawn by them.

Assets = Equities

The accounting equation demands that in accounting for an organization, the equality of assets and equities must be preserved. Thought of in another way, if the resources owned by an entity increase, the new resources had to have come from somewhere, and that source has a claim against them. If the things of value owned by an organization increase, the corresponding increase either in the amount of obligations or in the equities of owners must be recognized. Likewise, if the things of value owned by an entity decrease, obligations to nonowners may have been satisfied, or the equity of owners may have been reduced.

Classifications of Assets and Equities

Although there are decision situations in which information about total assets or total equities can be useful, in most cases, more detail is desired. Both assets and equities come in very different forms with very different characteristics, as we have already noted. For this reason, it is customary in accounting to adopt a scheme for classifying assets and equities of various types. The classifications can be as large or as small as necessary to achieve the objectives for measuring and reporting. As the number of classifications increases, the cost of measuring, record keeping, and reporting increases, so there is usually an economic constraint that limits the number of classifications actually employed.

The basic accounting equation is commonly expanded to highlight the two major equity classifications:

$$Assets = Liabilities + Owners'\,Equity$$

This expansion recognizes that there is a fundamental difference between the obligations the organization has to outsiders, or those who are not members or owners, and the obligation it has to owners, or shareholders—those who have invested capital in the organization. In the event the organization is dissolved, obligations to creditors must be met before assets are distributed to owners. This legal distinction provides the basis for this additional classification.

One reason why this expanded form of the accounting equation is used relates to the fundamental distinction between an organization or entity and its owners. The owners contribute capital, but they are not the entity. If the excess of assets over liabilities increases, owners' equity is increased. As long as owners do not make additional capital contributions or withdrawals from the assets of the firm, increases in owners' equity are usually associated with income-generating activities of an organization, whereas decreases usually result from losses.

Basic Financial Statements

The nature and format of financial statements are derived directly from the basic accounting framework and the accounting equation. A *Balance Sheet* (or *Statement of Financial Position*) lists the assets, liabilities, and owners' equity at a specified point in time. An asset-flow statement (the *statement of cash flows* is the most common) summarizes the reasons why a class of assets has increased or decreased over a period of time. A *Statement of Income* (or *Earnings*) explains why the retained earnings classification within owners' equity has changed over a period of time, assuming owners have not taken assets from the firm in the form of dividends.

Although financial statements are prepared in many different formats and may use account classifications that differ substantially, a reader of financial reports who understands the basic accounting equation can usually figure out how to read the financial reports of an organization regardless of the particular reporting scheme that the organization has chosen. The consolidated financial statements of the Coca-Cola Company and Subsidiaries for 1996 provide an illustration of the relationship between the accounting equation and a set of financial reports for a corporation. The Consolidated Balance Sheet (see **Exhibit 1**) illustrates the basic equality between assets and equities. The Consolidated Statement of Income (see **Exhibit 2**) measures how retained earnings were affected by operations before the payment of cash dividends, and the Consolidated Statement of Cash Flows (see **Exhibit 3**) shows why the amount of cash and cash equivalents changed because of operating, investing, and financing activities.

These financial reports provide an outline for reviewing some of the elements that will be found in every set of financial reports of a corporation.

The Balance Sheet

The *Balance Sheet* (or *Statement of Financial Position)* presents a company's financial position as of a specific date, based on measurements made in accordance with *Generally Accepted Accounting Principles* (*GAAP*) or some other reporting basis. By definition, the measured amount of total assets is always equal to the measured amount of liabilities and owners' equity. Except for monetary amounts such as cash, accounts receivable, and accounts payable, the measurements of each classification will rarely be equal to the actual current value or cash value shown. This is due to the fact that most measurements in accounting are made at the time of a transaction that took place in the past, and these historical measurements are retained in the accounts, even though the values of assets and some obligations may increase or decrease with the occurrence of events or passage of time. It is essential to remember that no statement of financial position will ever present the true financial value of an organization or the financial significance of the classifications used in the reports.

The classifications used by the Coca-Cola Company in its Consolidated Balance Sheet (**Exhibit 1**) are typical of those that will be found in the balance sheets of other companies. *Current Assets* include cash and other assets used in operations during the normal operating cycle of the business, or within one year if the operating cycle is shorter than one year. The *normal operating cycle* of a company is that period of time required to acquire services and materials to create a product or service, which is sold to a customer, who then pays for the product or service, thus supplying the cash to begin the cycle again. *Cash and cash equivalents* are measured at their face amounts, whether they are in the possession of the company or deposited in banks. *Marketable securities* represent temporary investments, which can be easily converted to cash if more cash is needed. *Trade accounts receivable* are amounts that are due from customers who have purchased goods or services on credit. *Inventories* typically include materials that will be converted into product, work-in-process inventory, and finished goods that are ready for sale or have not yet been delivered to customers. *Prepaid expenses* include expenditures that have been made to acquire future benefits or services (an insurance policy would be an example), but for which the benefits have not been obtained at the date of the financial reports.

Following the current assets are a number of other assets that are *not* current: that is, they are not expected to be used up within a year, or within the normal operating cycle of the business.

Property, Plant and Equipment represents the cost of long-lived, tangible assets that are used in the company's operations. Land is almost always included at its original cost, while other assets are stated at their original cost less the proportion of original cost that has been included in the expenses of prior periods' operations as depreciation.

Many companies, particularly large companies, have assets that are not used directly in their operations or that they do not have majority ownership of. These are considered "nonoperating" assets and are usually called *Investments.* Coca-Cola has a number of such "investments." *Marketable securities* are securities of other companies similar to the marketable securities in the "Current Assets" section except that *these* securities are expected to be held for a long-term period. *Equity method investments* are also investments in the securities of other companies, but these have to be accounted for somewhat differently (under the *equity method*) because the investor (here, Coca-Cola) owns enough of the companies to have "significant influence" over them (usually presumed to be 20% or more of their outstanding stock but less than 50%). The equity method of accounting essentially records the investor's pro-rata share of all of the earnings of the investee and represents a more elaborate way of accounting for the investment than occurs with ordinary "marketable securities." Other kinds of "investments" (not represented here) might be the cash surrender value of life insurance or special-purpose funds that accumulate cash in a systematic way to meet some specific future needs.

If a company has purchased another company for a price in excess of the fair market value of its identifiable assets, *goodwill* (which represents intangible things like the acquired company's excellent reputation or highly marketable brand names) is assumed to have been acquired and will be recorded as an additional asset.

On the other side of the accounting equation are liabilities and the owners' equity. *Liabilities* are obligations that an organization must satisfy by transferring assets to or performing services for a person or organization at some time in the future. *Current liabilities* are those that an organization expects to satisfy either with assets that have been classified as current or in the course of normal operations or during the following year. Liabilities not falling within these categories are usually shown as *long-term debts* or *other liabilities.*

Shareowners' Equity (or *Stockholders' Equity*) represents the interest of the owners in the organization. Mathematically, its total is always equal to the amount that remains after deducting the total liabilities of the organization from its total assets. Only by coincidence would this amount be equal to the true value of the organization to its owners. Instead, the total is very much an artifact of the measurements and accounting procedures that have been used to record and account for assets and liabilities.

The amount of assets that owners originally committed to the organization (usually cash paid for stock) is usually shown separately in the owners' equity section of the Balance Sheet. In the case of the Coca-Cola Company, that amount consists of *Common stock* with a certain "par value" (which is a nominal, base value) plus *Capital surplus* (often called *Additional paid-in capital*), which represents the money that owners paid for stock in excess of the par value. Once these original assets are turned over to an organization, no further measurements are made, and the market value of the shares representing ownership may differ substantially from the original amount paid by the original owners.

Reinvested earnings (often referred to as *Retained earnings*) shows the accumulated net income of an organization from its origin to the present, after deducting dividends to shareholders.

Following this, Coca-Cola shows four additional, special components of Shareowners' Equity. *Unearned compensation* refers to the value of stock that has been awarded to certain officers of the company but not yet earned. *Foreign currency translation adjustment* and *Unrealized gain on securities available for sale* represent temporary changes that have occurred in the value of certain assets. Because they are temporary in nature, they aren't immediately recorded as part of the income statement; instead, they are recorded as temporary additions to or subtractions from the value of Shareowners' Equity and are adjusted from period to period until they become permanent or fully realized. Lastly, *Treasury stock* measures amounts that Coca-Cola has paid to reacquire its own stock. Although these shares have not been canceled, they are no longer outstanding and therefore do not represent any owners' interest at the date of the Balance Sheet.

The Statement of Income

The results of operations of business over a period of time are shown in the Statement of Income, or the *Income Statement*. Just as the Balance Sheet can be represented by the accounting equation, the income statement can be represented by the following equation:

Revenues ~ Expenses = Net Income (or Net Loss)

In actual reports, this equation is expanded considerably and usually includes details about the nature of important categories, particularly in footnotes to the statement.

Revenues result from selling products or services to customers. In its Consolidated Statement of Income (see **Exhibit 2**), Coca-Cola shows a single figure for its "Net operating revenues" during the designated periods of time (that is, the years ending December 31, 1996 and 1995). Some companies might give figures for different kinds of revenue.

This is immediately followed by *Cost of goods sold*, which represents, for Coca-Cola, the direct, factory-related cost of producing the products it sold. (If Coca-Cola were a retailer rather than a manufacturer, cost of goods sold would represent the amount of money it paid to outside suppliers for the merchandise that it then resold to the public.) Coca-Cola's *Gross profit* represents simply the difference between Revenues and Cost of goods sold.

Following this is what Coca-Cola labels *Selling, administrative, and general expenses;* other companies sometimes call it *Operating expenses* or will sometimes break it down into a few different categories. This represents general overhead expenses that the company incurred during the designated periods of time. Deducting these general overhead expenses from the Gross profit figure yields the company's *Operating income*, which is thus a measure of the income derived from the principal operations of the company.

The Consolidated Statement of Income of Coca-Cola is typical in that, in addition to operating income, other income and expense items must be added and subtracted before the *net income* total is measured. In many organizations, these nonoperating amounts are significant, but they are shown separately to enable a reader of the financial report to make alternative assumptions about the efficiency and success of operations in the current or future periods.

The Statement of Cash Flows

The *Statement of Cash Flows* details the reasons why the amount of cash (and cash equivalents) changed during an accounting period. Just as the statement of income describes how retained earnings have changed during an accounting period, the statement of cash flows describes how the amount of cash and cash equivalents has changed during the accounting period. The statement's format reflects the three categories of activities that affect cash. Cash can be increased or decreased (1) because of *operations*, (2) because of the acquisition or sale of assets or *investments*, or (3) from changes in debt or stock or other *financial activities*.

Although it may not be self-evident from the Consolidated Statement of Cash Flows from the Coca-Cola Company (see **Exhibit 3**), the statement of cash flows can be thought of as containing much of the same kind of information as a checkbook register or bankbook. Sales or purchases of assets increase or decrease the amount of cash that can be deposited. Borrowing cash or payment of debt affect the balance similarly. Operations have similar effects on the balance of cash available. The reason this analogy to a bank balance is not obvious may be due to the most common form in which the statement of cash flows is presented. This common format reconciles the net income reported in the income statement to the net cash provided by operations. Upon further study, it will become apparent why statements of cash flows are often presented in this format rather than by showing directly the demands for cash made by operations and the receipts of cash provided by operations.

Accounting Concepts

Four basic accounting concepts underlie the presentation in any statement of income. They are the *accounting period concept*, the *accrual concept*, the *realization* or *recognition concept*, and the *matching concept*.

A statement of income is always presented for a period of time. In fact, part of the heading of the statement of income must include a description of the time period for which the income has been measured. The *accounting period concept* covers the period over which a statement of income has been prepared. The accounting period can be of any length, but customarily it is related to a calendar period such as one year, one-half year, or perhaps one month. It is often useful to think of the accounting period as the time between the preparation and presentation of two successive statements of financial position by an organization. The statement of income presents the changes in owners' equity due to operations and other events between one balance sheet and the next.

The *accrual concept* supports the idea that income should be measured at the time major efforts or accomplishments occur rather than simply when cash is received or paid. Revenue and expenses can be recognized before or after cash flows. If revenue is recognized, but cash has not been received, then it will be recorded among current assets as accounts receivable. Correspondingly, if an expense has been incurred, but cash has not been paid, it will be recorded as a current liability.

What accountants call the *realization concept* is really a family of rules that might be more clearly labeled *recognition concepts.* These rules aid the accountant in determining that a revenue or expense has occurred, so that it can be measured, recorded, and reported in financial reports. There is actually a large number of these rules, many of which are conditional on circumstances affecting a particular organization at a particular point in time. For example, revenue is often realized (recognized) when a product is shipped to a customer. However, in other circumstances where a customer has contracted for a special product, some portion of revenue might be recognized at the end of an accounting period, even though the product is not complete and has not been delivered. In general, revenue is recognized along with associated expenses when an exchange has taken place, the earnings process is complete, the amount of income is determinable, and collection of amounts due is reasonably assured.

The amount of expenses to be deducted in each accounting period is determined by the *matching concept* through which the expenses associated with revenue are identified and measured. The accountant attempts to match the cost and expenses of producing a product or service with revenues obtained from its delivery to customers, so that net income can be measured. This matching of revenues and expenses allows readers to understand better the possible expenses of future revenues the organization will try to earn.

Our introduction to the accounting framework and financial reports illustrates four additional accounting concepts. These concepts include the *money measurement concept*, the *business entity concept*, the *going concern concept*, and the *cost concept*.

Accountants measure things in terms of money. The *money measurement concept* has the advantage of expressing all measurements in a common monetary unit that can be added, subtracted, multiplied, and divided to produce reports which themselves can become the subject of further analysis. Nevertheless, there are many things that affect an organization but are difficult or impossible to measure in terms of money. The knowledge and skills of members or employees of an organization have great value, but they are virtually impossible to measure in terms of money. Customer loyalty may ensure future profitability, but only past revenues will be shown in past reports. Because accountants employ the money measurement concept, readers of accounting reports should not expect to find a complete picture or all the facts about an organization.

The *entity concept* delineates the boundaries of the organization for which accounts are kept and reports are made. The reports of the Coca-Cola Company that we have examined contain no information about who the owners or the managers of the Coca-Cola Company are. At the same time, because the accounts of many parts of the Coca-Cola Company have been consolidated, we cannot see the financial condition or financial success of a particular sales office or product line. Common sense tells us that within the Coca-Cola Company, accounts are probably maintained and reports prepared for each of those entities. The entity concept means that anyone who uses financial reports has to be sure that those reports are for the exact entity in which he or she is interested, whether it be the organization as a whole or a particular subset of it.

Financial reports assume that the entity is a *going concern*. Reports are not prepared on a basis that would show the liquidation value of an organization or what would happen if the organization was liquidated. Instead, the accountant works on the assumption that an entity will continue to operate much as it has been operating for an indefinitely long period in the future.

A fourth concept seen in the financial reports you have examined is the *cost concept*. Transactions provide the information necessary for measuring and recording assets in the accounts and subsequently reporting about them. Although a reader of a financial report may be interested in the value of assets or the value of an organization, the accountant is not. Assets are initially recorded by measuring the amount paid for them. When that cost is matched with revenues, it is matched at its historical amount rather than at the current value of the asset used to create a product or service. The cost concept means that as time passes asset measurements are not changed even if the current value of those assets is changing. Likewise, when coupled with the money measurement concept, no allowance is made for changes in the purchasing power of the currency that may have been used to acquire an asset. There can be no doubt that the cost concept greatly simplifies the accountant's job in maintaining a record that can become the basis for financial reports. But it does so by sacrificing the relevance of those reports to many kinds of economic decision making.

Three other concepts are important to financial reporting, even though they are somewhat less obvious. These are the concepts of *conservatism, consistency*, and *materiality*.

The *conservatism concept* operates as a safeguard to overstatement of asset values and owners' equity. It requires that accountants be slower to recognize revenues and gains and quicker to recognize expenses and losses. This potentially negative bias in the accountant's behavior is the basis for many jokes about the differences in the way accountants and other managers see things occurring in organizations.

The *consistency concept* requires that once an entity has selected an accounting method for a kind of event or a particular asset, that same method should be used for all future events of the same type and for that asset. The consistency concept enhances the comparability of accounting reports from one period to that of another. In that way, it enhances the usefulness of financial reports. Nevertheless, certain caution must be attached to any discussion of the consistency concept because accountants use the term consistency in a narrower sense than found in other uses. Consistency is required all the time, but there is no requirement for logical consistency at a moment in time. For example, assets that may appear identical may be accounted for using different accounting methods. All that is required is that the same method be used for the same asset over time, not that all like assets be accounted for using the same method. This means that financial statement users must be constantly alert for the specific accounting methods used in different parts of financial reports. Just because a reader of financial reports understands the way in which factory machinery has been measured and reported does not necessarily mean that the same reader will have any idea how trucks or delivery equipment have been measured and reported.

Finally, arching over the entire process of accounting and financial reporting is the *materiality concept*. This concept allows that the accountant does not need to attempt to measure and record events that are insignificant or to highlight events that differ from the usual or the norm. Events or assets judged to be insignificant can be ignored or disregarded. On the surface, this concept would seem to make good sense, as it focuses both the accountant and the financial report reader's attention on important things. Unfortunately, the exact line between what is significant and what is insignificant is very difficult to define. Furthermore, something may seem insignificant to the accountant but might be regarded as very significant to a managing director. The materiality concept is both a strength and a weakness in financial reporting, and a wise reader of reports must be constantly on guard for its occasionally pernicious effects.

Summary

The accounting equation

$$Assets = Equities$$

or in its expanded form

$$Assets = Liabilities + Owners'\ Equity$$

provides the basis for the accounting framework. The format for the statement of financial position derives directly from the accounting equation, and the assumed equality of assets and equities provides a basis for accounting record systems as well as the statement of financial position.

Two additional financial reports stem directly from the accounting equation. The statement of income explains the change in the owners' equity that occurs during an accounting period by giving details of both revenues that increase owners' equity and expenses that decrease owners' equity. It provides a basis for analyzing the effectiveness of operations. The statement of cash flows explains why the amount of cash and equivalents has increased or decreased during a period of time. It details whether or not operations have provided additional cash or have themselves consumed cash. It also reveals cash that is provided by new loans or that has been used to pay off debts, and how cash has been invested or obtained by selling assets.

This brief overview of the accounting framework and financial reporting has served as an introduction to eleven important accounting concepts, financial reports, and the work of accountants. Only practice and further study can give real meaning to these accounting concepts, but understanding their existence is critical to studying the work of accountants, and some of the reasons why they operate as they do. The 11 concepts introduced here include: accounting period, accrual, realization, matching, money measurement, entity, going concern, cost, consistency, conservatism, and materiality. We will see in detail how these concepts are applied as we continue in our study of accounting principles.