

An aerial photograph of the Chicago skyline and Lake Michigan coastline. The image shows a dense cluster of skyscrapers on the left, a multi-lane highway running parallel to the shore in the center, and the sandy beach and blue water of Lake Michigan on the right. The title 'CORPORATE' is overlaid in large, white, sans-serif capital letters across the top of the image.

C O R P O R A T E

F I N A N C I A L  
R E P O R T I N G

F o u r t h E d i t i o n

Brownlee • Ferris • Haskins

A large, blank white rectangular object, possibly a piece of paper or a book cover, is positioned in the bottom right corner of the image, partially obscuring the view of the lake and coastline.

FOURTH EDITION

# CORPORATE FINANCIAL REPORTING

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This book is dedicated to our families, for their encouragement and understanding, and for helping us keep things in perspective.

# PREFACE

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The importance of and the demands on corporate financial reporting continue to grow at an accelerating rate. Although there are many contributing factors, two of the most significant pertain to the expansion of global competition for goods and services and the trend toward deregulation and integration of financial markets. Corporations around the world compete for market share, earnings growth, and financial resources within their domestic markets and, increasingly, within foreign markets. The important task of measuring and presenting the financial results of the increasingly complex organizations engaged in such activities is primarily the responsibility of corporate financial reporting. Without question, this is a considerable challenge, for the related objectives, issues, concepts, and standards are subject to change and are open to question and debate on a continual basis. Consequently, the study of corporate financial reporting has the potential for being both interesting and highly relevant, for it involves an understanding of the contemporary business environment.

This book is written for students whose careers will require a substantial appreciation and understanding of financial accounting and reporting issues, problems, and practices. While we believe a good case could be made that our audience includes all business majors, we view students pursuing careers in public accounting, corporate accounting, investment or commercial banking, consulting, investment management, financial management, and general management, as well as future entrepreneurs, as our primary audience. The text, cases, and problems were written with the diverse interests of these students in mind.

This book differs from more traditional texts covering similar topics in two principal ways. The first is our focus on the issues, concepts, and divergent perspectives that have led to existing financial accounting and reporting standards. The intended result is a learning experience that is less procedural and more conceptual than that associated with the use of most other accounting textbooks.

The second distinguishing feature is the blend of accounting theory and practical application that occurs throughout the book. In writing this edition, we took the position that Congress, the Securities and Exchange Commission, standard-setting organizations, and various internal and external users of corporate financial information will continue to work toward improving the overall integrity of the financial reporting process. To us, this will involve considerably more than the mere issuance of additional accounting and reporting rules. Improved financial reporting will need to reflect the substance of more complex and dynamic business conditions, an appreciation of the different interests and perspectives of

corporate managers, external users, and independent accountants, and a search for a “true and fair” representation where conflicting views exist. It was with this in mind that we expanded the coverage to address a selection of international accounting and reporting issues, including the role of the International Accounting Standards Committee.

Although this book discusses and generally supports the concept of efficient capital markets, it takes the position that both *what* gets reported and *how* it gets reported make a great deal of difference to many constituents, particularly corporate managers. Because the ultimate responsibility for the preparation and integrity of corporate consolidated financial statements and related footnotes rests with management, we give considerable attention throughout the book to the management considerations associated with various financial reporting issues. In addition to benefiting future managers, we believe this perspective also benefits our other targeted constituencies.

This book is intended to provide students with a comprehensive perspective on current and future corporate financial reporting issues and practices in two ways. First, the individual chapters blend issues, concepts, standards, and stakeholder interests so as to convey the complexities, controversies, and uncertainties inherent in the financial reporting process. Most chapters also include a section on financial analysis. Additionally, even though the primary emphasis continues to be on financial reporting in the United States, most chapters contain a section that addresses international dimensions.

A comprehensive perspective is also facilitated through both the Illustrative Cases and the assignment cases and problems contained at the end of each chapter. These features provide examples of the complexity of the issues and the importance of informed judgments. Here is where students learn how difficult and controversial the application of accounting theory and generally accepted accounting principles can be to actual business situations. They quickly discover that, except in the simplest of situations, the solutions to financial reporting problems are not found merely by referring to an established body of accepted accounting standards. They begin to recognize the need for flexibility, particularly on international dimensions, and to see that attempts to develop highly detailed and specific rules have been only partially successful. On the other hand, students can understand why some issues probably need more extensive guidelines than do others. Before long, they begin to broaden their perspectives on financial reporting, and the process assumes a richness that most of them had not previously experienced or expected.

One of the strengths of including cases in this text, and of case method learning in general, is that it gives students the opportunity to decide how they would solve actual business problems and to defend their positions against others who have decided on different approaches or solutions. Also included at the end of each chapter are a series of problems that enable students to focus on a limited number of issues. Most chapters contain at least one longer and more comprehensive case, however, that provides students with an opportunity to perform in-depth analysis on a broader range of issues. We are firm believers in the numerous benefits associated with case method learning, and we wish both students and faculty much success and enjoyment in meeting the educational challenges that lie ahead.

**E. Richard Brownlee II**  
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PART

# I

# THE INSTITUTIONAL SETTING AND FUNDAMENTAL ACCOUNTING CONCEPTS

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# THE INSTITUTIONAL SETTING AND THE DEVELOPMENT OF FINANCIAL REPORTING STANDARDS

A popular folk song of the mid-1960s proclaims that, “the times, they are a changing.” In retrospect, the extent and speed of such change have probably far exceeded whatever the singer-songwriter had in mind at the time. Technological advances, particularly in the field of communications, have had a significant impact on the way people live. They have also dramatically affected business concepts and practices, regardless of whether the business is local, regional, national, or global in scope. As businesses around the world entered the new millennium, one of the few constants in the planning process was change itself.

The business transformation occurring today may be viewed as a change from the industrial age to the information age. Individuals and organizations today have access to information that was previously neither available nor expected. To some extent, the environment has changed from one of information insufficiency to information overload. As a result, internal and external users of corporate financial information have begun to question the adequacy and relevance of traditional financial reporting practices and to search for acceptable improvements.

From an external corporate financial reporting perspective, an important question concerns the extent to which the existing model may need to be changed to meet the needs of interested users in the twenty-first century. Fundamental changes in corporate perspectives have already begun to take place in the U.S., reflecting the “new economy.” For example, the Dow Jones Industrial Average has undergone one of the most significant overhauls in its 103-year history, as four “old economy” corporations were replaced by four corporations that were founded about 40 years or more after these original companies became part of the Dow Index. As of November 1, 1999, Chevron, Goodyear, Sears Roebuck, and Union Carbide have been replaced by Microsoft, Intel, Home Depot, and SBC Communications. Marking another break with tradition, two of the stocks added to the index trade on the Nasdaq Stock Exchange rather than on the New York Stock Exchange.

The important point here is that, if such a fundamental change has occurred in the composition of the oldest continuous barometer of the U.S. stock market in order to reflect the realities of a new economy, then it seems reasonable to expect significant changes to occur well into the next century with respect to the establishment of generally accepted accounting standards, the regulation of securities markets, and the manner in which corporations communicate their financial performance. The extent to which the market valuation of corporations is enhanced by objective, accurate, and unbiased historical financial information provided by corporations on a periodic basis, typically quarterly, in an age where financial forecasts prepared by analysts and corporations are becoming readily available in



a timely and inexpensive manner, is an issue that the reader should keep in mind when reading this text. Intelligent choices for change often require a thorough understanding of the past and an appreciation for why the present looks as it does. To begin that process, the following short story is presented.

One day in a small midwestern town, a fledgling balloonist convinced his wife to ride in his recently purchased hot-air balloon. Their ascent was flawless, and everything was fine until the wind velocity suddenly increased and changed directions. Feeling reasonably confident they were in no danger, the balloonist assured his wife that he had everything under control. As it turned out, they spent the next several hours drifting high above miles of fertile farmland. The view was spectacular, and they did not begin their descent until their fuel tank was almost empty. At that point the balloonist admitted he had no idea where they were.

The balloon finally came to rest in the middle of a large cornfield, at which time the balloonist's wife let him know just what she thought of his ballooning expertise. Fortunately for him, she was interrupted by a middle-aged man wearing overalls and a straw hat. "Excuse me," he said, "but what are you doing here?" The balloonist explained the situation as best he could and then asked, "Where are we?" "Well," replied the man, "you two are inside the basket of a hot-air balloon in the middle of an Iowa cornfield." Without hesitation the balloonist looked at the stranger and said, "Despite your appearance, I'll bet you aren't a farmer and that this isn't your farm." After a brief silence, the stranger admitted that the balloonist was right. "This is my sister's farm," he said. "I'm just visiting for a few days, but tell me, how did you know?" "That's easy," replied the balloonist, "you're an accountant." The stranger shook his head in disbelief and then remarked, "You're right again, but what gave me away?" The balloonist laughed and said, "Only an accountant could provide us with such precise data that contains so little information."

Although this tale pokes fun at the accounting profession in general, its message is less about accountants than about the information with which they are associated. Accounting information is intended to be helpful in understanding the financial consequences of an entity's economic activities and to be useful in decision making; however, this information is often perceived as incomprehensible and cumbersome. In essence, most people see accounting as a lot of details that convey little substantive, timely information. This book attempts to dispel that misconception by illuminating a subject area that most find intimidating. The reader will be taken through accounting information step by step as each piece of the puzzle is highlighted and deciphered. This journey is intended to produce a clear understanding of contemporary corporate financial reporting, which provides useful information to such external users as present and potential investors and creditors interested in making rational investment and credit decisions.

External users rely on financial information to help them make a variety of comparisons as part of their decision-making process. To elaborate:

Most, if not all, use of accounting information involves making comparisons—comparisons from period to period, comparisons among different enterprises, comparisons with some standard, such as a budget, comparisons with covenants, such as those in bond indentures or other financing agreements, comparisons with competitors, comparisons with regulatory requirements, and other comparisons, including comparisons with what an informed citizen merely perceives to be good, acceptable, or bad in a capitalistic society. Valid comparisons are possible only when they are made using comparable information.<sup>1</sup>

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<sup>1</sup>R.T. Sprouse, "Commentary on Financial Reporting," *Accounting Horizons*, June 1987.