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2011

ACCOUNTING DESK BOOK

The Accountant's Everyday Instant Answer Book

20th Edition!

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a Wolters Kluwer business

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ISBN 978-0-8080-2493-4

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Chapter 1

Principles of Financial Statements, Disclosure, Analysis, and Interpretation

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¶1000 OVERVIEW

The general objective of financial reporting is to provide reliable information on resources, obligations and progress. The information should be useful for comparability, completeness and understandability. The basic features involved in financial accounting are the individual accounting entity, the use of approximation and the preparation of fundamentally related financial statements.

The financial statements—balance sheet, income statement, change in stockholders' equity and statement of cash flows, as well as segment reports and interim reports—will summarize a firm's operations and ending financial position. Analysts, investors, creditors and potential investors and creditors will analyze these documents in their decision-making processes.

¶1001 FAIR PRESENTATION IN CONFORMITY WITH GAAP

When a business is audited, the CPA's audit report attests to the fact that the financial statements are presented in conformity with GAAP. This means a number of things, but high in importance is the use of accrual basis accounting as opposed to cash basis, tax basis or some other comprehensive basis of accounting. As the day approaches when what constitutes generally accepted accounting principles in the U.S. (U.S. GAAP) gives way to International Financial Reporting Standards (IFRS), it is important to understand what has really changed and what has remained the same. The process of bringing U.S. GAAP and IFRS together, called convergence, means that when the transition to IFRS finally takes place, the two sets of standards, while not identical, will closely resemble each other in most major respects. This is expected to minimize the difficulty of the transition and to buffer the shock to the financial markets.

Fair presentation in conformity with GAAP requires that the following four criteria be met:

1. GAAP applicable in the circumstances have been applied in accumulating and processing the accounting information.
2. Changes from period to period in GAAP have been properly disclosed.
3. The information in the *underlying* records is properly *reflected* and *described* in the financial statements in conformity with GAAP.
4. A proper balance has been achieved between the conflicting needs to:
   a. Disclose the important aspects of financial position and results of operation in conformity with conventional concepts, and

   b. Summarize the voluminous underlying data with a limited number of financial statement captions and supporting notes.

These criteria are fundamentally the same for U.S. GAAP and IFRS.

¶1003 12 Principles of Financial Statement Presentation

1. *Basic Financial Statements.* At minimum, these statements must include:
   a. Balance Sheet
   b. Statement of Income
   c. Statement of Changes in Stockholders' Equity
   d. Statement of Cash Flows
   e. Disclosure of Accounting Policies
   f. Full Disclosure in Related Notes

   Information is usually presented for two or more periods. Other information also may be presented, and in some cases required, as supplemental information (e.g., price-level statements, information about operations in different industries, foreign operations and export sales, and major customers (segment reporting)).
2. *The Balance Sheet.* A complete balance sheet must include:
   a. All assets
   b. All liabilities
   c. All classes of stockholders' equity
3. *The Income Statement.* A complete income statement must include:
   a. All revenues
   b. All expenses
4. *The Statement of Cash Flow.* A complete statement of cash flow includes and describes all important aspects of the company's operating, financing and investing activities.
5. *Accounting Period.* The basic time period is one year. An interim statement is for less than one year.
6. *Consolidated Financial Statements.* In the context of a parent company and its subsidiaries statements are presumed to be more meaningful than separate statements of the component legal entities. They are usually necessary when one of the group owns (directly or indirectly) over 50 percent of the outstanding voting stock. The information is presented as if it were a single enterprise.

7. *The Equity Basis*. For unconsolidated subsidiaries (consolidated is used where over 50 percent is owned) where ownership is between 20 percent and 50 percent of the voting stock and the investor has significant influence over investees, the equity method is used to report the amount of the investment on the investor's balance sheet. The investor's share of the net income reported by the investee is picked up (debited if income, credited if loss) and shown as investment income and an adjustment of the investment account is made for all earnings subsequent to the acquisition. Dividends are treated as an adjustment (credit) to the investment account. This approach, based on former APB 18 (now FASB codification ASC 232-10-15), employs the same ownership test, 20 percent or more up to 50 percent, to indicate the use of the equity method is appropriate, as IAS 28, the IASB rule.
8. *Translation of Foreign Branches*. Data are translated into U.S. Dollars by conventional translation procedures involving foreign exchange rates.
9. *Classification and Segregation*. These important components must be disclosed separately:
   a. Income Statement—Sales (or other source of revenue); Cost of Sales; Depreciation; Selling Administration Expenses; Interest Expense; Income Taxes.
   b. Balance Sheet—Cash; Receivables; Inventories; Plant and Equipment; Payables; and Categories of Stockholder's Equity:
      - Par or stated amount of capital stock; Additional paid-in capital
      - Retained earnings affected by:
        — Net income or loss,
        — Prior period adjustments,
        — Dividends, or
        — Transfers to other categories of equity.
      - Working capital—current assets and current liabilities should be classified as such to be able to determine working capital—useful for enterprises in manufacturing, trading and some service enterprises.
      - Current assets—cash and other that can reasonably be expected to be realized in cash in one year or a shorter business cycle.
      - Current liabilities—liabilities expected to be satisfied by the use of those assets shown as current; by the creation of other current liabilities; or in one year.
      - Assets and liabilities—should *not* be offset against each other unless a legal right to do so exists, which is a rare exception.

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- Gains and losses—arise from disposals of other than products or services and may be combined and shown as one item. Examples are the sale of equipment used in operations, gains and losses on temporary investments, non-monetary transactions and currency devaluations.
- Extraordinary items or gain or loss—should be shown separately under its own title. Items distinguished by unusual nature and infrequent occurrence should be shown net of taxes.
- Net income—should be separately disclosed and clearly identified on the income statement.
- Earnings per share information is shown for net income and for individual components of net income.

10. *Other disclosures (Accounting policies and notes)*. These include:
    a. Customary or routine disclosures:
       - Measurement bases of important assets
       - Restrictions on assets
       - Restriction on owners' equity
       - Contingent liabilities
       - Contingent assets
       - Important long-term commitments not in the body of the statements
       - Information on terms of equity of owners
       - Information on terms of long-term debt
       - Other disclosures required by the AICPA

    b. Disclosure of changes in accounting policies
    c. Disclosure of important subsequent events—between balance sheet date and date of the opinion
    d. Disclosure of accounting policies ("Summary of Significant Accounting Policies")
11. *Form of Financial Statement Presentation.* No particular form is presumed better than all others for all purposes. Several are used.
12. *Earnings Per Share.* This information must be disclosed on *the face of the Income Statement* and should be disclosed for:
    a. Income before extraordinary items
    b. Net income

    Disclosure should consider:
    a. Changes in number of shares outstanding
    b. Contingent changes
    c. Possible dilution from potential conversion of:
       - Preferred stock
       - Options
       - Convertible bonds
       - Warrants

This information is disclosed both for basic earnings per share and for fully-diluted earnings per share which adjusts the denominator for potentially dilutive shares arising from possible exercise of stock options, conversion of convertible debt to stock and the like. If the conversion of potentially dilutive securities is anti-dilutive—that is the fully diluted earnings per share is actually greater than the basic earnings per share—the shares are reported as not being dilutive. The anti-dilutive EPS is not shown on the face of the income statement.

¶1005 Materiality

Financial statements are subject to the constraint of materiality. There have been attempts by authoritative rule-making bodies, scholars of accounting, users of financial statements, and others to develop quantitative criteria for determining the materiality of items in the financial statements. They postulate that if Item A is X percent of a total, Item A is material. If Item B is Y percent of a total, then Item B is material, but... All efforts have proved fruitless, and there are no accepted quantitative standards that can be wholly relied upon for an unquestioned determination of whether an item is material or immaterial (and thus can be omitted from the financial statements or notes thereto).

The courts to some extent have helped. However, it should be cautioned that different jurisdictions in different geographic areas of the country have established many opinions and definitions of materiality. For example, the Tenth Circuit Court of Appeals ruled that information is material if "...the trading judgment of reasonable investors would not have been left untouched upon receipt of such information." (*Mitchell v. Texas Gulf Sulphur Co.*) In the "landmark" *Bar Chris* case the judge said that a material fact is one "...which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question" (*Escott et al. v. Bar Chris Construction Corporation et al.*).

Principally because the U.S. Supreme Court defined materiality in the *TSC Industries Inc. v. Northway Inc.* case, the following statement of the Court is considered to be an authoritative basis upon which to render a judgment of materiality:

> "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with the general description of materiality as a requirement that the defect have a significant *propensity* to affect the voting process."
>
> [Note: This decision dealt with omissions of material information.]

"The Securities and Exchange Commission defines *material information: 'The term material when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed.'*"

.01 What's Material?

The accountant must decide precisely what information requires disclosure. To do this, the accountant must exercise judgment according to the circumstances and facts concerning material matters and their conformity with Generally Accepted Accounting Principles. A few examples of material matters are:

1. The form and content of financial statements.
2. Notes to the statements.
3. The terminology used in the statements.
4. The classification of items in the statements.
5. Amount of detail furnished.
6. The bases of the amounts presented (e.g., for inventories, plants, liabilities).
7. The existence of affiliated or controlling interests.

A clear distinction between materiality and disclosure should be noted. Material information involves both quantitative (data) and qualitative information. Additionally, the information must be disclosed in a manner that enables a person of "average" comprehension and experience to understand and apply it to an investment decision. Contra speaking, information disclosed in a manner that only an "expert" can evaluate is not considered within the meaning and intent of disclosure requirements.

Materiality should be thought of as an abstract concept. Many efforts to define the term can be found in the literature (e.g., accounting and auditing books, law books, and Regulation S-X). Nevertheless, in the final analysis, judgments with respect to what is material resulting from court decisions, SEC actions, accountants' interpretations, and corporate and financial officers' judgments have ultimately evolved into the subjective judgment of individuals (accountants and management) responsible for deciding what is and is not material.

¶1007 Disclosures Required in Financial Statements

Following is an overview of the most important disclosures required in financial statements with a brief comment on the substance of each requirement.

.01 Accounting Policies

Accounting Principles Board Opinion 22 (APB 22), *Disclosure of Accounting Policies*, is the applicable GAAP. (See the discussion at the end of this chapter.) The disclosure should set forth the accounting principles underlying the statements that materially affect the determination of financial position, changes in financial position, and results of operations. Also included are the accounting principles relating to recognition of revenue, allocation of asset costs to current and future periods, the selection from existing acceptable alternatives, such as the inventory method chosen, and any accounting principles and methods unique to the industry of the reporting entity.

As a general rule, the preferred position of the review of accounting policies is footnote No. 1, but a section summarizing the policies preceding the footnotes is acceptable.

.03 Who Decides what Information Is Material?

This decision is the responsibility of management working with the company's accountant. As a generalization, the *causes* for material changes in financial statement items must be noted to the extent necessary for users to understand the business as a whole. This requirement applies to all financial statements, not just to the income statement. The following items are considered material and *must* be recognized.

1. Sales and revenues. Increases or decreases in sales and revenues that are temporary or nonrecurring and their causes.
2. Unusually increased costs.
3. Informative generalizations with respect to each important expense category.
4. Financial expenses. Changes in interest expenses (and interest income); changes in the company's cost of borrowing; changes in the borrowing mix (e.g., long-term vs. short-term).
5. Other income and expense items. These may include dividend income from investees; the equity in the income or losses of investees or of unconsolidated subsidiaries.
6. Income taxes. The effective tax rate paid by corporations should be reconciled to the statutory rates. The reconciliation provides the basis for a description of the reasons for year-to-year variations in the effective tax rate to which a business is subject. Changes caused by the adoption of new or altered policies of tax-deferred accounting are considered material.

7. Material changes in the relative profitability of lines of business.
8. Material changes in advertising, research and development, new services, or other discretionary costs.
9. The acquisition or disposition of a material asset.
10. Material and unusual charges or gains, including credits or charges associated with discontinuance of operations.
11. Material changes in assumptions underlying deferred costs and the plan for the amortization of such costs.
12. The cost of goods sold, where applicable. The gross margin of an enterprise can be affected by important changes in sales volume, price, unit costs, mix of products or services sold, and inventory profits and losses. The composition of cost among fixed, semi-variable and variable elements influences profitability. Changes in gross margins by an analysis of the interplay between selling prices, costs, and volume should be explained.
13. Cash flow information.
14. Dilution of earnings per share.
15. Segmental reporting.
16. Rental expense under leases.
17. Receivables from officers and stockholders.

¶1009 Full Disclosure

Full Disclosure is an attempt to present all essential information about a company in the following reports:

1. Balance Sheet
2. Income Statement
3. Statement of Changes in Stockholders' Equity
4. Statement of Cash Flows
5. Accompanying Footnotes

The objectives of financial reporting are set forth in *FASB Concepts Statement 1*. The financial statements, notes to the financial statements, and necessary supplementary information are governed by FASB standards. Financial reporting includes other types of information, such as *Management's Discussion and Analysis*, letters to stockholders, order backlogs, statistical data, and the like, commonly included in reports to shareholders.

.01 The Full Disclosure Principle

Financial facts significant enough to influence the judgment of an informed person should be disclosed. The financial statements, notes to the financial statements, summary of accounting policies, should disclose the information necessary to prevent the statements from being misleading. The information in the statements should be disclosed in a manner that the intended meaning of the information is apparent to a reasonably informed user of the statements.

¶1011 Disclosure in Financial Reporting

.01 Disclosure

The heart of the compilation and disclosure of financial information is *accounting*. Yet, the idea of "adequate disclosure" stands alone as the one concept in accounting that involves all of the good things and all of the dangers inherent in the professional practice of accounting and auditing. Probably the use of the colloquialism "disclosure" best describes the all-embracing nature of the concept. That is to say, *disclosure is the name of the financial reporting game.*

For decades the profession has been inundated with disclosure literature, rules, regulations, statements, government agencies' accounting regulations, court decisions, tax decisions, intellectualizing by academics, books and seminars, all concerning what disclosure is all about.

Yet nobody has answered precisely what continues to remain the essential question: Disclosure of *what*, by *whom*, for *whom*?

The lack of definitive qualitative and quantitative criteria for what information must or need not be disclosed forces upon the independent accountant the responsibility to decide what constitutes a matter requiring disclosure, requiring an exercise of judgment in light of the circumstances and facts available at the time. The *accountant's* responsibility is confined to the expression of an opinion based upon an examination. The representations made through the statements are *management's* responsibility.

What is a material fact, and for whom does a disclosed fact have material significance? What substantive standards of disclosure must the accountant maintain? Who is to promulgate these standards? The profession? One or all of the governmental regulatory agencies? A federal board of accounting? The courts? The Congress?

One conclusion is clear, however. There is an unmistakable trend toward increasing demands upon the accounting profession for more financial information. What better evidence can be cited than the conclusion of the AICPA Study

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