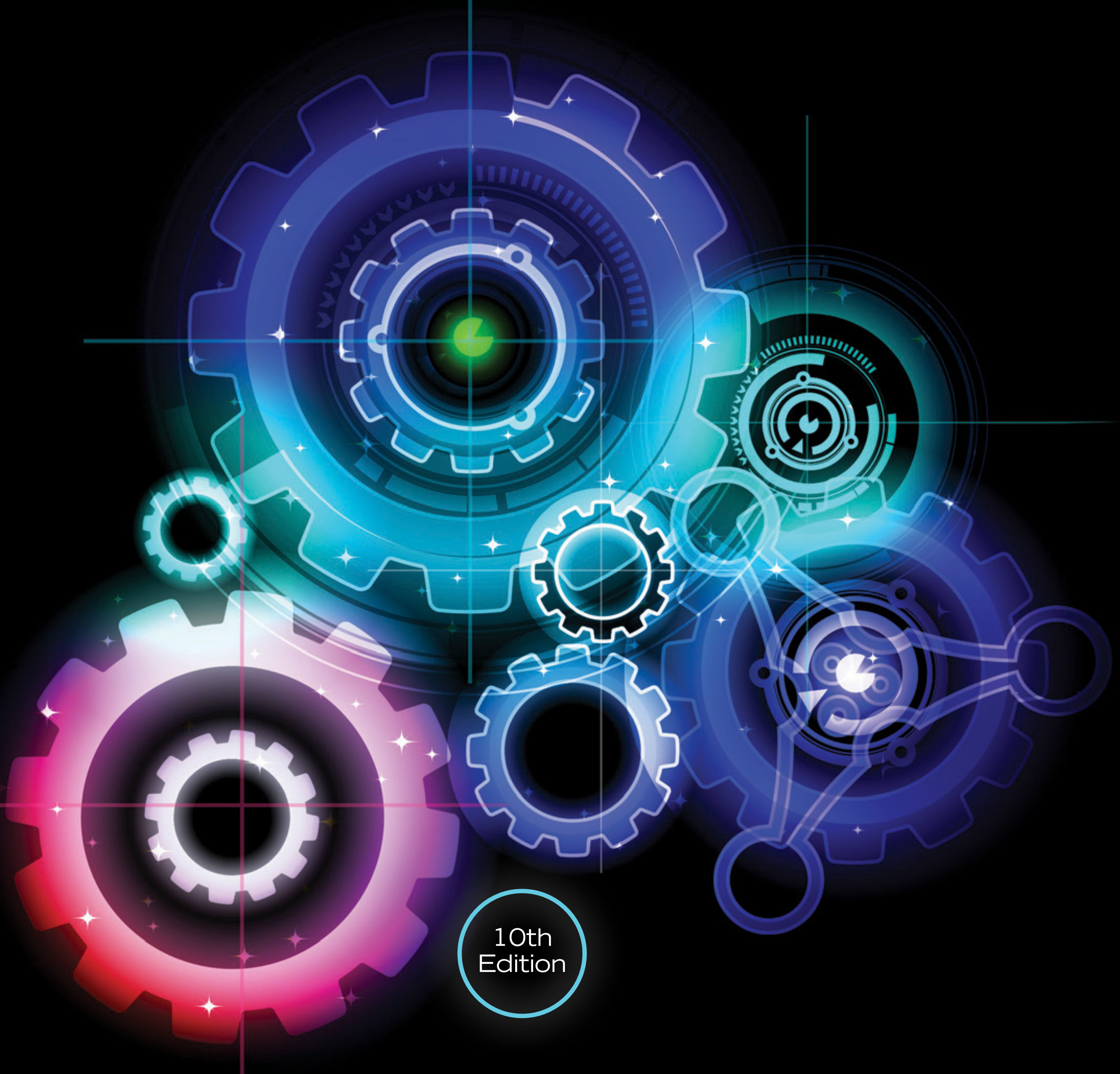

10th Edition

FINANCIAL ACCOUNTING

JAMIE PRATT • MICHAEL PETERS

WILEY

Financial Accounting

In an Economic Context

Tenth Edition

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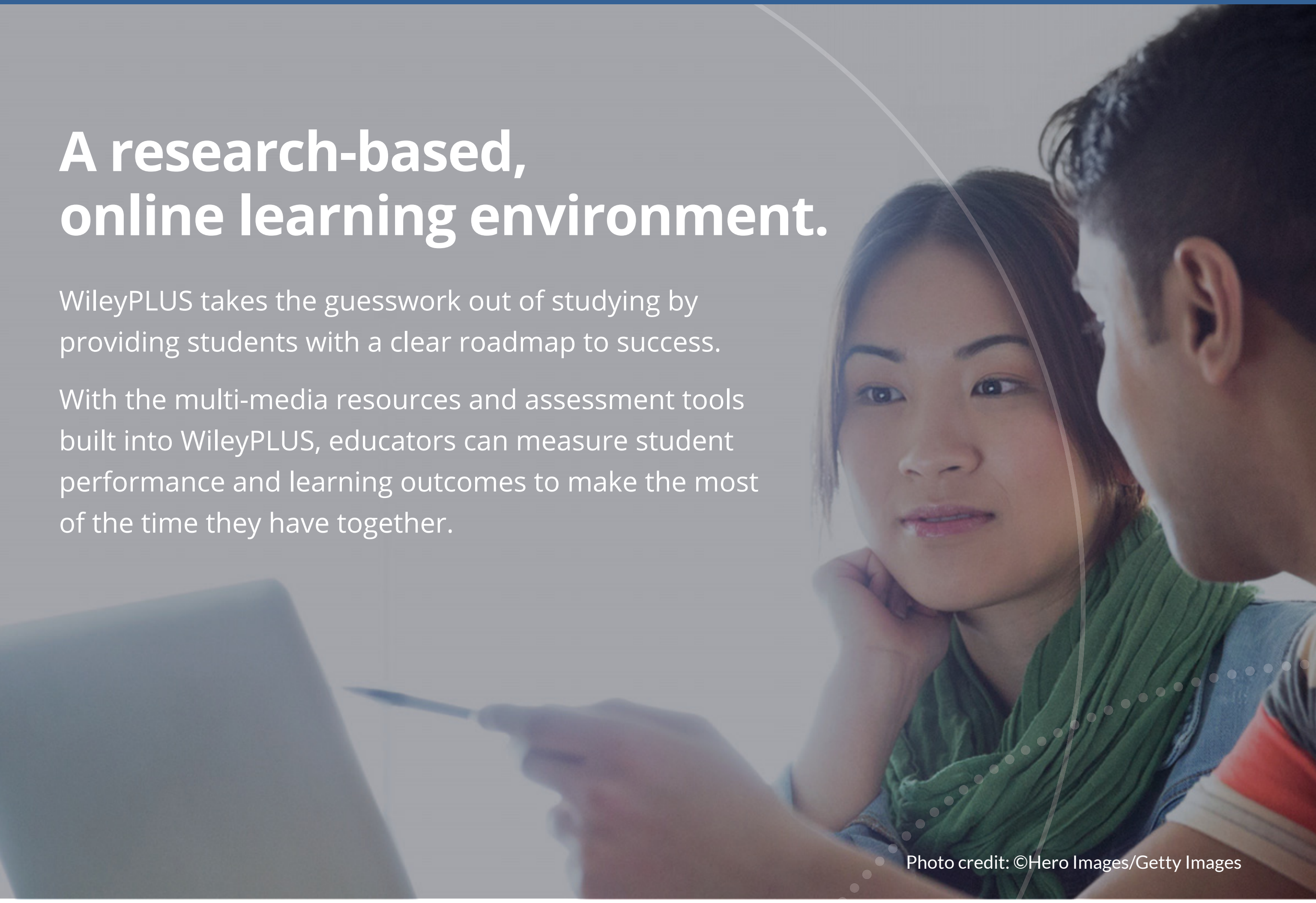

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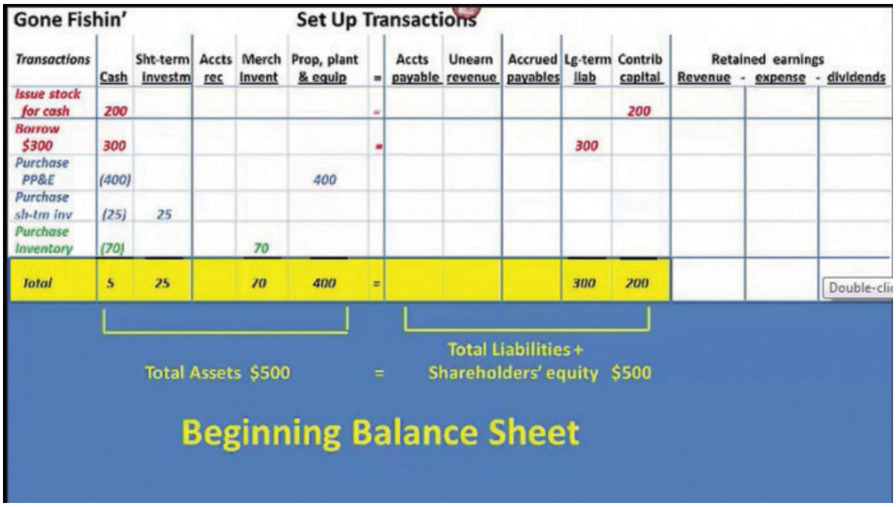

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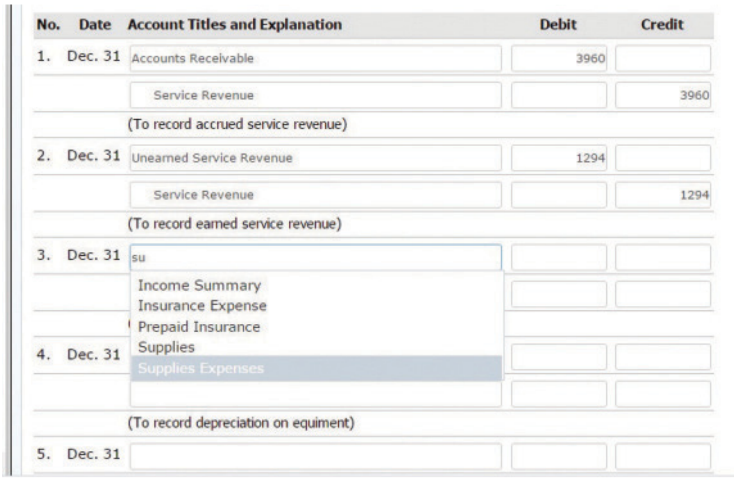

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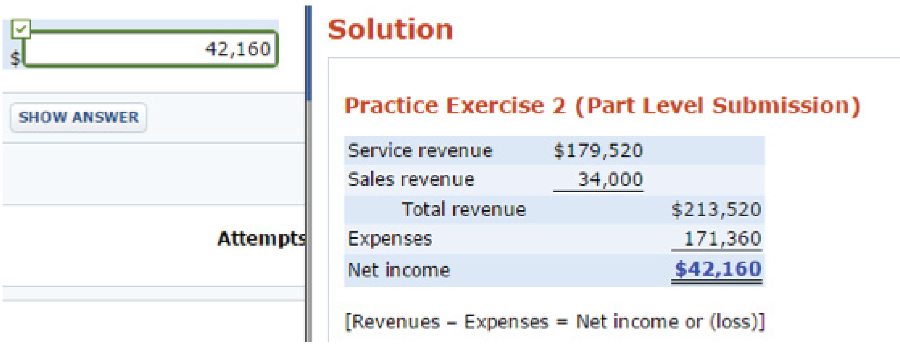

Students can practice their understanding of accounting topics with questions that are similar to select homework questions. Solutions for the select “similar” questions are provided.

New Features and Updates

Financial Accounting in an Economic Context continues to be an innovative resource in the area of introductory financial reporting and analysis. The tenth edition continues to build on the strengths of previous editions, while it introduces new ideas and refinements that better communicate the book's economic decision-making theme.

Concept Practice Exercises and Solutions

Concept Practice exercises and solutions in the body of the text prompt students to stop and review key concepts.

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 3

O'Malley and Richie purchased a computer for $8,000 on January 1. It was estimated to have a useful life of four years and it was depreciated evenly over that time period. Each of the four years it was serviced at a cost of $300. At the beginning of Year 2 due to a power surge the hard drive had to be reimaged and the software had to be reinstalled at a cost of $500. At the end of Year 2 the computer was upgraded with additional memory at a cost of $1,000. The computer was retired at the end of the fourth year. Compute the expenses (depreciation and maintenance) recognized by O'Malley and Richie over the four-year period.

SOLUTION

	Year 1	Year 2	Year 3	Year 4
Depreciation expense*	$2,000	$2,000	$2,500	$2,500
Maintenance and repairs expense**	300	800	300	300

*$8,000/4 = $2,000 for Years 1 and 2; for Years 3 and 4 the $1,000 upgrade was capitalized and depreciated over the remaining two-year life.

**The annual maintenance of $300 was expensed each year, and the $500 repair due to the power surge simply returned the computer to its original state prior to the damage, not upgrading it in any way.

Chapter 2

Chapter 2 was redesigned around a scenario that derives the nature of financial statements from the perspective of an entrepreneur trying to raise capital to start a new business. While the content of Chapter 2, which introduces the financial statements in more detail, is much the same as in prior editions, the new scenario adds a perspective that builds a complete set of financial statements in a uniquely effective and intuitive manner. The chapter concludes by identifying five key questions addressed by the financial statements, each of which considers a dimension of performance necessary for successful businesses. These questions then serve as a foundation throughout the text for how the financial statements should be analyzed.

Chapter 5

This tenth edition was written to further develop the idea that the financial statements should be viewed, not as individual statements, but instead as a package. They comprise an interrelated story about the historical performance of the firm and the key dimensions that in the past have driven that performance. This theme is very evident in Chapters 1–5 which introduce the economic role of the financial statements, how they should be interpreted, how they are prepared, and how they should be analyzed. In this part of the text especially they are rarely discussed as independent statements; they are viewed as an integrated whole. Chapter 5 has been revised to emphasize this perspective and better package the financial ratio analysis.

Up-to-date Real World Examples and Exercises

Many of real-world examples were updated in the textbook. Real-world company end-of-chapter questions were updated to include current, real-world data and values. All chapters were updated to address current financial accounting practices.

New Accounting Standards

Effective December 2017 investments in equity securities will no longer be classified as available-for-sale on trading securities. These investments will be carried on the balance sheet at fair market value and price changes will be reflected in earnings. In addition, the cost method will be eliminated. Chapter 8 (Investments in Equity Securities) especially and other sections of the text have been revised to reflect these important changes. Also, effective January 1, 2019 capital lease accounting will effectively be eliminated. Chapter 11 (Long-terms Liabilities: Notes, Bonds and Leases) still covers capital lease accounting but also discusses this upcoming major change.

Learning Objectives and Design

Each chapter now opens with an outline that lists new learning objectives for the chapter and concept practice exercises associated with each learning objective. A new, four-color design highlights pedagogical tools and will help students navigate through each chapter more easily.

LEARNING OBJECTIVE		PRACTICE
1. Describe the balance sheet in terms of equity and debt capital and producing and operating assets.	• Equity capital • Debt capital • Producing assets • Operating assets	**1a.** Distinguish equity capital from debt capital and producing assets from operating assets. **1b.** Describe how equity and debt capital and producing and operating assets can be organized into a balance sheet.
2. Explain the concept of net income, who owns it and what they can do with it.	• Net income • Dividends • Retained earnings	**2.** Explain the generation and distribution of net income.
3. Define the three major activities of a business.	• Attracting capital • Converting capital into assets • Managing assets	**3.** Classify transactions into three categories.
4. Describe the four financial statements in greater detail.	• Balance sheet • Income statement • Statement of shareholders' equity • Statement of cash flows	**4.** Match financial statements with descriptions.
5. Discuss how the financial statements can be viewed as a package and use the package to assess five fundamental metrics of a company's performance.	• Relationships among the statements • Operating performance • Asset investment • Asset financing • Cash management • Return on shareholder investment	**5a.** Identify how transactions can affect more than one financial statement. **5b.** Assess five fundamental financial metrics.

Hallmark Approach and Features

Continuing the Approach

The tenth edition continues to develop fundamental pedagogical elements, such as ethics cases, Internet exercises, brief end-of-chapter real-world exercises and issues for discussion, and a set of interesting and challenging "quality of earnings" cases. This edition also includes an updated glossary. But perhaps most important, this edition has maintained and improved upon its most distinctive feature—the economic decision-making approach and the balanced coverage of three important themes: economic factors. measurement issues, and mechanics.

Economic Factors

Financial accounting is meaningless without an understanding of the economic environment in which it exists. Each chapter in the tenth edition, therefore, includes frequent references to actual events and companies; quotes from well-known business publications and corporate annual reports—information about industry practices, debt covenants, compensation arrangements, and debt and equity markets; and in-depth discussions of legal liability, ethical issues, and management's incentives and influence on financial reports. At the end of each chapter students are directed to The Walt Disney Company SEC Form 10-K to answer questions relevant to that chapter. Furthermore, ratio analysis and international issues are introduced early and integrated throughout the text, and the coverage still reflects a strong user orientation with a distinct "quality and persistence of earnings" flavor. The important role of the economic environment in this text makes it more than simply a study of financial accounting. It is a study of modern business management as seen through the financial accounting process.

Measurement Issues

As future managers and users, students must understand the measurement issues underlying the financial statements before they can interpret and meaningfully use them. The tenth edition devotes considerable attention to the conceptual and theoretical foundation of financial accounting measurement, with special emphasis on how the financial statements provide useful measures of the key areas of business performance. Cash and accrual statements are treated as equally important, with the statement of cash flows being covered from the very beginning. Chapter 3 provides a framework for accounting measurement that is used throughout the remainder of the text.

Mechanics

Using financial statements without understanding the underlying mechanics is like trying to interpret a foreign language without knowing the vocabulary. Consequently, the tenth edition provides a strong mechanical foundation and stresses mechanics early and throughout the text. Journal entries and T-accounts play an important role, but they are never treated as a goal. Rather, they are characterized as an efficient way to communicate how economic events are reflected on the financial statements. A special coding is used throughout the text to link the form of each entry to the basic accounting equation and financial statements. Thorough mechanical coverage is especially important in a text that takes a user orientation because effective users must be able to infer transactions from the financial statements. This mechanical skill, referred to as *reverse T-account analysis*, is covered several times in the text, and many exercises and problems are designed to test it.

Decision-Making Perspective

This text presents financial accounting in a way that helps managers make decisions—a decision-making perspective. At a fundamental level, managers make two kinds of decisions: attracting capital and investing capital. Simply put, managers must attract capital from debt and equity investors and then invest it in operations, producing assets, and investment securities. Successful management is defined by generating a return from these investments that exceeds the cost of capital. As depicted in Figure P–l, these two kinds of decisions can be matched with the three themes discussed above (mechanics, measurement issues, and economic factors) to produce six basic questions that must be answered by managers who use financial accounting information when making decisions.

	Management Decisions	
	Attract Capital	**Invest Capital**
Mechanics	1 How do the transactions affect the financial statements?	4 How are financial ratios computed, and how can transactions be inferred from the financial statements?
Measurement Theory	2 How do these financial statement effects influence outside perceptions of the company's performance?	5 How do the financial statements and ratios indicate a company's performance?
Economics	3 How do these financial statement effects influence decisions of outsiders as well as debt and compensation contracts?	6 What action should be taken (e.g., invest, extend credit, adjust loan terms)?

FIGURE P–1

In their effort to attract capital, managers must address three questions when considering whether to enter into certain transactions: How do the transactions affect the financial statements? (cell 1); how do these financial statement effects influence outside perceptions of the company's performance? (cell 2); and how do these financial statement effects influence the decisions of outsiders as well as debt and compensation contracts? (cell 3). These questions must be answered if management is to understand the economic consequences of the transactions under consideration.

In their effort to invest capital, managers must address three different questions: How are financial ratios computed, and how can transactions be inferred from the financial statements? (cell 4); how do the financial statements and ratios indicate a company's performance? (cell 5); and what action should be taken (e.g., invest, extend credit, adjust loan terms)? (cell 6). These questions must be answered if management is to understand how to use financial accounting information properly.

The decision-making perspective simply means that all six questions are addressed in this text. These are the areas where management decision making intersects with financial accounting information, or, in other words, this is what managers need to know about financial reporting and analysis. It is this perspective that makes *Financial Accounting in an Economic Context* different from all other texts.

Successful Features Retained from Previous Editions

With few exceptions, the text retains the main features of previous editions. Below is a brief description of the most important ones.

Globalization of Business and Financial Reporting Standards While the tenth edition is still based on U.S. GAAP, IFRS standards and concepts are woven throughout the entire text. It may be unlikely that the United States will require IFRS standards, but IFRS standards are now accepted on U.S. exchanges when submitted by non-U.S. firms. Also highlighted in the tenth edition are important differences in business practices and cultures across national borders. Indeed, we live in a global business world, and the tenth edition reflects what future business leaders need to know about accounting to operate effectively within it.

Statement of Cash Flows The tenth edition discusses the statement of cash flows from the very first chapter and in Chapter 4 demonstrates how to prepare a statement of cash flows from the activity in the cash T-account. Mechanical differences between accruals and cash flows are introduced and illustrated in Appendix 4A, which also includes coverage of reverse T-account analysis as well as the preparation of a relatively simple statement of cash flows from two balance sheets and an income statement. Chapters 6 through 12 contain frequent boxed-in items that highlight the accrual to cash adjustments in the operating section of the statement of cash flows of well-known companies, which serves as a periodic reminder to students—regardless of the account being studied—of the reconciliation between net income and net cash provided by operating activities. Chapter 14 contains an illustration of how to prepare a more complicated statement of cash flows from two balance sheets and an income statement.

Fair Market Value Accounting Fair market value accounting is woven throughout the tenth edition. While one might still describe the current accounting model as based on historical cost, heavy reliance on the lower-of-cost-or-market concept in the valuation of assets, accounting for trading and available-for-sale securities, the reliance on present value concepts in asset and liability valuation, and relatively recently, the U.S. adoption of the fair value option all point toward a measurement system that is gradually moving toward fair valuation—both for U.S. GAAP and IFRS. Savvy business students should know something about how fair market values are reflected in the financial statements.

Complete Financial Statement Analysis Package A strength of this text is its financial statement analysis perspective and the tenth edition continues in this tradition. The perspective is introduced in Chapter 1, fundamentally developed in Chapter 2 in which five key questions for analysis are derived, and thoroughly covered in Chapter 5, which is devoted specifically to financial statement analysis. Appendix 5A covers shareholder value creation and the ROE model as well as analyses of cash flow patterns, business segments, and projected financial statements. This theme is continued in Chapters 6–13, all of which end with a special section that discusses ROE analyses in terms of the chapter topic and directs students to a website where they can analyze real company data used as input in a prepopulated ROE spreadsheet model.

Flexible Modules Chapter 3 (The Measurement Fundamentals of Financial Accounting), Chapter 4 (The Mechanics of Financial Accounting), and Chapter 5 (Using Financial Statement Information) have been written so that they can be covered in any order. This modular structure adds an important dimension of flexibility to the text.

Real-World Review Throughout each chapter, real-world applications of chapter topics are highlighted and boxed. In the tenth edition, these boxed items also include real-world insights on general international issues, IFRS, and the reconciliation of net income with net cash from operations on the statement of cash flows.

Ethics Vignettes Each chapter closes with a short business scenario that introduces an ethical issue related to the material covered in the chapter. Several questions that follow each scenario are designed to encourage meaningful class discussion.

Industry Data Many of the chapters contain tables that compare accounting practices and show students the importance of accounting numbers and ratios across different industries and well-known companies. Updated in the tenth edition, these tables illustrate that the financial accounting issues faced by retailers, manufacturers, service enterprises, and financial institutions are quite different. A brief explanation of the operations of companies in different industries and how these operations give rise to different financial accounting concerns follows each table.

The Walt Disney Company SEC Form 10-K Disney is referenced periodically throughout the text and each chapter contains an end-of-chapter case that requires students to access the Disney report via the Internet and relate the financial statements to accounting issues covered in the chapter.

Contents

About the Authors

Jamie Pratt

Jamie Pratt is Alva L. Prickett Chair of Accounting at the Kelley School of Business in Indiana University. He received his doctoral degree from Indiana in 1977 and has held faculty positions at the University of Washington (Seattle), University of Zurich, Northwestern University, and INSEAD–returning to Indiana in 1991. He served as chair of the Accounting Department from 1998–2004, and chair of Graduate Accounting Programs from 2006–2007. He teaches financial accounting and financial statement analysis at both the undergraduate and graduate levels, and he has received teaching awards at each of the institutions listed above. In addition, he has taught in executive education programs all over the world. His research interests primarily include financial reporting and auditing issues, and he publishes frequently in the top academic accounting journals, including *The Accounting Review*, *Journal of Accounting Research*, *Contemporary Accounting Research*, *Accounting, Organizations & Society*, *Auditing: a Journal of Practice and Theory* as well as journals devoted to educational issues such as *Issues in Accounting Education* and *Journal of Accounting Education*. He has served as Associate Editor of *The Accounting Review*, program chair for the American Accounting Association (AAA) annual meeting, and he has received a number of AAA awards and recognitions. Professor Pratt was sole author of a popular textbook through 9 editions (*Financial Accounting in an Economic Context*), and co-authored another textbook (*Financial Reporting for Managers: a Value Creation Perspective*). He has also been involved in the creation of a number of other educational materials, including mini-lecture videos, casebooks, spreadsheet exercises, and state-of-the-art interactive cd-rom products. Parents of three grown boys, he and his wife (Kathy) live in Bloomington, Indiana where he enjoys sports, landscaping, and playing the piano.

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Professor Peters is the Chair and Alvin A. Clay Professor of Accountancy at the Villanova School of Business. Prior to Villanova University, he was an assistant professor at the University of Maryland-College Park. He received his Ph.D. in accounting from Indiana University. Prior to his doctoral work, he graduated with a degree in accounting from Michigan State University and an MBA in finance from Indiana University. He was previously a Certified Public Accountant in the States of Michigan and Maryland. Professor Peters has work experience in public accounting after his undergraduate degree and commercial banking after his MBA degree. Professor Peters has taught financial accounting at both the executive MBA, MBA, MAC, and undergraduate levels at Villanova University. He has been noted in BusinessWeek as an outstanding faculty for his MBA teaching at the University of Maryland–College Park and has also received various teaching awards. His research interests are in financial reporting and auditing along with educational issues. He's published in the top accounting academic journals such as *The Accounting Review; Contemporary Accounting Research; Auditing: A Journal of Practice and Theory;* and educational journals such as *Issues in Accounting Education.* He lives in Devon, Pennsylvania with his wife Jeannine and two children.

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Jamie Pratt

An Overview of Financial Accounting

PART 1

Chipotle Mexican Grill, the fast-growing, casual restaurant chain, has been a popular stock investment ever since its 2006 initial public stock offering. In October 2015, however, the company released a report, indicating earnings of $4.59 per share of outstanding stock, which was below the $4.63 amount expected by the analysts. The response of the stock market was swift, with Chipotle share prices dropping by over 7 percent. The company reported new store openings and strong 12.2 percent revenue growth, but higher labor and marketing expenses cut into profit growth.

What are revenues and earnings? How do they relate to stock prices? What role do analysts and their expectations play? Would an investment in Chipotle be a wise move? Answering such questions begins with an understanding of the business environment, investment decisions, and financial statements—topics addressed in Part 1 of this textbook.

CHAPTER 1

Financial Accounting and Its Economic Context

LEARNING OBJECTIVE		PRACTICE
1. Discuss the role of financial reports in investment decisions and the difference between the economic consequence and user perspectives.	• Profit-seeking entities • Users of financial statements • User decisions • Consequences of user decisions	**1.** User perspective vs. economic consequence perspective
2. Explain the difference between consumption and investment and why investors demand documentation and independent audits.	• Spending decisions • Documentation of past financial performance and current condition • Differing incentives	**2a.** Consumption vs. investment choices **2b.** Information necessary for investing
3. Describe the standard audit report, management letter, four financial statements, and related footnotes.	• Audit report • Management letter • Financial statements • Footnotes	**3.** Financial decision-making information package
4. Differentiate debt from equity and the concepts of solvency and earning power.	• Debt investment • Equity investment • Solvency • Earning power	**4a.** Debt vs. equity investments **4b.** Solvency vs. earning power
5. List the major elements of the environment in which financial reports are prepared and used and describe how these elements encourage effective corporate governance.	• Providers of capital • Companies • Debt and compensation contracts • Auditors • Board of directors • Legal liability • Professional reputation and ethics	**5.** Effective corporate governance
6. Summarize the current status of accounting standard setting—both in the United States and internationally.	• Securities and Exchange Commission (SEC) • U.S. Generally Accepted Accounting Principles (U.S. GAAP) • International Financial Reporting Standards (IFRS)	**6.** U.S. GAAP vs. IFRS

LEARNING OBJECTIVE 1

Discuss the role of financial reports in investment decisions and the difference between the economic consequence and user perspectives.

Like schoolchildren who have practiced fire drills dozens of times, investors know exactly what to do when news leaks out that a company's financial records may not be in order. First, sell the stock; then, look around to see who else might get sucked up into the budding scandal and drop them like a hot potato. Investors followed their "fire drill" to the letter when they learned that the financial records of New Century, one of the nation's leading lenders of high-risk loans, were misstated. Its stock price plummeted, it was forced to declare bankruptcy, and one of the worst credit crises in U.S. history was underway.

The situation described above is all too common. Billions of dollars are lost each year by investors who base their investment decisions on misleading reported numbers. This text, beginning with this first chapter, explains how that could happen. It also describes how you can avoid the fate of those investors who, believing the profits reported by New Century, chose to invest their hard-earned money and lost much of it. The first step involves understanding the **financial accounting** process.

Financial Reporting and Investment Decisions

Financial reporting plays an important role in investment decisions.

1. *Profit-seeking companies*—Managers of profit-seeking companies prepare reports containing financial information for the owners of these companies. In addition to other information, these reports contain four financial statements: the balance sheet, the income statement, the statement of shareholders' equity, and the statement of cash flows.
2. *Owners and other interested parties (users)*—Although prepared primarily for the owners, these financial reports are often available to the public and are read by other interested parties who use them to assess the financial condition and performance of the company as well as the performance of its managers. Such interested parties, called users in this text, include potential investors, bankers, government agencies, and the company's employees, customers, and suppliers.
3. *User decisions*—Users obtain information from the financial reports that helps assess the company's past performance, predict its future performance, and control the activities of its managers. Thus financial reports help users to make better decisions. Investors, for example, use financial reports to choose companies in which to invest their funds; bankers use them to decide where to loan their funds and what interest rates to charge.
4. *Effects of user decisions*—User decisions affect the financial condition and performance of the company and the economic well-being of its managers. For example, a banker may use the information contained in a financial report to decide not to loan a certain company much-needed funds. Such a decision may cause the company to struggle and may cost managers their jobs and owners their investments.

Figure 1–1 illustrates how financial reporting relates to investment decisions. Note its dynamic nature: The financial information provided by managers of a profit-seeking company is used by interested parties to make decisions that, in turn, affect a company's financial condition

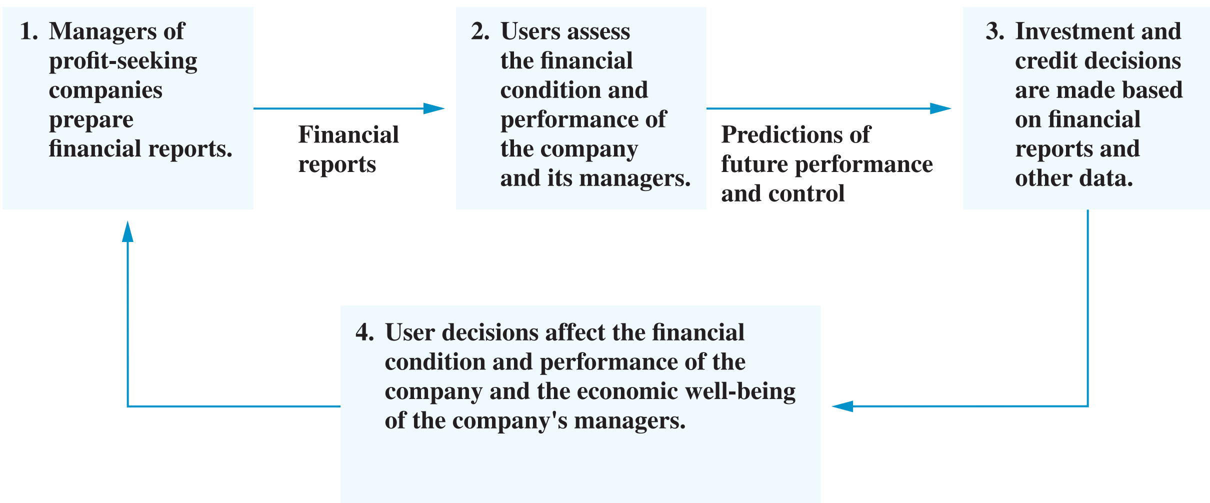

FIGURE 1–1 Financial reporting and investment decisions

and the economic well-being of its managers. Managers need to understand the process depicted in Figure 1–1 from two perspectives:

1. Economic consequences
2. User orientation

Economic Consequences

To run a company effectively, management must be able to attract capital (funds) from outsiders who use financial statements to evaluate the company's performance and financial health. Managers apply for loans from bankers, for example, who use the financial statements to determine whether to grant the loan and, if so, what interest rate to charge. Because using financial statements by outsiders leads to economic consequences for managers and the companies they operate (e.g., higher interest rates), it is important that they know how economic events (e.g., business decisions) affect the financial statements. Consider a case where management is deciding to either purchase or rent equipment. When making such a decision, an astute manager would consider how the choice affects the financial statements because it could influence the way in which the company is viewed by outsiders. Considering and understanding how such events affect the financial statements are referred to in this text as an **economic consequence perspective**.

User Orientation

Managers are also users of financial statements, such as when they are called upon to assess the performance and financial health of other companies. Questions such as the following are often answered by analyzing financial statements provided by those companies.

- Should we purchase a company?
- Should we use a company as a supplier?
- Should we extend credit or loan funds to a company?

Accordingly, managers also need to know how to read, evaluate, and analyze financial statements. We call this perspective a **user orientation**.

The next section develops a scenario designed to highlight issues particularly important to users of financial statements. That same scenario serves as the basis for the next section, which covers the economic environment in which financial statements are prepared and used. Appendix 1A introduces managerial, tax, and not-for-profit accounting.

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 1

Choose the best response to the following questions.

1. Which of the following groups are not likely to be users of financial statements prepared by a company?
   a. Company owners
   b. Potential investors in the company
   c. Banks
   d. Company suppliers and customers
   e. Company managers
   f. All of the above are users of financial statements.
2. A bank requires Blake Company to provide financial statements for the past five years as it considers loaning money to Blake. Blake's managers prepare the financial statements and want them to look as good as possible so that the bank will grant the loan and charge a low interest rate.

a. The bank is viewing the financial statements from an economic consequence perspective, while Blake's managers are viewing the financial statements from a user perspective.
b. The bank is viewing the financial statements from a user perspective, while Blake's managers are viewing the financial statements from an economic consequence perspective.
c. Both parties are viewing the financial statements from a user perspective.
d. Both parties are viewing the financial statements from an economic consequence perspective.

SOLUTION

1. f. Any party interested in the past financial performance and condition of a company would be considered a potential user of financial statements, which includes a company's owners, potential investors, managers, creditors, customers, suppliers, employees, government agencies, and other groups.

2. b. The bank wants to use the financial statements to assess the past financial performance and current condition of Blake to guide its credit-granting decision. Blake's managers are using the financial statements to attract funds and they know that if the financial statements reflect poorly on the company the bank may not grant the loan.

The Demand for Financial Information: A User's Orientation

LEARNING OBJECTIVE 2

Explain the difference between consumption and investment and why investors demand documentation and independent audits.

Suppose that you recently learned that a long-lost relative died and left you a large sum of money. You know little about financial matters, so you consult Mary Jordan, a financial advisor, to help you decide what to do with the funds. She tells you that you have two choices: You can consume it or you can invest it.

Consumption and Investment

In consuming your new fortune, you would spend the money on goods and services, such as a trip around the world, expensive meals, a lavish wardrobe, or any other expenditures that bring about immediate gratification. Consumption expenditures, by definition, are enjoyed immediately and have no future value.

In investing the fortune, you would spend the money on items that provide little in the way of immediate gratification. Rather, they generate returns of additional money at later dates. In essence, investments trade current consumption for more consumption at a later date. Examples include investing in stocks and bonds, real estate, rare art objects, or simply placing the money in the bank.

Where to Invest?

You decide to invest the money, and with a little direction from Mary, you begin to explore investment alternatives. You find that investments come in a number of different forms, however, and you quickly become overwhelmed, confused, and frustrated. Just as you are about to give up your search and put all your money in the bank, a man by the name of Martin Wagner knocks at your door. Through a mutual friend, Martin has heard of your recent windfall and states that he has an interesting offer for you.

Martin claims that he manages a very successful research company, called Microline, owned by a group of European investors. In its short history, the company has earned a reputation for innovation in software development. As Martin describes it, Microline's research staff is on the verge of designing a virtual reality gaming system that will revolutionize the industry in the future.

Martin has come to you for capital—$1 million, to be exact. The company's research and development efforts have run short of funds, and money is still needed to complete the design. With your money, Martin asserts that the system can be completed and sold, producing millions of dollars of income, some of which will provide you with a handsome return on your investment. Without your capital, Martin believes that the project may have to be abandoned.

The Demand for Documentation

You have listened to Martin's story and now must decide what to do. Your first thought is that you simply cannot accept his word without some documented evidence. How do you really know that he has successfully managed this business for the past two years and that $1 million will enable the company to turn this design into a fortune in the future?

After careful consideration, you decide that you need to see some proof before making a final decision. You ask for specific documents to show that Microline has been run successfully for the past two years, is currently in reasonably good financial condition, and has the potential to generate income of the magnitude Martin suggests. He agrees to provide you with such documentation because he knows that if he does not, you will invest your money elsewhere, and both he and Microline will suffer.

Several days later, Martin returns with a set of financial statements prepared by Microline's accountants. He explains the meanings of the numbers on the statements and further claims that the records at his office can be used to verify them. Taken at face value, the figures look promising, but somehow Martin's explanation is not convincing. It occurs to you that Martin might have fabricated or at least influenced the figures. After all, Microline needs money, and who would blame Martin for showing you only the figures that make Microline's situation look attractive to a potential investor?

The Demand for an Independent Audit

You require that Martin go one step further. He must return again with financial statements that have been checked and verified by an independent outsider who is an expert in such matters. You insist that the person not be employed by Microline or have any interest whatsoever in the company and have the appropriate credentials to perform such a task. In essence, you demand that Martin hire a **certified public accountant (CPA)** to verify Microline's financial statements. You require, in other words, that Microline subject itself to an **independent audit**. Martin agrees because, once again, if he does not, you will take your money and invest it elsewhere. At the same time, Martin is somewhat troubled. He knows that hiring and working with a CPA can be very costly and time-consuming.

Martin and the CPA: Different Incentives

Time passes and you become concerned that Martin has taken too long to return with the financial statements. You have thought of several questions since Martin's last visit and decide to call on him in person. You arrive at Microline's office and are seated by Martin's secretary. While you are waiting, you hear Martin's voice through the partly open door to his office. He seems to be discussing Microline's financial statements with the CPA. While you cannot understand exactly what is being said, it is clear that they are not in complete agreement and that they are both strong in their convictions.

You wonder why Martin and the CPA might view the financial statements from different perspectives and speculate that perhaps the CPA recommended presenting Microline's financial condition in a way that was unsatisfactory to Martin. You reason that Martin should probably follow the CPA's recommendation because, after all, the CPA is the expert in financial reporting. You realize, however, that Martin wants the statements to be as attractive as possible and that he may have some influence over the CPA. Indeed, Martin did hire the CPA and does pay the CPA's fee.

Before long, the CPA leaves and Martin invites you into his office. During your short discussion, you mention nothing of what you think you have heard. Martin answers your questions confidently and assures you that the statements will be ready within the week. Satisfied, you return home.

CONCEPT PRACTICE FOR LEARNING OBJECTIVE 2

Choose the best response to the following questions.

2a. Which of the following purchases would be considered consumption instead of investment?

a. Purchasing a savings bond issued by the U.S. government.
b. Purchasing a ticket for a Mediterranean cruise.
c. Purchasing an ownership interest in a new start-up company.
d. Purchasing a rare coin in hopes that its value would increase.

2b. Suppose you are considering investing in a company (Solar Inc.) that manufactures an important part used in solar power systems. Which of the following information items should influence you the most in deciding whether or not to invest?

a. A statement by Solar's management that it believes that the company has performed well.
b. A set of financial statements prepared by Solar's management and reviewed closely by Solar's chief financial officer.
c. A set of financial statements prepared by Solar's management audited by an independent outside financial expert.
d. Statements by Solar's suppliers that Solar has paid its bills on time.

SOLUTION

2a. b. Investments are made anticipating a financial return. A Mediterranean cruise may be very enjoyable and well worth the cost, but the money spent on it will be gone forever. In all three of the other cases a financial return is expected.

2b. c. Financial statements provide a package that would allow you to reasonably assess Solar Inc.'s past financial performance and current financial condition. Because Solar's management, who prepares its financial statements, is biased, it is normally best to have the statements reviewed by an independent outside expert. The other alternatives either address only part of financial performance or are not independent.

The Auditor's Report, the Management Letter, and the Financial Statements

LEARNING OBJECTIVE 3

Describe the standard audit report, management letter, four financial statements, and related footnotes.

Martin arrives at your home with seven official-looking documents: (1) an **auditor's report**, a short letter written by the auditor that describes the activities of the audit and comments on the financial position and operations of Microline; (2) a **management letter**, signed by Martin, which accepts responsibility for the figures on the statements; (3) a balance sheet; (4) an income statement; (5) a statement of shareholders' equity; (6) a statement of cash flows; and (7) a comprehensive set of footnotes, which more fully explains certain items on the four statements listed above. You briefly review the documents and tell Martin that you will have a decision for him soon.

The Auditor's Report

You begin your examination by reviewing the auditor's report, from which you hope to learn how credible the financial statements actually are (see Figure 1–2).

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF MICROLINE:

We have audited the accompanying balance sheet of Microline as of December 31, 2016 and 2015, and the related statements of income, shareholders' equity, and cash flows for the years then ended. We have also audited management's assessment of the effectiveness of its internal control over financial reporting. These financial statements and the effectiveness of the internal controls are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and management's assessment of the internal controls based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board. 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. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of the internal controls. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Microline as of December 31, 2016, and 2015, and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles. Also, in our opinion management maintained effective internal control over financial reporting as of December 31, 2016.

Arthur Price

Arthur Price, Certified Public Accountant
March 12, 2017

FIGURE 1–2 The standard audit report

Overall, you are reassured by the auditor's report. It indicates that the auditor reviewed Microline's records thoroughly and concluded that the statements (1) were prepared in conformity with generally accepted accounting principles, (2) present fairly Microline's financial condition and operations, and (3) resulted from an effective internal control system. You suspect that the auditor could have rendered a much less favorable report, such as that the statements were not prepared in conformance with generally accepted accounting principles, or that no opinion could be reached because Microline's accounting system and internal controls were so poorly designed, or that Microline was in danger of failure. You also realize, however, that you know very little about internal control systems, auditing standards, and generally accepted accounting principles, and that Microline's management made a number of significant estimates when preparing the statements. This discovery is somewhat troubling because, even with the audit, it seems that Microline's management may have had some subjective influence on the financial statements.

The Management Letter

You next read the management letter, hoping to learn more about how the financial statements were prepared and audited (see Figure 1–3).

MANAGEMENT'S RESPONSIBILITIES:

Management is responsible for the preparation and integrity of the financial statements and the financial comments appearing in this financial report. The financial statements were prepared in accordance with generally accepted accounting principles and include certain amounts based on management's best estimates and judgments. Other financial information presented in this financial report is consistent with the financial statements.

The Company maintains a system of internal controls designed to provide reasonable assurance that the assets are safeguarded and that transactions are executed as authorized and are recorded and reported properly. The system of controls is based upon written policies and procedures, appropriate division of responsibility and authority, careful selection and training of personnel, and a comprehensive internal audit program. The Company's policies and procedures prescribe that the Company and all employees are to maintain the highest ethical standards and that its business practices are to be conducted in a manner that is above reproach.

Arthur Price, an independent certified public accountant, has examined the Company's financial statements, and the audit report is presented herein. The Board of Directors has an Audit Committee composed entirely of outside directors. Arthur Price has direct access to the Audit Committee and meets with the committee to discuss accounting, auditing, and financial reporting matters.

Martin Wagner

Martin Wagner, Chief Executive Officer
March 12, 2017

FIGURE 1–3
Management letter

Once again, you are both reassured and troubled. It is comforting to know that Microline's management is accepting responsibility for the integrity of the statements, which have been prepared in conformance with generally accepted accounting principles, and that the company has an **internal control system** that safeguards the assets and reasonably ensures that transactions are properly recorded and reported. It is also nice to know that Microline's policies prescribe that its employees maintain high ethical standards. However, you still do not understand generally accepted accounting principles, are still concerned that the statements reflect management's estimates and judgments, and have very little idea about the function of Microline's board of directors and audit committee.

The Financial Statements

You briefly review the four financial statements (see Figure 1–4) and note first that dollar amounts are listed for both 2016 and 2015. This discovery is somewhat discouraging because only information about the past is included on the statements and is subject to the auditor's report and management letter. Nothing about Microline's future prospects is included in the financial statements—but the future is what interests you most. Whether Microline is able to provide an acceptable return on your $1 million investment depends primarily on what happens in the future. The past is often a poor indicator of the future.

You also observe that each statement emphasizes a different aspect of Microline's financial condition and performance. The balance sheet, for example, lists the company's assets, liabilities, and shareholders' equity. On the income statement, expenses are subtracted from revenues to produce a number called net income. The statement of shareholders' equity includes (1) the beginning and ending common stock and retained earnings balance, which can be found on the