Chapter 1

Introduction to Business Activities and Overview of Financial Statements and the Reporting Process

LEARNING OBJECTIVES

1. Understand four key activities of business entities: (a) establish goals and strategies, (b) obtain financing, (c) make investments, and (d) conduct operations.
2. Understand the purpose and content of the financial statements: (a) balance sheet, (b) income statement, (c) statement of cash flows, and (d) statement of shareholders' equity.
3. Understand the roles of participants in the financial reporting process, including managers and governing boards, accounting standard setters and regulators, independent external auditors, and financial statement users.
4. Gain an awareness of financial reporting as part of a global system for providing information for resource allocation decisions, including two financial reporting systems (U.S. GAAP and International Financial Reporting Standards).
5. Understand the difference between the cash basis and the accrual basis of accounting, and why the latter provides a better measure of performance.

In making resource allocation decisions, investors and creditors depend on reliable and relevant information about financial position, profitability, and risk. Financial reports are a key source of this information. The process of preparing those reports is *financial accounting*, or, more broadly, *financial reporting*. Understanding the basics of the financial reporting process is fundamental to understanding how to use financial reports for resource allocation decisions, such as making investments.

You are about to embark on the study of financial accounting. You will learn the concepts underlying the accounting principles firms use to measure the results of their business activities, the accounting principles themselves, some of the judgments and estimates managers must make to apply accounting principles, and tools for analyzing financial statements. You will learn about two similar—but not identical—financial accounting systems: U.S. GAAP[1] and International Financial Reporting Standards (IFRS). Accounting systems specify the financial accounting principles that firms must use, and the kinds of estimates and judgments that managers must make in applying those principles. We introduce these two systems in this chapter, illustrate them with a firm that uses U.S. GAAP (Great Deal, Inc., hereafter Great Deal) and a firm that uses IFRS (Thames Limited, hereafter Thames), and continue to present both systems throughout the book.[2]

Our goal is to help you understand the concepts, methods, and uses of financial accounting to enable you to use financial accounting information effectively. As a financial statement user, you will encounter financial reports with a variety of formats and presentations. We show a few of those variations, understanding that you will encounter many more.

As the chapter title suggests, this chapter introduces the concepts, methods, and uses that later chapters discuss in detail. We begin with a description of Great Deal's and Thames's business activities. We next see how firms measure the results of their business activities and report those

[1] GAAP refers to generally accepted accounting principles. U.S. GAAP is the authoritative guidance for financial accounting in the United States. We discuss U.S. GAAP and IFRS in more detail throughout the book.

[2] Financial information presented for Great Deal and Thames Limited is derived from the financial reports of two actual firms that report using U.S. GAAP and IFRS, respectively. That information has been modified for inclusion in this book.

results in their financial statements. Finally, we describe several components of the financial reporting process and introduce U.S. GAAP and IFRS.

OVERVIEW OF BUSINESS ACTIVITIES

The managers of a business[3] prepare financial reports to present information about that business's activities to external users. External users include owners of the business, lenders, regulators, and employees. Understanding those financial reports requires an understanding of the activities of the business:

1. Establishing goals and strategies.
2. Obtaining financing.
3. Making investments.
4. Conducting operations.

We illustrate these four business activities using two firms, Great Deal and Thames.

Example 1 Great Deal, based in the United States, operates more than 3,500 retail stores in the United States and around the world. The United States is its largest market. It prepares financial statements using U.S. GAAP. Its retail stores sell consumer electronics, home office products, entertainment software, appliances, and related services.

Example 2 Thames, based in France, is an electronics company that provides information systems and related services to the aerospace, defense, and security sectors. Thames prepares its financial statements using IFRS. It operates around the world. Europe is its largest market.

Although Great Deal and Thames differ in terms of business model, size, and geographical scope, their managers must carry out similar kinds of business activities. Differences in the two firms' business models affect the content of each of the activities.

Establish Corporate Goals and Strategies

Goals are the end results toward which the firm directs its energies, and **strategies** are the means for achieving those results. Examples of corporate goals include maximizing the return to the firm's owners, providing a good working environment for employees, and improving the environmental performance of the firm's products and manufacturing processes. Management, under the oversight of the firm's governing board (or boards),[4] sets the firm's strategies—for example, determining the firm's lines of business and its geographic locations and the strategies for each business unit. Factors that would affect a firm's goals and strategies include the following:

1. Goals and strategies of competitors.
2. Barriers to entry of the industry, such as patents or large investments in buildings.
3. Nature of the demand for the firm's products and services. For example, demand might be increasing, such as for certain pharmaceutical products, or demand might be relatively stable, such as for groceries.
4. Existence and nature of government regulation.

Firms provide extensive information about their corporate goals and strategies. For example, a recent Great Deal financial report indicates that store development, including entering new markets, opening new stores in existing markets, and remodeling/expanding existing stores, plays a role in Great Deal's growth. The report provides quantitative information about store openings and store closings in the past year as well as plans for the coming year. Similarly,

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[3]We use the terms *managers* and *management* to refer to employees who make operating, investing, and financing decisions and apply accounting standards to prepare financial statements. We also use the term *firms* to refer to these same decision makers.

[4]By law, some countries require firms to have two governing boards; other countries require one.

Thames's recent financial report announced a plan to address the difficult business outlook in its main markets by undertaking cost-cutting efforts.

Establishing corporate goals and strategies does not directly affect the firm's cash flows. The other three business activities—carrying out operations, making investments, and obtaining financing—either generate cash or use cash. The statement of cash flows, introduced later in the chapter, describes these cash flows in more detail.

Obtain Financing

To carry out their plans, firms require **financing**, that is, funds from owners and creditors. Owners provide funds to a firm and in return receive ownership interests. For a corporation, the ownership interests are shares of common stock and the owners are **shareholders** or **stockholders**.[5] In some cases the common shares trade in active markets such as the New York Stock Exchange and the London Stock Exchange. Firms whose shares trade in active markets are **publicly traded** and subject to special regulations. When the firm raises funds from owners, it has no obligation to repay these funds. Sometimes, a firm's governing board may decide to distribute **dividends** to that firm's shareholders. Dividends are a distribution of assets, often cash, to owners.

Creditors provide funds that the firm must repay in specific amounts at specific dates. *Long-term* creditors require repayment from the borrower over a period of time that exceeds one year. *Short-term* creditors require payment over the next year. One common form of long-term financing is *bonds*. A bond agreement specifies the amount borrowed and the terms of repayment, including the timing and amounts of cash the borrower agrees to pay to the creditors. Another common form of long-term borrowing is bank loans. Banks usually lend for periods between several months and several years. Finally, suppliers of raw materials or merchandise that do not require payment immediately also provide funds—the firm gets raw materials or merchandise now but does not pay cash until later.

Each firm makes financing decisions about the proportion of funds to obtain from owners, long-term creditors, and short-term creditors. Corporate finance courses cover the techniques that firms use to make financing decisions.

Make Investments

A firm makes investments to obtain the productive capacity to carry out its business activities. **Investing activities** involve acquiring the following:

1. **Land, buildings, and equipment.** These investments provide the capacity to manufacture and sell products and to create and sell services. They are usually long term, in the sense that they provide productive capacity for a number of years.
2. **Patents, licenses, and other contractual rights.** These investments provide rights to use ideas and processes. They are intangible, in the sense that they do not have a physical existence.
3. **Common shares or bonds of other firms.** These investments make a firm an owner or creditor of another firm. Short-term investments in equity shares typically involve partial ownership, while long-term investments in equity interests involve partial or complete ownership of another business.
4. **Inventories.** Firms maintain an inventory of products to sell to customers. For example, Great Deal maintains inventories of consumer electronics, home office products, entertainment software and appliances.
5. **Accounts receivable from customers.** In many businesses, customers do not pay for goods and services immediately. *Accounts receivable* describes the amounts owed to a firm by its customers for short periods, such as 30 days. In extending credit to customers, the firm does not collect cash right away. If the firm did not extend the credit, however, it might not make the sale in the first place.
6. **Cash.** Most firms maintain cash balances (like a corporate checking account) to pay their current bills.

[5] If the business is organized as a partnership, the owners are partners. If the business is organized as a proprietorship, the owner is the proprietor. This book considers corporations, in which the owners are shareholders or stockholders.

Managerial accounting courses and corporate finance courses cover the techniques that firms use to make investment decisions.

Carry Out Operations

Management operates the productive capacity of the firm to generate earnings. **Operating activities** include the following:

1. *Purchasing.* The purchasing department of a retailer, such as Great Deal, acquires items to sell to customers. The purchasing department of a firm with manufacturing operations, such as Thames, acquires raw materials needed for production.
2. *Production.* The production department in a manufacturing firm combines raw materials, labor services, and other manufacturing inputs to produce goods for sale. A service firm combines labor inputs and other inputs to provide services to customers.
3. *Marketing.* The marketing department oversees selling and distributing products and services to customers.
4. *Administration.* Administrative activities include data processing, human resource management, legal services, and other support services.
5. *Research and development.* A firm undertakes research and development with the objective of discovering new knowledge that it can use to create new products, new processes, or new services.

Managerial accounting, marketing, and operations management courses cover the techniques that firms use to make operating decisions.

PRINCIPAL FINANCIAL STATEMENTS

Firms communicate the results of their business activities in the **annual report to shareholders**.[6] The annual report may contain letters from the firm's management describing the firm's goals, strategies, and accomplishments, as well as descriptions and pictures of the firm's products, facilities, and employees. If the firm's shares trade publicly, it will also file an annual report with a regulator, typically a government agency.[7] The applicable laws and regulations of the country where the shares trade specify the form and content of the annual report. In the United States, regulatory requirements applicable to publicly traded firms require the inclusion of a **Management's Discussion and Analysis (MD&A)**, in which management discusses operating results, liquidity (sources and uses of cash), capital resources, and reasons for changes in profitability and risk during the past year.

We focus on the four principal financial statements and the supplementary information that firms report, including the following:

1. *Balance sheet or statement of financial position* at a specified time.
2. *Income statement or statement of profit and loss* for a specified time period.
3. *Statement of cash flows.*
4. *Statement of shareholders' equity or statement of changes in shareholders' equity.*
5. *Notes* to the financial statements, including various supporting schedules.

[6] Many firms provide these annual reports on their Web sites, often in the investor relations section. Some securities regulators' Web sites also provide required filings, including annual reports.

[7] The regulator may also require *interim reports*, for example, on a quarterly basis. In the United States, firms whose shares trade publicly file quarterly reports that contain a subset of the information in the annual report. Those quarterly reports appear on the regulator's Web site (www.sec.gov). The U.S. regulator is the Securities and Exchange Commission (SEC).

The following sections of this chapter briefly discuss each of these five items. In describing these items, we refer to the financial statements of Great Deal and Thames. Great Deal's financial statements appear in **Exhibits 1.1–1.4**, and Thames's financial statements appear in **Exhibits 1.5–1.8**. We begin with several observations about conventions and concepts that apply to financial statements in general.

Financial Reporting Conventions

In this section we describe some conventions used in financial statement preparation. These conventions govern the length of time covered by the financial statements (the accounting period), the number of reporting periods included in the financial reports, the monetary amounts, and the terminology and level of detail in the financial statements.

Length of Reporting (Accounting) Period Financial statement presentations can span intervals of any length. The most common accounting period for external reporting is one year, called the **fiscal year**. While many firms use the calendar year as their fiscal year (that is, the fiscal year ends on December 31), some firms select other fiscal year-ends. When the fiscal year ends in June–December of calendar year T, convention describes the financial reports as pertaining to fiscal year T. For example, Thames's financial report for the year ended December 31, 2013, reports Thames's performance for fiscal 2013. When the fiscal year ends in January–May of year T, convention describes the financial reports as pertaining to fiscal year T − 1. For example, Great Deal's financial report for the year ended February 27, 2013, reports Great Deal's performance for fiscal 2012.[8]

Number of Reporting Periods To assist in making comparisons over time, both U.S. GAAP and IFRS require firms to include results for multiple reporting periods in each report. Firms must include two balance sheets describing the beginning and ending balances of the accounts for the current fiscal year and the prior fiscal year. Refer to **Exhibit 1.1**, which shows that Great Deal's fiscal 2012 annual report includes a balance sheet as of February 27, 2013 (the end of fiscal 2012), and a balance sheet as of February 28, 2012 (the end of fiscal 2011). For the income statement, statement of cash flows, and statement of shareholders' equity, SEC rules require statements for the current year and the two prior years; IFRS requires statements for the current year and the prior year.

Monetary Amounts The financial statements report a numerical amount, the **monetary amount**, for each listed item. The financial statements indicate the measuring units, both the numerical expression such as in thousands or in millions, and the currency, such as dollars ($) or euros (€). A firm typically reports in the currency of the country where it is headquartered or where it conducts most of its business. For example, a firm with headquarters and most of its business activities in England would report its results in pounds sterling (£).

Terminology and Level of Detail U.S. GAAP and IFRS contain broad guidance on what the financial statements must contain, but neither completely specifies the level of detail or the names of accounts. IFRS contains relatively more guidance. For example, IFRS describes the line items that the balance sheet must display and described items that the firm must separately disclose.[9] U.S. GAAP contains no analog to this IFRS guidance.[10] *You should therefore expect to encounter variation in the ways financial statements display information and variation in the level of detail provided.* In addition, the rules do not always require firms to use specific names for accounts and line items on the financial statements. While practice tends to converge on certain names, such as cash, accounts receivable, and inventories, *you should expect to encounter variation in account titles as well as variation in format and display*.

With these conventions in mind, we turn to a discussion of the financial statements.

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[8] Not all firms follow this convention, so use caution in comparing results across firms.

[9] International Accounting Standards Board (IASB), *International Accounting Standard 1*, "Presentation of Financial Statements," revised 2003.

[10] As of late 2011, a long-running project underway to improve and converge the U.S. GAAP and IFRS guidance for financial statement presentation was incomplete.

EXHIBIT 1.1

Great Deal, Inc.
Consolidated Balance Sheets
(amounts in millions of US$)

	February 27, 2013	February 28, 2012
Assets		
Current Assets		
Cash and cash equivalents	$ 1,826	$ 498
Short-term investments	90	11
Receivables	2,020	1,868
Merchandise inventories	5,486	4,753
Other current assets	1,144	1,062
Total current assets	10,566	8,192
Property and Equipment		
Land and buildings	757	755
Leasehold improvements	2,154	2,013
Fixtures and equipment	4,447	4,060
Property under capital lease	95	112
	7,453	6,940
Less: Accumulated depreciation	(3,383)	(2,766)
Net property and equipment	4,070	4,174
Goodwill	2,452	2,203
Tradenames	159	173
Customer relationships	279	322
Equity and other investments	324	395
Other assets	452	367
Total assets	$18,302	$15,826
Liabilities and Shareholders' Equity		
Current Liabilities		
Accounts payable	$ 5,276	$ 4,997
Unredeemed gift card liabilities	463	479
Accrued compensation and related expenses	544	459
Accrued liabilities	1,681	1,382
Accrued income taxes	316	281
Short-term debt	663	783
Current portion of long-term debt	35	54
Total current liabilities	8,978	8,435
Long-term liabilities	1,256	1,109
Long-term debt	1,104	1,126
Total liabilities	11,338	10,670
Commitments and contingencies	—	—
Shareholders' Equity		
Preferred stock	—	—
Common stock	42	41
Additional paid-in capital	441	205
Retained Earnings	5,797	4,714
Accumulated other comprehensive income	40	(317)
Total Great Deal shareholders' equity	6,320	4,643
Noncontrolling interests	644	513
Total shareholders' equity	6,964	5,156
Total Liabilities and Shareholders' Equity	$18,302	$15,826

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Balance Sheet

The **balance sheet**, also called the **statement of financial position**, provides information, at a point in time, on the firm's productive resources and the financing used to pay for those resources. **Exhibit 1.1** presents Great Deal's balance sheet as of February 27, 2013, and February 28, 2012. **Exhibit 1.5** presents Thames's balance sheet as of December 31, 2013, and December 31, 2012. These balance sheets present information at the end of each firm's fiscal year. Great Deal's annual report states that its fiscal year ends on February 27 or February 28 of each year; Thames states that its fiscal year ends on December 31. The financial position of

EXHIBIT 1.2

Great Deal, Inc.
Consolidated Statements of Earnings
(amounts in millions of US$)

	February 27, 2013	February 28, 2012	February 27, 2011
Revenue	$49,694	$45,015	$40,023
Cost of goods sold	37,534	34,017	30,477
Gross profit	12,160	10,998	9,546
Selling, general, and administrative expenses	9,873	8,984	7,385
Restructuring charges	52	78	0
Goodwill and trade name impairment	0	66	0
Operating income	2,235	1,870	2,161
Other income (expense)			
Investment income and other	54	35	129
Investment impairment	0	(111)	0
Interest expense	(94)	(94)	(62)
Earnings before income tax expense and equity in income (loss) of affiliates	2,195	1,700	2,228
Income tax expense	802	674	815
Equity in income (loss) of affiliates	1	7	(3)
Net earnings including noncontrolling interests	1,394	1,033	1,410
Net earnings attributable to noncontrolling interests	(77)	(30)	(3)
Net earnings attributable to Great Deal, Inc.	$ 1,317	$ 1,003	$ 1,407
Earnings per share attributable to Great Deal, Inc.			
Basic	$3.16	$2.43	$3.20
Diluted	$3.10	$2.39	$3.12
Weighted-average common shares outstanding (in millions)			
Basic	416.8	412.5	439.2
Diluted	427.5	422.9	452.9

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the firm at other times during the year can differ substantially from that depicted on the end-of-year balance sheet.

Concepts of Assets, Liabilities, and Shareholders' Equity The balance sheet lists the firm's assets, liabilities, and shareholders' equity and provides totals and subtotals. Each line item on the balance sheet has a title that indicates the nature of the item and a numerical amount, in units of currency. For example, the first item on Great Deal's balance sheet is Cash and Cash Equivalents of $1,826 million. The heading of the balance sheet indicates the measuring unit is millions of U.S. dollars. The first item on Thames's balance sheet is Goodwill, net, measured in millions of euros (€); the amount is €2,986.9 million.

Assets are economic resources with the potential to provide future economic benefits to a firm. The firm's investments in items to provide productive capacity are examples of assets. For example, both Great Deal and Thames list property and equipment (Thames calls these "tangible assets, net") among the assets on their balance sheets.[11]

Liabilities are creditors' claims. Creditors have provided funds, or goods and services, and the firm has an obligation to pay creditors for those goods and services. We describe two examples of liabilities that result from a firm's having previously received benefits (inventories, labor services):

- Both Great Deal and Thames have made purchases but have not yet paid the entire amount owed. Great Deal includes the amount owed to its suppliers in the liability account labeled "Accounts payable." Thames includes the amount in the account "Accounts, notes and other current payables."

[11]The order in which the assets appear differs between Great Deal's and Thames's balance sheets. We discuss this ordering later in this chapter.

EXHIBIT 1.3

Great Deal, Inc.
Consolidated Statements of Cash Flows
(amounts in millions of US$)

	February 27, 2013	February 28, 2012	February 27, 2011
Operating Activities			
Net earnings including noncontrolling interests	$ 1,394	$ 1,033	$ 1,410
Adjustments to reconcile net earnings to total cash provided by operating activities:			
Depreciation	838	730	580
Amortization of definite lived intangible assets	88	63	1
Asset impairments	4	177	0
Restructuring charges	52	78	0
Stock-based compensation	118	110	105
Deferred income taxes	(30)	(43)	74
Excess tax benefits from stock-based compensation	(7)	(6)	(24)
Other, net	(4)	12	(7)
	2,453	2,154	2,139
Changes in operating assets, net of acquired assets and liabilities:			
Receivables	(63)	(419)	12
Merchandise inventories	(609)	258	(562)
Other assets	(98)	(175)	42
Accounts payable	141	139	221
Other liabilities	279	(75)	74
Income taxes	103	(5)	99
Total cash provided by operating activities	2,206	1,877	2,025
Investing Activities			
Additions to PPE, net of non-cash expenditures	(615)	(1,303)	(797)
Purchases of investments	(16)	(81)	(8,501)
Sales of investments	56	246	10,935
Acquisitions of businesses, net of cash acquired	(7)	(2,170)	(89)
Change in restricted cash	18	(97)	(85)
Settlement of net investment hedges	40	0	0
Other, net	(16)	(22)	1
Total cash (used in) provided by investing activities	(540)	(3,427)	1,464
Financing Activities			
Repurchase of common stock	0	0	(3,461)
Issuance of common stock	138	83	146
Dividends paid	(234)	(223)	(204)
Repayments of debt	(5,342)	(4,712)	(4,353)
Proceeds from issuance of debt	5,132	5,606	4,486
Acquisition of noncontrolling interests	(34)	(146)	0
Excess tax benefits from stock-based compensation	7	6	24
Other, net	(15)	(23)	(16)
Total cash (used in) provided by financing activities	(348)	591	(3,378)
Effect of exchange rate changes in cash	10	19	122
Increase (decrease) in cash and cash equivalents	1,328	(940)	233
Cash and cash equivalents at beginning of year	498	1,438	1,205
Cash and cash equivalents at end of year	$ 1,826	$ 498	$ 1,438
Supplemental disclosure of cash flow information:			
Income taxes paid	732	766	644
Interest paid	78	83	49

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EXHIBIT 1.4

Great Deal, Inc.
Consolidated Statements of Changes in Shareholders' Equity (amounts in millions of US$ except share amounts)

	Common Shares	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Subtotal	Non-controlling Interests	Total
Balance at February 28, 2010	**481**	**$48**	**$430**	**$5,507**	**$216**	**$6,201**	**$ 35**	**$6,236**
Net earnings	—	—	—	1,407	—	1,407	3	1,410
Other comprehensive income (loss), net of tax:								
Foreign currency translation adjustments	—	—	—	—	311	311	2	313
Unrealized losses on available for sale investments	—	—	—	—	(25)	(25)		(25)
Total comprehensive income						1,693	5	1,698
Cumulative effect of adopting a new accounting standard related to uncertain tax positions	—	—	—	(13)	—	(13)	—	(13)
Stock options exercised	4	—	93	—	—	93	—	93
Tax benefit from stock options, restricted stock, and employee stock purchase plan	—	—	17	—	—	17	—	17
Issuance of common stock under employee stock purchase plan	1	—	53	—	—	53	—	53
Stock-based compensation	—	—	105	—	—	105	—	105
Common stock dividends, $0.46 per share	—	—	—	(204)	—	(204)	—	(204)
Repurchase of common stock	(75)	(7)	(690)	(2,764)	—	(3,461)	—	(3,461)
Balance at February 27, 2011	**411**	**41**	**8**	**3,933**	**502**	**4,484**	**40**	**4,524**
Net earnings	—	—	—	1,003	—	1,003	30	1,033
Other comprehensive income (loss), net of tax:								
Foreign currency translation adjustments	—	—	—	—	(830)	(830)	(175)	(1,005)
Unrealized losses on available for sale investments	—	—	—	—	(19)	(19)	—	(19)
Reclassification adjustment for impairment loss on available for sale security	—	—	—	—	30	30	—	30
Total comprehensive income						184	(145)	39
Acquisition of business	—	—	—	—	—	—	666	666
Acquisition of noncontrolling interest	—	—	—	—	—	—	(48)	(48)
Stock options exercised	2	—	34	—	—	34	—	34
Tax benefit from stock options, restricted stock, and employee stock purchase plan	—	—	4	—	—	4	—	4
Issuance of common stock under employee stock purchase plan	1	—	49	—	—	49	—	49
Stock-based compensation	—	—	110	—	—	110	—	110
Common stock dividends, $0.54 per share	—	—	—	(222)	—	(222)	—	(222)
Balance at February 28, 2012	**414**	**41**	**205**	**4,714**	**(317)**	**4,643**	**513**	**5,156**
Net earnings	—	—	—	1,317	—	1,317	77	1,394
Other comprehensive income (loss), net of tax:								
Foreign currency translation adjustments	—	—	—	—	329	329	76	405
Unrealized gains on available for sale investments	—	—	—	—	28	28	—	28
Total comprehensive income						1,674	153	1,827
Purchase accounting adjustments	—	—	—	—	—	—	(22)	(22)
Stock options exercised	4	1	95	—	—	96	—	96
Tax loss from stock options, restricted stock, and employee stock purchase plan	—	—	(19)	—	—	(19)	—	(19)
Issuance of common stock under employee stock purchase plan	1	—	42	—	—	42	—	42
Stock-based compensation	—	—	118	—	—	118	—	118
Common stock dividends, $0.56 per share	—	—	—	(234)	—	(234)	—	(234)
Balance at February 27, 2013	**419**	**$42**	**$441**	**$5,797**	**$ 40**	**$6,320**	**$644**	**$6,964**

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- Employees have provided labor services for which Great Deal and Thames have not made full payment. Great Deal includes the amounts owed to employees in the liability account "Accrued compensation and related expenses." Thames includes them in "Accounts, notes and other current payables."

EXHIBIT 1.5

Thames Limited
Consolidated Balance Sheets
(amounts in millions of euros [€] except share amounts)

	December 31, 2013	December 31, 2012
Goodwill	€ 2,986.9	€ 2,793.2
Other intangible assets, net	925.3	1,129.3
Tangible assets, net	1,338.3	1,262.9
Total noncurrent operating assets	5,250.5	5,185.4
Share in net assets of equity affiliates	711.0	692.4
Available for sale investments	101.9	175.4
Loans and other financial assets	171.9	258.8
Total noncurrent financial assets	6,235.3	6,312.0
Fair value of derivatives: interest rate risk management	24.8	13.1
Pension and other employee benefits	66.0	44.0
Deferred tax assets	678.0	433.5
Noncurrent assets	7,004.1	6,802.6
Inventories and work in progress	2,210.8	2,227.4
Construction contracts: assets	2,243.2	2,400.6
Advances to suppliers	342.4	548.2
Accounts, notes and other current receivables	3,934.8	4,064.1
Fair value of derivatives: currency risk management	172.6	292.4
Total current operating assets	8,903.8	9,532.7
Current tax receivables	40.4	13.1
Current accounts with affiliated companies	94.8	65.1
Marketable securities	4.4	22.4
Cash and equivalents	1,960.1	1,499.8
Total current financial assets	2,099.7	1,600.4
Current assets	11,003.5	11,133.1
Total assets	**€18,007.6**	**€17,935.7**
Capital, paid-in surplus and other reserves	€ 4,168.3	€ 4,498.9
Cumulative translation adjustment	(283.2)	(399.8)
Treasury shares	(141.5)	(150.2)
Shareholders' equity	3,743.6	3,948.9
Noncontrolling interests	10.2	2.9
Total shareholders' equity and noncontrolling interests	3,753.8	3,951.8
Financial debt: long term	1,651.6	761.3
Pension and other employee benefits	856.7	847.5
Deferred tax liabilities	258.6	268.6
Noncurrent liabilities	2,766.9	1,877.4
Advances received from customers on contracts	3,849.4	3,687.4
Refundable grants	172.8	169.5
Construction contracts: liabilities	882.7	578.4
Reserves for contingencies	1,129.8	961.5
Accounts, notes and other current payables	4,736.0	5,045.9
Fair value of derivatives: currency risk management	100.7	279.5
Total current operating liabilities	10,871.4	10,722.2
Current tax payables	92.2	88.9
Financial debt: short term	326.4	1,136.3
Current accounts with affiliated companies	196.9	159.1
Total current financial liabilities	523.3	1,295.4
Total current liabilities	11,486.9	12,106.5
Total Liabilities and Shareholders' Equity	**€18,007.6**	**€17,935.7**

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Shareholders' equity shows the amount of funds owners have provided either by buying shares or by reinvesting (retaining) the net assets generated by earnings. Owners have a claim on the firm's assets because they have provided funds to the firm. The owners' claim is a residual interest in the firm's assets. That is, owners have a claim on assets that are *in excess of* the assets required to meet creditors' claims. Shareholders' equity lists both the amount invested by shareholders for their ownership interests and the amount of retained earnings. Thames combines contributed capital and retained earnings in the account "Capital, paid-in surplus and other reserves"; Thames's total shareholders equity is €3,743.6 million. Great Deal also uses the term *shareholders' equity*. As of February 27, 2013, there were 419 million shares issued

EXHIBIT 1.6

Thames Limited
Consolidated Profit and Loss Account
(amounts in millions of euros [€])

A. Consolidated Profit and Loss Statements	**2013**	**2012**
Revenues	**€ 12,881.5**	**€12,664.8**
Cost of sales	(10,633.4)	(9,964.5)
Research and development expenses	(550.5)	(440.2)
Marketing and selling expenses	(901.9)	(806.7)
General and administrative expenses	(543.4)	(558.7)
Restructuring costs	(116.1)	(32.5)
Amortization of intangible assets	(84.4)	(109.8)
Income from operations	**51.8**	**752.4**
Impairment of noncurrent operating assets	(260.1)	(69.1)
Gain (loss) on disposal of assets and other	(1.0)	35.2
Income of operating activities	**(209.3)**	**718.5**
Financial interest on gross debt	(91.6)	(101.4)
Financial income from cash and equivalents	26.0	49.6
Cost of net financial debt	(65.6)	(51.8)
Other financial income (expense)	(44.9)	(49.8)
Other components of pension charge	(105.1)	(11.1)
Income tax	175.3	(103.0)
Share in net income (loss) of equity affiliates	48.0	57.6
Net income (loss)	**€ (201.6)**	**€ 560.4**
Of which:		
Net income, Group Share	(201.8)	559.9
Noncontrolling interests	0.2	0.5
Basic earnings per share	€ (1.03)	€ 2.87
Diluted earnings per share	€ (1.03)	€ 2.85

B. Consolidated Statements of Comprehensive Income	**2013**	**2012**
Net income (loss)	**€ (201.8)**	**€ 559.9**
Translation of the financial statements of foreign subsidiaries	119.1	(263.3)
Foreign investments' hedge, net of tax	(2.5)	2.9
Cash flow hedge, net of tax	51.4	(29.7)
Financial assets available for sale, net of tax	1.5	(0.5)
Total other comprehensive income (loss), net of tax	169.5	(290.6)
Total comprehensive income (loss), for the period	**€ (32.3)**	**€ 269.3**

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to shareholders, who had provided total funds to Great Deal of $483 million (= $42 + $441). Great Deal's retained earnings is $5,797 million, discussed next.

Retained earnings represent the *net assets* (= total assets − total liabilities) a firm derives from its earnings that exceed the dividends it has distributed to shareholders. Management operates the firm's assets with the intent of generating earnings. That is, the firm expects to receive more assets than it consumes in operations. The increase in assets, after claims of creditors, is called Retained Earnings, and it belongs to the firm's owners. As of February 27, 2013, Great Deal's retained earnings is $5,797 million, meaning that cumulative earnings exceed cumulative dividends by $5,797 million. As of December 31, 2013, Thames has an *accumulated deficit*, as shown in **Exhibit 1.8**, the Consolidated Statement of Changes in Shareholders Equity and Minority Interests.[12] An accumulated deficit means that cumulative earnings less dividends are negative. The amount of Thames's accumulated deficit at December 31, 2013 is €197.3 million.

An amount of assets equal to retained earnings does not appear on any single line on the balance sheet. Instead, firms use the assets generated by the retention of earnings to acquire various assets including inventories, buildings, equipment, and other assets. Almost all successful firms use a large percentage of the assets they generate by earnings to replace assets and to grow, rather than to pay dividends.

[12] Authoritative guidance uses the term *noncontrolling interest*, not *minority interest*. However, firms sometimes continue to use the latter term in their financial reports.

EXHIBIT 1.7

Thames Limited
Consolidated Statements of Cash Flows
(amounts in millions of euros [€])

	2013	2012
Net income (loss)	**€ (201.6)**	**€ 560.4**
Add (deduct):		
Income tax expense (gain)	(175.3)	103.0
Share in net (income) loss of equity affiliates, net of dividends	(21.5)	(29.6)
Depreciation and amortization of tangible and intangible assets	420.8	433.0
Provisions for pensions and other employee benefits	162.6	70.9
Impairment of noncurrent operating assets	260.1	69.1
Gain (loss) on disposals of assets	1.0	(35.2)
Net allowance to restructuring provisions	12.1	(85.9)
Other items	26.6	49.4
Change in working capital requirements and in reserves	924.6	(44.5)
Payment of contributions / pension benefits	(156.2)	(189.7)
Income tax paid (received)	(98.2)	(80.1)
Net cash flows from operating activities	**1,155.0**	**820.8**
Capital expenditure	(418.9)	(534.6)
Proceeds from disposal of tangible and intangible assets	5.8	11.7
Acquisitions	(148.0)	(173.2)
Disposals	—	89.1
Change in loans	4.1	(24.7)
Change in current assets with affiliated companies	(32.0)	(6.8)
Decrease (increase) in marketable securities	24.0	(3.3)
Net cash flows from investing activities	**(565.0)**	**(641.8)**
Dividends paid	(204.7)	(195.3)
Exercise of stock options	4.6	12.3
Proceeds from sale of treasury shares	17.0	(56.8)
Increase in debt	1,125.2	412.8
Repayment of debt	(1,103.9)	(184.4)
Net cash flows from financing activities	**(161.8)**	**(11.4)**
Effect of exchange rate variations	32.1	(131.9)
Total increase (decrease) in cash	**460.3**	**35.7**
Cash at beginning of period	1,499.8	1,464.1
Cash at end of period	1,960.1	1,499.8
Supplemental disclosure of cash flow information:		
Interest received	32.5	32.5
Interest paid	82.2	82.2

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Equality of Assets and Liabilities Plus Shareholders' Equity The total of all assets equals the total of all liabilities and all shareholders' equity amounts. This equation holds for both Great Deal and Thames:

	Assets	=	Liabilities[13]	+	Shareholders' Equity
Great Deal	$18,302	=	$11,338	+	$6,964
Thames	€18,007.6	=	€14,253.8	+	€3,753.8

A firm invests the resources it obtains from financing. The balance sheet views the same resources from two perspectives. First, as the assets the firm currently holds, having acquired them with funds. Second, as the claims of creditors and owners who provided the funds. Thus,

Assets = Liabilities + Shareholder's Equity

or

Investing = Financing
Resources = Sources of Resources
Resources = Claims on Resources

[13]Neither Great Deal nor Thames reports a subtotal for total liabilities. To obtain total liabilities, sum the liability accounts. Thames shows Shareholders' Equity = €3,743.6, and Minority Interest (another component of Shareholders' Equity) = €10.2. Minority interest (noncontrolling interest) is discussed in **Chapter 14**.

EXHIBIT 1.8 **Consolidated Statement of Changes in Shareholders' Equity and Minority Interests (amounts in millions of euros [€] except share amounts)**

	Number of shares outstanding (in 000s)	Share capital	Paid-in surplus	Retained earnings	Cash flow hedge	AFS investments	Cumulative translation adjustment	Treasury shares	Share-holders' equity	Non-controlling interest	Total
Balance at December 31, 2011	**195,401**	**595.0**	**3,638.2**	**(173.8)**	**86.0**	**4.5**	**(139.4)**	**(129.6)**	**3,880.9**	**3.3**	**3,884.2**
Net income	—	—	—	559.9	—	—	—	—	559.9	0.5	560.4
Other comprehensive loss	—	—	—	—	(29.7)	(0.5)	(260.4)	—	(290.6)	(0.5)	(291.1)
Total comprehensive income	—	—	—	559.9	(29.7)	(0.5)	(260.4)	—	269.3	—	269.3
Capital increase	391	1.2	9.6	—	—	—	—	—	10.8	—	10.8
Dividends	—	—	—	(195.3)	—	—	—	—	(195.3)	—	(195.3)
Share based payments	—	—	—	27.9	—	—	—	—	27.9	—	27.9
Changes in treasury shares	(811)	—	—	(20.4)	—	—	—	(20.6)	(41.0)	—	(41.0)
Other	—	—	—	(3.7)	—	—	—	—	(3.7)	—	(3.7)
Changes in scope of consolidation	—	—	—	—	—	—	—	—	—	(0.4)	(0.4)
Total transactions with shareholders	(420)	1.2	9.6	(191.5)	—	—	0.0	(20.6)	(201.3)	(0.4)	(201.7)
Balance at December 31, 2012	**194,981**	**596.2**	**3,647.8**	**194.6**	**56.3**	**4.0**	**(399.8)**	**(150.2)**	**3,948.9**	**2.9**	**3,951.8**
Net income	—	—	—	(201.8)	—	—	—	—	(201.8)	0.2	(201.6)
Other comprehensive loss	—	—	—	—	51.4	1.5	116.6	—	169.5	0.6	170.1
Total comprehensive income	—	—	—	(201.8)	51.4	1.5	116.6	—	(32.3)	0.8	(31.5)
Capital increase	299	0.9	7.5	—	—	—	—	—	8.4	—	8.4
Dividends	—	—	—	(204.7)	—	—	—	—	(204.7)	—	(204.7)
Share based payments	—	—	—	22.5	—	—	—	—	22.5	—	22.5
Changes in treasury shares	187	—	—	(1.6)	—	—	—	8.7	7.1	—	7.1
Other	—	—	—	(6.3)	—	—	—	—	(6.3)	—	(6.3)
Changes in scope of consolidation	—	—	—	—	—	—	—	—	—	6.5	6.5
Total transactions with shareholders	486	0.9	7.5	(190.1)	—	—	0.0	8.7	(173.0)	6.5	(166.5)
Balance at December 31, 2013	**195,467**	**597.1**	**3,655.3**	**(197.3)**	**107.7**	**5.5**	**(283.2)**	**(141.5)**	**3,743.6**	**10.2**	**3,753.8**

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The amounts of individual assets that make up total assets, represented by accounts receivable, inventories, equipment, and other assets, reflect a firm's investment decisions. The mix of liabilities plus shareholders' equity reflects a firm's financing decisions, each measured at the balance sheet date.

Balance Sheet Classification and Aggregation Both U.S. GAAP and IFRS require that balance sheets separate current items from noncurrent items.[14]

- *Current assets* include cash and assets that a firm expects to turn into cash, or sell, or consume within one year from the date of the balance sheet. Examples are accounts receivable and inventory.
- *Current liabilities* represent obligations a firm expects to pay within one year. Examples are accounts payable to suppliers and salaries payable to employees.
- *Noncurrent assets* are assets that will be used for several years. Examples include land, buildings, equipment, and patents.
- *Noncurrent liabilities and shareholders' equity* are sources of funds whose suppliers do not expect to receive payment within the next year. Rather, they expect payment sometime after next year.

The line items on the balance sheet represent *aggregated* amounts. For example, the amount shown for the line item labeled "Merchandise inventories" on Great Deal's balance sheet represents all of Great Deal's inventories.

[14]Great Deal displays its current assets and current liabilities first. Thames displays its noncurrent assets and noncurrent liabilities first. IFRS, but not U.S. GAAP, permits the display used by Thames.

Balance Sheet Measurement Both U.S. GAAP and IFRS use two bases to measure the monetary amounts at which assets, liabilities, and shareholders' equity appear on the balance sheet:

1. The historical amount, which reflects the acquisition cost of assets or the amount of funds originally obtained from creditors or owners.
2. The current amount, which reflects some measure of current value as of the balance sheet date. The notion of a current amount, or current value, can be applied to assets, to liabilities, or to shareholders' equity.

Some accounting information is reported at *historical cost*, a **historical amount**, and some at *current cost*, a **current amount** (one example of a current amount is *fair value*), depending on the requirements of U.S. GAAP and IFRS. Later chapters discuss and illustrate these measurement bases.

Analysis of the Balance Sheet Firms typically finance current assets with current liabilities and finance noncurrent assets with noncurrent liabilities and shareholders' equity. Current assets such as accounts receivable generally convert into cash within one year. Firms can use this near-term cash flow to pay current liabilities, which require payment within one year. Noncurrent assets, such as buildings and equipment, generate cash flows over several years. Firms can use these more extended cash inflows to repay long-term liabilities as they come due.

Great Deal's balance sheet as of February 27, 2013, shows the following (in millions of US$):

Current Assets	$10,566	Current Liabilities	$ 8,978
Noncurrent Assets	7,736	Noncurrent Liabilities and Shareholders' Equity	9,324
Total	$18,302	Total	$18,302

Similar information presented in Thames's balance sheet as of December 31, 2013, reveals the following (in millions of euros [€]):

Current Assets	€11,003.5	Current Liabilities	€11,486.9
Noncurrent Assets	7,004.1	Noncurrent Liabilities and Shareholders' Equity	6,520.7
Total	€18,007.6	Total	€18,007.6

These data show that Thames and Great Deal have raised funds from noncurrent sources (noncurrent liabilities and shareholders' equity) in amounts that exceed (in the case of Great Deal) or are less than (in the case of Thames) the amount of noncurrent assets.

Income Statement

The **income statement** (sometimes called the **statement of profit and loss** by firms applying IFRS), provides information on profitability. The terms **net income**, **earnings**, and **profit** are interchangeable. **Exhibit 1.2** shows Great Deal's income statement for fiscal years 2012, 2011, and 2010. Great Deal refers to its income statement as the Consolidated Statement of Earnings. **Exhibit 1.6** shows Thames's income statement for 2012 and 2013. Thames refers to its income statement as the Consolidated Profit and Loss Account.

The income statement reports a firm's success in generating earnings during a given reporting period.[15] Net income is equal to revenues minus expenses, adjusted for any gains or losses. (We ignore gains and losses in this chapter.) The income statement reports the sources and amounts of a firm's revenues and the nature and amounts of its expenses. A firm strives to generate more revenues than expenses. Net income indicates a firm's accomplishments (revenues)

[15]An income statement can report for a period of any length: a year, a quarter, or a month. In all cases, the reporting period is the time period between two successive balance sheets, and the time period over which the firm measures net income.

relative to the efforts required (expenses) in pursuing its operating activities. When expenses for a period exceed revenues for that period, the result is a **net loss**.

Revenues (also called **sales** or **sales revenue**) measure the inflows of assets from selling goods and providing services to customers. In exchange for providing goods and services, firms receive assets (either cash or promises to pay cash, Accounts Receivable). The amount of revenue generated is equal to the net assets received. Great Deal reports revenue of $49,694 million for fiscal 2012. Thames reports revenue of €12,881.5 million for fiscal 2013.

Expenses measure the outflow of assets incurred in generating revenues. *Cost of goods sold* or *cost of sales* (an expense) measures the cost of inventories sold to customers. For a service firm, cost of sales measures the cost of providing services. *Selling and administrative expenses* measure the cost of selling and administrative services received during the period. An *expense* means that an asset decreases or a liability increases. The amount of the expense is equal to the asset decrease or the liability increase.

Classification of Revenues and Expenses Firms classify revenues and expenses in different ways and apply different levels of aggregation. For example, Thames reports expenses for research and development of €550.5 million in 2013. Some firms might include this expense in another line item. Thames's income statement classifies some expenses by the department that carried out the activities (for example, marketing and selling expenses) and some expenses by their nature (for example, income taxes).

Relation Between the Income Statement and the Balance Sheet The income statement links the balance sheet at the beginning of the period with the balance sheet at the end of the period. The balance sheet amount for retained earnings represents the sum of all prior earnings (or losses) of a firm in excess of dividends.[16] Net income (or net loss) for the current period helps explain the change in retained earnings between the beginning and the end of the period. For example, Great Deal's income for fiscal 2012, labeled on the income statement "Net earnings attributable to Great Deal, Inc." was $1,317 million. **Exhibit 1.4** shows that Great Deal paid cash dividends of $234 million to shareholders in fiscal 2012. We can use this information to analyze the change in Great Deal's retained earnings (in millions of US$):

Retained Earnings, February 28, 2012	$4,714
Add Net Income for Fiscal 2012	1,317
Subtract Dividends Declared and Paid During Fiscal 2012	(234)
Retained Earnings, February 27, 2013	$5,797

Statement of Cash Flows

The **statement of cash flows** reports information about cash generated from (or used by) operating, investing, and financing activities during the period. It shows where the firm obtains or generates cash and where it spends or uses cash. If a firm is to continue operating successfully, it must generate more cash than it spends. A firm generates cash from operations when it collects more cash from customers than it spends on operating activities. While firms can borrow cash from creditors, future operations must generate cash to repay these loans.

Exhibit 1.3 presents the statements of cash flows for Great Deal for fiscal years 2012, 2011 and 2010. **Exhibit 1.7** shows this information for Thames for fiscal years 2013 and 2012. These statements have three sections, describing operating, investing, and financing activities that generate or use cash.

Operating Activities Most firms expect to collect more cash from customers than they pay to suppliers, employees, and others in carrying out operating activities. For many firms, operating activities provide the largest source of cash. Both Great Deal and Thames generated significant cash flows from operating activities in the years presented. For example, Thames's

[16]Other items can also affect retained earnings. Later chapters discuss some of these and others are beyond the scope of this textbook.

cash provided by operating activities in 2013 was €1,155.0 million. Great Deal's cash provided by operating activities in 2012 was $2,206 million.[17]

Investing Activities Firms acquire buildings, equipment, and other noncurrent assets to maintain or expand their productive capacity. These acquisitions, referred to as **capital expenditures**, use cash. A firm can obtain the cash needed for capital expenditures from selling existing assets, from operating activities, and from financing activities. Great Deal's cash paid for additions to property and equipment was $615 million in fiscal 2012. Thames's capital expenditures in 2013 was €418.9 million.

Financing Activities Firms obtain financing to support operating and investing activities by issuing debt or common shares. The firm uses cash to pay dividends and to repay or retire existing debt financing, such as repaying long-term debt. For example, Great Deal's statement of cash flows shows that in fiscal 2012 it used $5,342 million cash to repay long-term debt, it borrowed $5,132 by issuing debt, and it paid $234 million in cash dividends. Thames borrowed €1,125.2 million, it repaid €1,103.9 million, and it paid cash dividends of €204.7 million.

Relation of the Statement of Cash Flows to the Balance Sheet and Income Statement The statement of cash flows explains the change in cash between the beginning and the end of the period. It also displays the changes in cash from operating, investing, and financing activities. The following table analyzes the changes in cash for Great Deal (for fiscal 2012) and for Thames (for fiscal 2013). Numbers in parentheses ( ) are subtracted, indicating a net use of cash.

Changes in Cash for Great Deal (fiscal 2012) and Thames (fiscal 2013)

	Great Deal	Thames
Cash at the Start of Fiscal 2012 or 2013	$ 498	€1,499.8
Cash Flow from Operations During the Year	2,206	1,155.0
Cash Flow from Investing During the Year	(540)	(565)
Cash Flow from Financing During the Year	(348)	(161.8)
Adjustment for Exchange Rate Differences[18]	10	32.1
Cash at the End of Fiscal 2012 or 2013	$1,826	€1,960.1

In addition to sources and uses of cash, the statement of cash flows shows the relation between net income and cash flow from operations. Cash flow from operations exceeds net income for each of the three years shown for Great Deal. Cash flow from operations is positive in fiscal 2013 for Thames, even though it reported a loss for that year, and cash flow from operations exceeded net income for fiscal 2012.[19]

Statement of Shareholders' Equity

The fourth financial statement presents changes in shareholders' equity. Firms use various titles for the **statement of shareholders' equity**. For example, Great Deal's statement, in **Exhibit 1.4**, is called Consolidated Statements of Changes in Shareholders' Equity, while Thames's statement, in **Exhibit 1.8**, is called Consolidated Statement of Changes in Shareholders' Equity and Minority Interests. This statement displays components of shareholders' equity, including common shares and retained earnings, and changes in those components. For example, Great Deal's retained earnings changed between February 28, 2012, and February 27, 2013, because Great Deal earned net income (an increase of $1,317 million) and paid cash dividends (a decrease of $234 million).

[17] Both of these statements begin with net income and make adjustments to net income to calculate cash flow from operations. **Chapter 6** discusses these adjustments.

[18] Both Great Deal and Thames operate in several countries, implying that their activities involve multiple currencies. Thames reports a €32.1 million effect of exchange rate changes and includes that amount in its statement of cash flows. Great Deal reports the effects of exchange rate changes as $10 million. This book does not consider the accounting effects of different currencies or of changes in exchange rates among currencies.

[19] **Chapter 6** discusses reasons for the difference between net income and cash flow from operations.

Supporting Schedules and Notes

The financial statements present aggregated information, for example, the total amount of land, buildings, and equipment. Financial reports provide more detail for some of the items reported in the financial statements. They provide additional explanatory material to help the user understand the information in the financial statements. The additional material appears in **schedules** and notes.

The **notes** to the financial statements describe the accounting guidance that the firm uses to prepare those financial statements. The notes also provide information that elaborates on, or *disaggregates*, items presented in the financial statements. Understanding a firm's balance sheet, income statement, statement of cash flows, and statement of changes in shareholders' equity requires understanding the notes.

Summary: Principal Financial Statements

The financial statements provide information about a firm's financial position (balance sheet), its profitability (income statement), its cash-generating activity (statement of cash flows), and its changes in shareholders' equity. The balance sheet reports amounts of assets, liabilities, and shareholders' equity at the balance sheet date. The income statement reports the outcome of using assets to generate earnings during a reporting period and helps explain the change in retained earnings on the balance sheet between the beginning and end of the period. The statement of cash flows reports the cash inflows and outflows from operating, investing, and financing activities and explains the change in cash on the balance sheet between the beginning and end of the period. The statement of shareholders' equity reports the reasons why the components of shareholders' equity increased or decreased during the reporting period. Users should read the financial statements in conjunction with the supporting notes and schedules, which provide additional information to help users understand the financial statements.

▶ PROBLEM 1.1 FOR SELF-STUDY

Preparing a balance sheet and an income statement. The following information is based on the annual report of Sargent AG, a German multinational firm. Amounts are reported in millions of euros (€).

	September 30	
	2013	**2012**
Balance Sheet Items		
Accounts Payable	€ 8,382	€ 8,443
Property and Equipment (net of accumulated depreciation)	10,555	12,072
Cash and Cash Equivalents	4,005	10,214
Common Stock	8,823	8,335
Intangible Assets	17,120	13,074
Other Noncurrent Assets	3,371	4,370
Long-Term Investment Securities	12,577	7,998
Inventories	12,930	12,790
Long-Term Debt	9,860	13,122
Other Noncurrent Liabilities	8,174	9,547
Other Shareholders' Equity Items	351	858
Accounts Receivable	14,620	15,148
Other Current Assets	16,377	11,862
Other Current Liabilities	33,098	28,939
Retained Earnings	20,453	16,702
Current Income Taxes Payable	2,414	1,582

(continued)

	September 30
	2013
Income Statement Items	
Cost of Sales	€51,572
Income Tax Expense	1,192
Other (Nonoperating) Expense	144
Sales	72,448
Research & Development Expenses	3,399
Selling, General, and Administrative Expenses	12,103

a. Prepare a comparative balance sheet as of September 30, 2013 (fiscal 2013), and September 30, 2012 (fiscal 2012) in the format used in **Exhibit 1.1**. Classify the balance sheet items into the following categories: current assets, noncurrent assets, current liabilities, noncurrent liabilities, and shareholders' equity. Refer to the **Glossary** at the back of the book if you have difficulty with any of the accounts. For each year, verify that assets equal liabilities plus shareholders' equity on your balance sheet.

b. Prepare an income statement for the year ending September 30, 2013. Classify income statement items into revenues and expenses.

c. Based only on the information given here, did this firm pay cash dividends to its shareholders during the year ending September 30, 2013? If yes, what is the amount?

Solutions to self-study problems appear at the end of each chapter.

FINANCIAL REPORTING PROCESS

This section discusses participants in the **financial reporting process**:

1. Managers and governing boards of reporting entities.
2. Accounting standard setters and regulatory bodies.
3. Independent external auditors.
4. Users of financial statements.

This section also discusses three concepts and conventions that underpin the financial reporting process:

1. The distinction between recognition and realization.
2. Materiality.
3. The accounting period.

MANAGERS AND GOVERNING BOARDS OF REPORTING ENTITIES

Firms receive funds from owners with the expectation that managers will use the funds to increase shareholder value. **Managers** are agents of the shareholders and have responsibility for safeguarding and properly using the firm's resources. Managers establish internal controls to ensure the proper recording of transactions and the appropriate measurement and reporting of the results of those transactions. Shareholders elect a **governing board**, sometimes called a *board of directors*. The governing board is responsible for selecting, compensating, and overseeing managers; for establishing dividend policy; and for making decisions on major issues such as acquisitions of other firms and divestitures of lines of business. Some governing boards, including the boards of publicly traded U.S. firms, have a special committee charged with oversight of financial reporting.

Managers are responsible for preparing the firm's financial reports. If the firm's shares trade publicly, laws and regulations specify the accounting system the firm must follow (for example, U.S. GAAP or IFRS). Management is responsible for understanding the transactions, events, and arrangements that it reports in the firm's financial statements and for properly applying accounting standards.

Accounting Standard Setters and Regulatory Bodies

Firms apply accounting standards to prepare their financial reports. This book considers two systems of accounting standards, U.S. GAAP and IFRS. This section discusses these two sets of standards and their regulatory regimes.

U.S. GAAP In the United States the **Securities and Exchange Commission (SEC)**, an agency of the federal government, has the authority to establish accounting standards. The SEC is also the enforcement agency for U.S. securities laws. These laws apply to firms that access the public debt and equity markets of the United States. The SEC enforces the application of required accounting standards for **U.S. SEC registrants** as well as **non-U.S. SEC registrants** (also called **foreign private issuers**). A U.S. SEC registrant is a firm incorporated in the United States that lists and trades its securities in the United States. A non-U.S. SEC registrant is a firm incorporated under non-U.S. laws that has filed the necessary documents with the SEC to list and trade its securities in the United States.

Although it occasionally issues authoritative accounting guidance, the SEC has largely delegated the task of setting U.S. financial accounting standards to the **Financial Accounting Standards Board (FASB)**, a private-sector body with seven voting members. FASB members work full time for the FASB and sever all relations with their previous employers. As the FASB considers a financial reporting issue, its due-process procedures ensure that it receives input from constituencies, including preparers of financial reports, auditors, and financial statement users.[20]

Common terminology includes the pronouncements of the FASB in the compilation of accounting rules, procedures, and practices known as **generally accepted accounting principles (GAAP)**. The applicable accounting guidance for preparing financial reports of U.S. firms is **U.S. GAAP**. The applicable guidance includes, as well, writings of the SEC, consensuses of the Emerging Issues Task Force (a committee that operates under the oversight of the FASB), and some pronouncements of the American Institute of Certified Public Accountants (AICPA, a professional association). From its inception in 1973 until 2009, the FASB issued its major pronouncements in the form of ***Statements of Financial Accounting Standards (SFAS)***, with both a number (for example, *SFAS 95*) and a title (for example, "Statement of Cash Flows").

In 2009, the FASB completed a codification project that organized all of U.S. GAAP by topic (for example, revenues). The FASB ***Accounting Standards Codification*** is now the source of U.S. GAAP and can be accessed on the FASB's Web site. Authoritative guidance is referred to in terms of its codification section (or ASC for *Accounting Standards Codification*); for example, Inventory is in FASB ASC 330; Revenue is in ASC 605; and Research and Development is in ASC 730. The FASB issues new authoritative guidance in the form of *Accounting Standards Updates* (ASU) that are amendments to the Accounting Standards Codification.

FASB board members make standard-setting decisions guided by a **conceptual framework** that addresses the following issues:[21]

1. *Objective of financial reporting.* The conceptual framework establishes the objective of financial reporting as providing information to current and potential investors, creditors, and others to assist them in making resource allocation decisions.[22]
2. *Qualitative characteristics of accounting information.* The conceptual framework establishes two qualitative characteristics of financial information that enable the information to meet the objective of financial reporting. The two characteristics are relevance and representational faithfulness:
   - **Relevance.** The information should be pertinent to the decisions made by users of financial statements. This means that the information should have the capacity to affect their resource allocation decisions.
   - **Representational faithfulness.** The information should represent what it is supposed to represent. This means that the information should correspond to the phenomenon being reported, and it should be reasonably complete and free from bias and error.

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[20] Additional information is available on the FASB's Web site (www.fasb.org).

[21] The FASB's conceptual framework is in *Statements of Financial Accounting Concepts*, available on the FASB's Web site.

[22] With one exception, a method of accounting for inventories and cost of goods sold, the accounting methods permitted or required by U.S. GAAP differ from the methods required for calculating taxable income in the United States. With the exception of inventories, you should assume there will be significant differences between tax accounting methods and financial accounting methods under U.S. GAAP and IFRS.

The conceptual framework also establishes certain features of financial information that enhance the ability of that information to meet the objective of financial reporting.

- **Comparability.** The information should facilitate comparisons across firms and over time. Accounting information is comparable if firms account for similar events and transactions the same way.
- **Verifiability.** Information is verifiable if knowledgeable and independent observers of that information reach consensus that a specified depiction of an item is a faithful representation of that item. Information can be verified in several ways, including, for example, direct observation, such as counting the amount of cash or inventory.
- **Timeliness** and **understandability.** In order to be useful for resource allocation decisions, information must be available to decision makers in time to be capable of influencing their decisions. Also, decision makers must be able to understand that information. Financial reports are prepared with the assumptions that users have reasonable business knowledge and analyze the reports diligently.

3. *Elements of financial statements.* The conceptual framework defines assets, liabilities, revenues, expenses, and other items. An item can appear in the financial statements only if it meets these definitions. Items that do not meet these definitions may be disclosed in the notes.
4. *Recognition and measurement principles.* The conceptual framework defines **recognition** as the depiction of an item in words and numbers in the financial statements with the amount included in the totals. For example, the amount payable to suppliers is a recognized item that appears as a liability on the balance sheet, and its amount is part of total liabilities. Other items in financial reports are not recognized in the financial statements but, if significant, appear as **disclosures** in the notes to the financial statements. The conceptual framework specifies criteria that an item must meet in order for it to be recognized in the financial statements. It also describes various ways to measure recognized items.

The conceptual framework guides the FASB in setting accounting standards. The conceptual framework is not a rigorous, analytical structure from which the FASB can logically deduce acceptable accounting methods, however.[23]

International Financial Reporting Standards (IFRS) At one time, accounting was a largely jurisdiction-specific activity. This meant that *each* country developed its own distinct accounting standards. As a result, firms based in different countries applied different standards in their financial reports, impeding comparisons of firms by investors and creditors. The globalization of capital markets has increased the need for comparable financial statements across countries.

The **International Accounting Standards Board (IASB)** is an independent accounting standard-setting entity with voting members from several countries. (As of 2011, there were 15 voting members; this number is subject to change.) Standards set by the IASB are **International Financial Reporting Standards (IFRS)**. The IASB's conceptual framework is similar to the FASB's conceptual framework and is used for similar purposes. The IASB began operating in 2001.[24] More than 100 countries require or permit firms to use IFRS, or a set of standards based on or adapted from IFRS. Each of these countries has its own regulatory arrangements for enforcing the application of IFRS. These enforcement arrangements differ considerably across countries.

In 2007 the U.S. SEC adopted rules that permit non-U.S. firms that list and trade their securities in the United States (non-U.S. SEC registrants) to apply IFRS in their financial reports filed with the SEC without any reconciliation to U.S. GAAP. Prior to this rule change, non-U.S. SEC registrants could use any set of accounting standards to prepare their financial reports, but they had to reconcile those reported numbers to the numbers that they would have reported had they prepared the financial statements using U.S. GAAP. The main effect of the 2007 rule change is to create *two* sets of acceptable financial reporting systems in the

[23]**Chapter 17** discusses the FASB's conceptual framework more fully.

[24]The standards set by its predecessor body, the International Accounting Standards Committee (IASC), are called *International Accounting Standards (IAS)*, and IFRS includes them.

United States, specifically, U.S. GAAP for U.S. SEC registrants and IFRS for non-U.S. SEC registrants.[25]

The FASB and IASB have committed to converge their standards. The goal of the **convergence** process is to eliminate differences between U.S. GAAP and IFRS and to improve the resulting standards. The intention is produce a single set of high-quality financial reporting standards. In addition, a separate project is under way to converge, complete, and improve the conceptual frameworks.[26]

Independent Auditors

Regulatory bodies require firms whose securities trade publicly to obtain an audit of their financial reports by an independent external auditor.[27] Even if the securities do not trade publicly, financing sources such as banks may require that the firm obtain an independent audit of its financial reports. An audit involves the following:

1. An assessment of the capability of a firm's accounting system to accumulate, measure, and synthesize transactional data.
2. An assessment of the operational effectiveness of the accounting system.
3. A determination of whether the financial report complies with the requirements of the applicable authoritative guidance.

The auditor obtains evidence for the first assessment by studying the procedures and internal controls built into the accounting system. The auditor obtains evidence for the second assessment by examining a sample of actual transactions. The auditor obtains evidence for the third assessment through a combination of audit procedures. The auditor's conclusions appear in the **audit opinion**, part of the financial report.

Concerns over the quality of financial reporting and auditing have led to government initiatives in the United States. For example, the **Sarbanes-Oxley Act** of 2002 established the **Public Company Accounting Oversight Board (PCAOB)**, which is responsible for monitoring the quality of audits of SEC registrants. This Act requires the PCAOB to register firms conducting independent audits; establish acceptable auditing, quality control, and independence standards; and provide for periodic inspections of registered auditors. In addition, for larger firms whose shares trade in the United States, the Sarbanes-Oxley Act requires the independent auditor to provide an assessment of the effectiveness of a firm's internal control system for financial reporting.

Users of Financial Statements

Standard setters and securities regulators intend that financial reports provide information that helps decision makers allocate resources (for example, lend funds or buy shares) and evaluate the results of their decisions. Financial reporting is not intended to measure firm value or to provide *all* the information decision makers may need to make resource allocation decisions. Financial reporting is intended to provide information that is useful in helping decision makers assess the amount, timing, and uncertainty of future cash flows.

Users of financial statements must have reasonable business knowledge and reasonable knowledge of the kinds of transactions that firms engage in. They must also have reasonable knowledge of the financial accounting guidance that firms follow to prepare financial reports, and reasonable understanding of the judgments and estimates required to apply those principles.

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[25] Non-U.S. SEC registrants could also choose to apply U.S. GAAP. Or they could apply some other accounting standards (not IFRS and not U.S. GAAP) and reconcile the resulting numbers to U.S. GAAP. As this book goes to press, the SEC has not decided whether to permit or require U.S. SEC registrants to apply IFRS.

[26] Specific information about convergence activities appears on the FASB's Web site (www.fasb.org) and on the IASB's Web site (www.ifrs.org). **Chapter 17** summarizes some of the differences between U.S. GAAP and IFRS.

[27] Employees of a firm may also conduct audits (called *internal audits*). The employees' knowledge and familiarity with the activities of their firm enhance the quality of the audit work and increase the likelihood that the audit will generate suggestions for improving operations.

BASIC ACCOUNTING CONVENTIONS AND CONCEPTS

Recognition and **realization** are two fundamental accounting concepts. We have previously described recognized items as being depicted in words and numbers on the face of the financial statements, with their amounts included in the totals. Items must meet certain conditions in order for them to be recognized.[28] Realization refers to converting a noncash item to cash. An example of a realized event is collecting cash on an account receivable.

Accounting conventions recognize many accounting items (that is, include them in the financial statements) before the firm realizes them (that is, converts them to cash). To illustrate, suppose a firm ships an item for $1,000 on account, payable in 30 days, to a creditworthy customer. The firm *recognizes* revenue when it ships the goods but *realizes* revenue when it collects the cash.

Materiality captures the notion that financial reports need not include items that are so small as to be meaningless to users. Immaterial items do not appear in the financial reports. No precise quantitative materiality threshold exists, so financial statement preparers must apply judgment to decide whether a given item is immaterial.

The **accounting period convention** refers to the length of financial reporting periods. Most business activities do not divide into distinguishable pieces. For example, a firm acquires a plant and uses it in manufacturing products for 30 years. A firm purchases delivery equipment and uses it to transport merchandise to customers for five years. Because there is no natural stopping point in business activities, the convention is to prepare financial statements for periods of specified length. This approach facilitates timely comparisons and analyses among firms.

An accounting period (also called a **reporting period**) is the time between two successive balance sheet dates. Balance sheets prepared at the end of the day on December 31 of one year and at the end of the day on December 31 of the next year bound a calendar-year accounting period. The December 31 balance sheet is also the beginning balance sheet for the next year. Balance sheets prepared at the end of the day on November 30 and at the end of the day on December 31 bound a one-month accounting period—the month of December.

Some firms use the calendar year as the accounting period, while others use a **natural business year** that coincides with changes in the level of operating activities. For example, firms often establish their year-end as the point in time when inventories are at their lowest level. Retailers, like Great Deal, use a year-end close to the end of January or February, the natural end of the holiday sales season. The ending date of a natural business year is therefore associated with the activities of the particular firm's business.

Firms may prepare *interim reports* for periods shorter than a year. Preparing interim reports does not eliminate the need to prepare an annual report. Firms with publicly traded securities in the United States must prepare and file with the SEC quarterly reports as well as annual reports. Firms file quarterly reports on SEC form 10-Q (the 10-Q report) and file annual reports using SEC form 10-K (the 10-K report). Some firms use the 10-K report as their annual report to shareholders. Other firms incorporate the 10-K report into their annual report. Still others prepare a separate annual report to shareholders in addition to the 10-K report.

ACCOUNTING METHODS FOR MEASURING PERFORMANCE

Many operating activities start in one accounting period and finish in another. For example, a firm may acquire a building in one period and use it in operations for 30 years. Firms may purchase merchandise in one accounting period, pay for it in a second, sell it in a third, and collect cash from customers in a fourth. Cash collection can precede the sale of merchandise, as occurs when customers make advance payments, or follow it, as occurs with sales made on account. Measuring performance for a specific accounting period requires measuring the amount of

[28] For example, **Chapter 4** discusses the recognition criteria for items to be included as assets and liabilities on the balance sheet. **Chapter 8** discusses the criteria for recognizing revenues on the income statement.

revenues and expenses from operating activities that span more than one accounting period. The following are two approaches to measuring operating performance:

1. The cash basis of accounting.
2. The accrual basis of accounting.

Cash Basis of Accounting

Under the **cash basis of accounting**, a firm measures performance from selling goods and providing services as it receives cash from customers and makes cash expenditures to providers of goods and services. To understand performance measurement under the cash basis of accounting, consider the following information.

Example 3 Joan Adam opens an art supply store (Adam-Art Supply) on January 1, 2013. The financing of the store consists of €150,000 in cash, provided by Joan in exchange for all the common stock of the firm. The firm rents space on January 1 and pays two months' rent of €14,000 in advance. During January it acquires merchandise costing €140,000, paying €86,000 in cash and acquiring the rest (€54,000) on account for payment in February. Sales to customers during January total €140,000, of which €114,000 is for cash and €26,000 is on account for collection in February and March. The cost of the merchandise sold during January was €42,000. The firm paid €25,000 in salaries.

Using the cash basis of accounting, the firm records sales as it receives cash. Income is cash receipts less cash disbursements for goods and services. Adam-Art Supply made €140,000 in total sales during January, but it records performance equal to cash receipts of €114,000. It will record the remaining €26,000 as performance when customers pay the amounts owed in later months. The firm acquires merchandise costing €140,000 during January but pays €86,000 cash to suppliers. Under cash-basis accounting, the performance measure subtracts only the cash paid from cash receipts. The firm also subtracts January's cash expenditures for salaries (€25,000) and rent (€14,000), even though it paid the rent for both January and February. Cash expenditures for merchandise and services (€125,000 = €86,000 + €25,000 + €14,000) exceeded cash receipts from customers (€114,000) during January by €11,000:

Cash Inflows	
Cash Receipts from Customers	€ 114,000
Total Cash Inflows	114,000
Cash Outflows	
Cash Paid for Rent	(14,000)
Cash Paid for Merchandise	(86,000)
Cash Paid for Salaries	(25,000)
Total Cash Outflows	(125,000)
Net Cash Flow	€ (11,000)

As a basis for measuring performance for a particular accounting period, the cash basis of accounting has three weaknesses.

1. The cash basis does not match the cost of the efforts required to generate inflows with the inflows themselves. Cash outflows of one period can relate to operating activities whose cash inflows occur in preceding or succeeding periods. For example, the store rental payment of €14,000 provides rental services for both January and February. Yet the cash basis subtracts the full amount in measuring performance during January and none for February. As a result, February's performance will look better than January's for no reason except the timing of cash payments for rent.

   The cash basis does a better job of matching the cost of the efforts required in generating inflows with the inflows themselves over a longer period than over a shorter period. For example, if Adam-Art Supply calculates cash-basis performance over *two* months, January and February, the €14,000 cost of rental services exactly matches the period over which the firm receives the benefits. Delaying performance measurement is not a good solution, however, because users of financial statements want timely information and because of the

reasons given in the description of the accounting period convention—business activities do not divide neatly into discrete projects and discrete periods.

2. The cash basis separates the recognition of revenue from the process of earning those revenues. A firm should recognize revenues when it earns them by delivering goods and services to customers. Delivery often occurs before the firm collects cash from customers. Waiting to recognize revenues until the firm collects cash results in reporting the effects of operating activities one or more periods *after* the critical revenue-generating activity—the customer's purchase of goods and service—has occurred. For example, sales to customers during January by Adam-Art Supply were €140,000. Under the cash basis, the firm will not recognize €26,000 of this amount until it collects the cash in February or later.
3. Performance measured using the cash basis is sensitive to the timing of cash expenditures. For example, the cash-basis measure reduces the performance for Adam-Art Supply in January by the entire €14,000 cash payment for rent, even though the firm will benefit from the results of those expenditures for two months in the future. A delay of even a few days in cash expenditures near the end of the accounting period will increase earnings for that period.

Accrual Basis of Accounting

The **accrual basis of accounting** recognizes revenue when a firm sells goods (manufacturing and retailing firms) or renders services (service firms). And it recognizes expenses in the period when the firm recognizes the revenues that the costs helped produce. Thus accrual accounting attempts to match expenses with revenues. When the usage of an asset's future benefits does not match with particular revenues, the firm recognizes those costs as expenses in the period when the firm uses the benefits.

Example 4 Under the accrual basis of accounting, Adam-Art Supply recognizes, for January 2013, the entire €140,000 of sales during January as revenue, even though it has received only €114,000 in cash by the end of January. The firm reasonably expects to collect the remaining accounts receivable of €26,000 in February or soon thereafter. The sale of the goods, rather than the collection of cash from customers, triggers the recognition of revenue. The merchandise sold during January cost €42,000. Recognizing this amount as an expense (cost of goods sold) matches the cost of the merchandise sold with revenue from sales of those goods. Of the advance rental payment of €14,000, only €7,000 applies to the cost of benefits consumed during January. The remaining rental of €7,000 purchases benefits for the month of February and will therefore appear on the January 31 balance sheet as an asset. Unlike the cost of merchandise sold, January's salaries and rent expenses do not match January revenues. These costs become expenses of January to the extent that the firm consumed salary and rent services during the month. Using the accrual basis of accounting, Adam-Art would report January net income of €66,000:

Sales Revenue	€140,000
Cost of Goods Sold	(42,000)
Rent Expense	(7,000)
Salaries Expense	(25,000)
Net Income	€ 66,000

The accrual basis of accounting illustrates the **matching convention**: it matches expenses with their related revenues by subtracting their amount in measuring performance. The accrual basis focuses on revenues and expenses in measuring performance. This measure of performance is independent of whether the firm has collected cash for the inflows from generating revenues or spent cash for the outflows from the expenses.

The accrual basis of accounting provides a better measure of January operating performance for Adam-Art Supply than does the cash basis, for two reasons.

1. Revenues more accurately reflect the results of sales activity during January than does cash received from customers during that period.
2. Expenses more closely match reported revenues than expenditures match receipts.

The accrual basis also provides a superior measure of performance for future periods because activities of future periods will bear their share of the costs of rent and other services the firm will consume.

Most firms use the accrual basis of accounting. From this point on, all discussions assume use of the accrual basis.

PROBLEM 1.2 FOR SELF-STUDY

Cash versus accrual basis of accounting. Thompson Hardware Store commences operations on January 1, 2013, when Jacob Thompson invests $30,000 for all of the common stock of the firm. The firm rents a building on January 1 and pays two months' rent in advance in the amount of $2,000. On January 1 it also pays the $1,200 premium for property and liability insurance coverage for the year ending December 31, 2013. The firm purchases $28,000 of merchandise inventory on account on January 2 and pays $10,000 of this amount on January 25. On January 31 the cost of unsold merchandise is $15,000. During January the firm makes cash sales to customers totaling $20,000 and sales on account totaling $9,000. The firm collects $2,000 from these credit sales by the end of January. The firm pays other costs during January as follows: utilities, $400; salaries, $650; and taxes, $350. What are Thompson Hardware Store's revenues, expenses, and income for January, assuming (1) the accrual basis of accounting and (2) the cash basis of accounting?

SUMMARY

This chapter shows how business activities relate to the financial statements. The chapter provides a broad overview of the four basic financial statements. Later chapters examine the concepts and procedures underlying each statement. This chapter also describes the financial reporting process and introduces U.S. GAAP and IFRS.

Now we turn to the study of financial accounting. To comprehend the concepts and procedures in the book, you should study the numerical examples presented in each chapter and prepare solutions to several problems, including the self-study problems.

SOLUTIONS TO SELF-STUDY PROBLEMS

SUGGESTED SOLUTION TO PROBLEM 1.1 FOR SELF-STUDY

(Preparing a balance sheet and an income statement using data of Sargent AG)

a. Balance sheet for years ended September 30, 2013, and September 30, 2012.

	September 30	
	2013	2012
Assets		
Cash and Cash Equivalents	€ 4,005	€10,214
Accounts Receivable	14,620	15,148
Inventories	12,930	12,790

(continued)

	September 30	
	2013	2012
Other Current Assets	16,377	11,862
Total Current Assets	47,932	50,014
Property and Equipment (net of accumulated depreciation)	10,555	12,072
Intangible Assets	17,120	13,074
Long-Term Investment Securities	12,577	7,998
Other Noncurrent Assets	3,371	4,370
Total Noncurrent Assets	43,623	37,514
Total Assets	€91,555	€87,528
Liabilities and Shareholders' Equity		
Accounts Payable	€ 8,382	€ 8,443
Current Income Taxes Payable	2,414	1,582
Other Current Liabilities	33,098	28,939
Total Current Liabilities	43,894	38,964
Long-Term Debt	9,860	13,122
Other Noncurrent Liabilities	8,174	9,547
Total Noncurrent Liabilities	18,034	22,669
Total Liabilities	61,928	61,633
Common Stock	8,823	8,335
Retained Earnings	20,453	16,702
Other Shareholders' Equity Items	351	858
Total Shareholders' Equity	29,627	25,895
Total Liabilities and Shareholders' Equity	€91,555	€87,528

	Assets	=	Liabilities	+	Shareholders' Equity
Fiscal 2013:	€91,555 million	=	€61,928 million	+	€29,627 million
Fiscal 2012:	€87,528 million	=	€61,633 million	+	€25,895 million

b. Income statement for year ended September 30, 2013:

Sales	€72,448
Cost of Sales	(51,572)
Research and Development Expenses	(3,399)
Selling, General, and Administrative Expenses	(12,103)
Operating Profit	5,374
Other (Nonoperating) Expense	(144)
Earnings Before Income Taxes	5,230
Income Tax Expense	(1,192)
Net Income	€ 4,038

c. Yes. The change in Retained Earnings is €3,751 million, and Net Income is €4,038 million. Based on this information only, dividends are €287 million (= €4,038 − €3,751).

SUGGESTED SOLUTION TO PROBLEM 1.2 FOR SELF-STUDY

(Thompson Hardware Store: cash versus accrual basis of accounting)

Calculation of revenues, expenses, and income for January 2013 under the cash basis and accrual basis of accounting:

	Cash Basis	Accrual Basis
Revenues	$22,000	$29,000
Expenses:		
Rent	$ 2,000	$ 1,000
Insurance	1,200	100
Costs of Inventory	10,000	13,000
Utilities	400	400
Salaries	650	650
Taxes	350	350
Total Expenses	$14,600	$15,500
Net Income	$ 7,400	$13,500

KEY TERMS AND CONCEPTS

Goals
Strategies
Financing
Shareholders, stockholders
Publicly traded
Dividends
Creditors
Investing activities
Operating activities
Annual report to shareholders
Management's Discussion and Analysis (MD&A)
Fiscal year
Monetary amount
Balance sheet or statement of financial position
Assets
Liabilities
Shareholders' equity
Retained earnings
Historical amount
Current amount
Income statement or statement of profit and loss
Net income, earnings, profit
Net loss
Revenues, sales, sales revenue
Expenses
Statement of cash flows
Capital expenditures
Statement of shareholders' equity
Schedules and notes
Financial reporting process
Managers
Governing board
Securities and Exchange Commission (SEC)
U.S. SEC registrant
Non-U.S. SEC registrant, foreign private issuer
Financial Accounting Standards Board (FASB)
U.S. GAAP (generally accepted accounting principles)
Statements of Financial Accounting Standards (SFAS)
Accounting Standards Codification
Conceptual framework
Relevance
Representational faithfulness
Comparability
Verifiability
Timeliness
Understandability
Recognition
Disclosure
International Accounting Standards Board (IASB)
International Financial Reporting Standards (IFRS)
Convergence
Audit opinion
Sarbanes-Oxley Act
Public Company Accounting Oversight Board (PCAOB)
Realization
Materiality
Accounting period convention, reporting period
Natural business year
Cash basis of accounting
Accrual basis of accounting
Matching convention