

# 1. Financial Reporting. Assumptions of the Accounting Model

## 1.1 Types of firms

A **sole proprietorship** is a business owned and run by only one person. The owner has unlimited personal liability for any of the firm's debts. He may be required to repay debt from personal assets unless he declares personal bankruptcy. The life of a sole proprietorship is limited to the life of the owner.

A **partnership** is a business owned and run by more than one owner. All partners are legally responsible for the firm's debt. The partnership ends on the death or withdrawal of any single partner.

A **limited partnership** is a partnership with two kinds of owners, general partners and limited partners. General partners are personally responsible for the firm's debt obligations. Limited partners have liability limited to their investment. They cannot run the business. Their private property cannot be seized to pay off the firm's outstanding debt.

A **private company** (limited liability company) is a limited partnership with only limited partners. The owners have limited liability, but they can also run the business. Shares of private companies are not traded on stock markets.

A **public company** is a legal entity solely responsible for its obligations. The owners are not liable for any obligations of a corporation. The shares of public companies are traded on organized stock exchanges. In the United States large business companies are registered as **corporations** and usually the shares of corporations are traded on organized stock exchanges.

An owner of a company (a private company or a public company) is known as a shareholder, stockholder or equity holder. The shareholders of a company exercise their control by electing a board of directors. The board of directors delegates decisions that involve day-to-day running of the corporation to its management team (chief executive officer).

## 1.2 Financial Reports

Financial reports include information on a company, management, company's strategy and activities, and financial statements. For a holding companies they include consolidated financial statements.

Users of financial reporting include:

1. company's managers
2. stockholders and potential investors
3. bondholders and lending institutions (banks)
4. employees and labor unions
5. regulatory bodies and the general public
6. academic teachers and students.

Financial reports required by regulated bodies are prepared according to specified forms and usually include auditor's opinion and report on its audit of the financial statements.

In the United States the Securities and Exchange Commission (SEC) is an agency of the federal government that has a legal power to set financial reporting requirements for public companies. It requires that certain financial information should be included in the annual report to

shareholders. This annual report, along with supplementary information must be included in the annual filing to the SEC, known as 10-K report or Form 10-K. A student is required to know what is the content of such report. What kind of information beyond the audited financial statements and auditor's opinion is included in financial report?

Link:

Coca-Cola 10-K 2014 Report.

<http://www.coca-colacompany.com/content/dam/journey/us/en/private/fileassets/pdf/2015/02/2014-annual-report-on-form-10-k.pdf>

In Poland the Polish Financial Supervision Authority (PFSA) (Polish: Komisja Nadzoru Finansowego (KNF)) is the financial regulatory authority for Poland. Its responsibilities include supervising of banking, capital markets, insurance, pension scheme and electronic money institutions. Public companies are required to prepare reports according to regulations of the Ministry of Finance.

## 1.3 Accounting Standard-Setting Organizations

### 1.3.1 International Accounting Standards Board

International Accounting Standards (IAS) were issued between 1973 and 2001 by International Accounting Standards Committee (IASC). The **International Accounting Standards Board (IASB)** has continued to publish new standards from 1 April 2001 calling them **International Financial Reporting Standards (IFRS)**. IASB is located in London.

IFRS are used in the European Union and many countries in the world, but not in the United States. Over 115 countries adopted IFRS. IFRS are not used in the United States, but may be used by foreign companies listed on U.S. securities exchange.

The purpose of financial statements according to IAS 1 is: "Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it. To meet this objective, financial statements provide information about an entity's: assets, liabilities, equity, income and expenses, including gains and losses, contributions by and distributions to owners in their capacity as owners; and cash flows.

This information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

The IASB issues three major types of pronouncements:

1. **International Financial Reporting Standards.**
2. Framework for financial reporting.
3. International financial reporting interpretations.

### 1.3.2 Financial Accounting Standards Board

In the United States a huge number of institutions have been engaged in developing GAAP (generally accepted accounting principles) since 1933. The American Institute of Certified Public Accountants (AICPA) and the **Financial Accounting Standards Board (FASB)** have been the most significant. AICPA played the major role in establishing GAAP prior to 1973. Since 1973 the FASB has been the designating organization for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental organizations.

All companies in the United States are required to use FASB standards.

The FASB issues:

1. **Statements of Financial Accounting Standards (SFASs)**
2. Interpretations
3. Technical bulletins
4. Statements of Financial Accounting Concepts (SFACs)

### 1.3.3 Convergence of international standards and U.S. GAAP

SFAS's issued by FASB are much more complex and more detailed than IRFS's issued by IASB. It is generally believed that a single set of high-quality global accounting standards is needed to enhance comparability. Convergence to a single set of high-quality financial reporting standards appears to be a real possibility. In 2002 the IASB and the FASB confirmed their commitment to the convergence of U.S. GAAP and international standards by issuing a memorandum of understanding (often referred to as the Norwalk Agreement).

Links:

International Accounting Standards Board

<http://www.ifrs.org/Pages/default.aspx>

Financial Accounting Standards Board

<http://www.fasb.org/home>

List of International Financial Accounting Standards:

[http://en.wikipedia.org/wiki/List\\_of\\_International\\_Financial\\_Reporting\\_Standards](http://en.wikipedia.org/wiki/List_of_International_Financial_Reporting_Standards)

List of FASB Pronouncements

[http://en.wikipedia.org/wiki/List\\_of\\_FASB\\_Pronouncements](http://en.wikipedia.org/wiki/List_of_FASB_Pronouncements)

## 1.4 Assumptions of the Accounting Model

The FASB Conceptual Framework was influenced by several underlying assumptions.<sup>1</sup>

### 1.4.1 Business Entity

The concept of separate entity means that the business entity for which the financial statements are prepared is separate and distinct from the owners of the entity.

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<sup>1</sup> The description of traditional assumptions of the accounting model is based on chapter 1 of the book: Charles H. Gibson, Financial Reporting and Analysis 9E, Using Financial Accounting Information, Thompson South-Western, 2004.

## **1.4.2 Going Concern or Continuity**

The going-concern assumption means that the entity will remain in business for an indefinite period. It disregards the possibility that the entity will be liquidated or will go bankrupt. The going-concern assumption should be dropped, if an entity is threatened with bankruptcy or liquidation. In such a case the liquidation values should be presented.

## **1.4.3 Time period**

Most businesses use the calendar year and thus end the accounting time period on December 31. Some businesses may select a natural business year. The accounting period may be also shorter than a year. Many transactions are unfinished at any particular time period and there are many inaccuracies in the reporting.

## **1.4.4 Monetary Unit, Exchange Rates and Inflation**

Financial statements use local currencies as monetary units. Holding companies that have subsidiaries in other countries have to decide what exchange rate should be used to convert foreign currencies into local currency.

In September 1979, the FASB issued SFAS No. 33 “Financial Reporting and Changing Prices”, which required that certain large, public companies disclose supplementary information concerning the impact of changing prices (inflation) in their annual reports. Currently no U.S. company provides such information.

## **1.4.5 Historical Cost**

SFAC No.5 identified five different measurement attributes used in practice: historical cost, current cost, current market value, net realizable value, and present value. Historical cost is mostly used in practice because it is objective and determinable. Other approaches are used when it becomes obvious that the historical cost cannot be recovered.

## **1.4.6 Conservatism**

According to the concept of conservatism, the accountant must select the measurement with the least favorable effect on net income and financial position. The conservatism concept cannot be used to choose subjective low numbers. An acceptable use of conservatism concept would be to value assets or liabilities at a lower of historical cost or market value.

## **1.4.7 Recognition of revenue (Realization)**

The point of recognition of revenue should be the point in time when the revenue can be reasonably and objectively determined. There are many different approaches:

1. Cost Recovery (the first revenue can be treated as a return of the investment)
2. During Production
3. End of Production
4. Sale
5. Receipt of Cash

Revenue is usually recognized at the moment of sale. If a customer does not pay the bill, there is no cash inflow. Taxes have to be paid. Going to the court influences additional cost. Such situation deteriorates liquidity.

### **1.4.8 Matching**

The revenue recognition is closely related to match the appropriate costs against revenue. Some costs can be easily matched with revenues. Some other costs have no direct connection with revenue.

### **1.4.9 Consistency**

The consistency concept requires to give the same treatment to comparable transactions from period to period.

### **1.4.10 Full Disclosure**

The accounting reports must disclose all facts that may influence the judgment of an informed reader.

### **1.4.11 Materiality**

The materiality concept involves the relative size and importance of an item to a firm. For example, an item that costs \$100 may be expensed by a huge company, but the same item might be carried as an asset by a small company.

### **1.4.12 Industry practices**

Some different approaches may be found in highly regulated industries, such as banking, insurance, railroad, and utilities. Financial statements of companies in different industries may be not comparable.

### **1.4.13 Transaction approach**

Some of the items (not transactions) are not recorded and will be not disclosed. They fall outside the transaction approach. For example, one of a company's major suppliers may go bankrupt. This information may not appear in financial statements.

### **1.4.14 Cash Basis**

The cash basis recognizes the revenue when cash is received and recognizes expenses when the cash is paid. It does not provide information on profitability in the short run. It is not used in practice.

### **1.4.15 Accrual Basis**

The accrual basis of accounting recognizes revenue when realized (recognition concept) and expenses when incurred (matching concept). The accrual basis requires numerous adjustments. For example if an invoice has been paid in advance for longer period, the accountant must determine the amounts that are appropriate to the current period.

## Task 1

1. Create a TASK FORCE (group of 3 students). Choose a leader.
2. Choose a company from the list of the biggest corporations in the world to prepare financial analysis.
3. Find the latest financial report of a selected company on the web site of a company and read it to understand the company.

Table 1. List of Dow Jones Industrial Average Index companies as of November 8, 2015

	Code	Name	Business Sector	Industry Code	Market cap Min USD
1	AAPL.O	Apple Inc	Technology Equipment	Computer Hardware	674 950
2	MSFT.O	Microsoft Corp	Software & IT Services	Software	438 696
3	XOM	Exxon Mobil Corp	Energy - Fossil Fuels	Integrated Oil & Gas	351 643
4	GE	General Electric Co	Industrial Conglomerates	Industrial Conglomerates	302 468
5	JNJ	Johnson & Johnson	Pharmaceuticals & Medical Research	Diversified Pharmaceuticals	282 007
6	JPM	JPMorgan Chase & Co	Banking & Investment Services	Banks	252 010
7	PFE	Pfizer Inc	Pharmaceuticals & Medical Research	Diversified Pharmaceuticals	209 450
8	PG	Procter & Gamble Co	Personal & Household Products & Services	Household Products	205 594
9	DIS	Walt Disney Co	Cyclical Consumer Services	Diversified Media	195 235
10	V	Visa Inc	Banking & Investment Services	Consumer Lending	191 591
11	WMT	Wal Mart Stores Inc	Retailers	Discount Stores	188 445
12	VZ	Verizon Communications Inc	Telecommunications Services	Integrated Telecommunications Services	186 273
13	KO	Coca-Cola Co	Food & Beverages	Non-Alcoholic Beverages	182 483
14	CVX	Chevron Corp	Energy - Fossil Fuels	Integrated Oil & Gas	176 968
15	HD	Home Depot Inc	Retailers	Home Improvement Products & Services Retailers	161 771
16	INTC.O	Intel Corp	Technology Equipment	Semiconductors	159 691
17	MRK	Merck & Co Inc	Pharmaceuticals & Medical Research	Diversified Pharmaceuticals	152 555
18	CSCO.O	Cisco Systems Inc	Technology Equipment	Communications Equipment	144 730
19	IBM	International Business Machines Corp	Software & IT Services	IT Services & Consulting	134 118
20	NKE	Nike Inc	Cyclical Consumer Products	Footwear	112 302
21	UNH	UnitedHealth Group Inc	Unable to collect data for the field 'RF.G.IndustryCode'	Unable to collect data for the field 'RF.G.IndustryCode'	109 426
22	MCD	McDonald's Corp	Cyclical Consumer Services	Restaurants & Bars	104 045
23	BA	Boeing Co	Industrial Goods	Aerospace & Defense	99 117
24	MMM	3M Co	Industrial Conglomerates	Industrial Conglomerates	98 058
25	UTX	United Technologies Corp	Industrial Goods	Aerospace & Defense	89 412
26	GS	Goldman Sachs Group Inc	Banking & Investment Services	Investment Banking & Brokerage Services	84 953
27	AXP	American Express Co	Banking & Investment Services	Consumer Lending	73 129
28	DD	E I du Pont de Nemours and Co	Chemicals	Diversified Chemicals	57 939
29	CAT	Caterpillar Inc	Industrial Goods	Heavy Machinery & Vehicles	42 992
30	TRV	Travelers Companies Inc	Insurance	Property & Casualty Insurance	34 407

Source: Actual market data collected by author.

### Web Pages:

Ticker	Company	URL	
1	MMM	3M Co.	<a href="http://www.3m.com">http://www.3m.com</a>
2	AXP	American Express Co.	<a href="http://www.americanexpress.com">http://www.americanexpress.com</a>
3	AAPL	Apple Inc.	<a href="http://www.apple.com">http://www.apple.com</a>
4	BA	Boeing Co.	<a href="http://www.boeing.com">http://www.boeing.com</a>
5	CAT	Caterpillar Inc.	<a href="http://www.cat.com">http://www.cat.com</a>
6	CVX	Chevron	<a href="http://www.chevron.com">http://www.chevron.com</a>
7	CSCO	Cisco Systems Inc.	<a href="http://www.ciscosystems.com">http://www.ciscosystems.com</a>
8	KO	Coca-Cola Co.	<a href="http://www.thecoca-colacompany.com">http://www.thecoca-colacompany.com</a>
9	DIS	DJA	<a href="http://corporate.disney.go.com/">http://corporate.disney.go.com/</a>
10	DD	E.I. DuPont de Nemours & Co.	<a href="http://www.dupont.com">http://www.dupont.com</a>
11	XOM	Exxon Mobil	<a href="http://www.exxonmobil.com/corporate">http://www.exxonmobil.com/corporate</a>
12	GE	General Electric Co.	<a href="http://www.ge.com">http://www.ge.com</a>
13	GS	Goldman Sachs Group Inc	<a href="http://www.goldmansachs.com/">http://www.goldmansachs.com/</a>
14	HD	Home Depot Inc.	<a href="http://www.homedepot.com">http://www.homedepot.com</a>
15	INTC	Intel Corp.	<a href="http://www.intel.com/content/www/us/en/homepage.html">http://www.intel.com/content/www/us/en/homepage.html</a>
16	IBM	International Business Machines Corp.	<a href="http://www.ibm.com/us/en">http://www.ibm.com/us/en</a>
17	JNJ	Johnson & Johnson	<a href="http://www.jnj.com">http://www.jnj.com</a>
18	JPM	JPMorgan Chase	<a href="http://www.jpmorganchase.com/corporate/Home/home.htm">http://www.jpmorganchase.com/corporate/Home/home.htm</a>
19	MCD	McDonald's Corp.	<a href="http://www.mcdonalds.com">http://www.mcdonalds.com</a>

20	MRK	Merck & Co. Inc.	<a href="http://www.merck.com">http://www.merck.com</a>
21	MSFT	Microsoft Corp.	<a href="http://www.microsoft.com">http://www.microsoft.com</a>
22	NKE	NIKE Inc	<a href="http://www.nike.com/">http://www.nike.com/</a>
23	PFE	Pfizer Inc.	<a href="http://www.pfizer.com">http://www.pfizer.com</a>
24	PG	Procter & Gamble Co.	<a href="http://www.pg.com">http://www.pg.com</a>
25	TRV	Travelers Cos.	<a href="http://www.travelers.com">http://www.travelers.com</a>
26	UTX	United Technologies Corp.	<a href="http://www.utc.com/Home">http://www.utc.com/Home</a>
27	UNH	UnitedHealth Group Inc.	<a href="http://www.unitedhealthgroup.com">http://www.unitedhealthgroup.com</a>
28	VZ	Verizon Communications	<a href="http://www.verizon.com">http://www.verizon.com</a>
29	V	Visa Inc	<a href="http://www.visa.com/">http://www.visa.com/</a>
30	WMT	Wal-Mart Stores Inc.	<a href="http://www.walmart.com">http://www.walmart.com</a>