2. Financial Statements and Reporting Topics. Financial Accounting Concepts. Auditor's Report

2.1 The Strategic Goal of a Firm

The firm must maximize the welfare of its stockholders (residual claimants). The expected and realized rate of return should be greater than required rate of return by stockholders. When we consider the market values of the assets and claims, rather than their accounting values, the result is a market-value balance sheet, also called an economic balance sheet.

Table 2. Accounting Balance Sheet

Assets	*Equity and Liabilities*
Non-current (fixed) Assets (book value)	Equity (book value)
Current Assets (book value)	Long Term Debt (book value)
	Current Liabilities (book value)

The wealth created by the firm (stockholders and debtholders) or economic value added

Table 3. Economic Balance Sheet

Assets	*Capital*		*Investors*	*Expectations and Cost of Capital*
Wealth created	Equity (**market value**)	**Firm**	Stockholders	Required Rate of Return = Cost of Equity
Non-Current (fixed) Assets (book value or market value)				
Net Current Assets (book value or market value)	Long Term Debt (book value or market value)		Debt holders	Required Rate of Return = Cost of Debt

The wealth created by the firm (stockholders and debt holders) or economic value added for stockholders is reflected in the market value of the equity higher than the book value of equity. The cash flow that the firm is expected to generate in the future (due to good investment projects) determines the wealth created available to the firm's stockholders.

The term "firm" means that we look at the company from the point of view of both stockholders (equity) and debt holders (long term debt).

2.1.1 Stockholders

An investor (stockholder, shareholder, common stockholder, equity holder) providing capital to a public company usually becomes a fractional owner. A piece of paper that records this arrangement between the company and investor is called a common stock certificate or share, and the stockholder is usually free to sell these shares at any time through a financial market called a stock market (or stock exchange).

Stockholders expect to get their rewards in one of two ways: via **dividends** and/or via **capital gains**. Dividend payments are made at the discretion of the corporation to its stockholders. There is no assurance that a firm will in fact pay dividends. Stockholders may expect **capital gains**, in which they sell their stock in the stock market for a higher price than

they paid for it. Again, there is no assurance that the price of the stock will go up, resulting in capital gains when the stock is sold.

2.1.2 Debtholders

When investors lend capital to a company, the company agrees to repay the debt at a set interest rate. A company may use a bank loan or issue bonds. A bank providing a loan or a bondholder becomes a creditor of the company.

A loan agreement involves interest rate and schedule of repayments. Usually this loan is an asset of a bank till maturity of a loan. Sometimes banks arrange pools of loans and sell them through the so called securitization process.

A company may also issue bonds. The document that records this arrangement between the issuing company and the investor is called a **bond**. Bondholders can sell their securities at any time in the bond markets. Bonds typically have a face value, the bond's nominal value ussually of $1000 and a maturity date of several years. On the maturity date, the company agrees to pay back to the bondholder the face value of the bond. Like stockholders, bondholders have two sources of rewards: **interest payments** and **capital gains**. The rate of interest (coupon rate, coupon) is stated on the bond. The capital gain expected may in fact turn out to be a capital loss, the result of selling a bond for a price less than the original purchase price.

The interest payments and the repayment of principal to the bank or to the bondholders are fairly certain.

2.1.3 Managers

The **manager of a company** is an **agent** acting on behalf of the **principal** (equityholder). The relationship between the principal and the agent is called **agency relationship**. Managers who follow their own self-interest **may** seek to improve their own welfare and not that of the shareholders. This **agency problem** is clearly undesirable for shareholders. The resulting inefficiencies, called **agency costs**, lower the firm's value.

2.1.4 Stakeholders

Stakeholders include customers, suppliers, workers, government, the "world wide community" in which a firm operates.

2.2 Financial Accounting Concepts

Some basic definitions of international accounting standards and US accounting standards are presented in the table

Table 4. Financial Accounting Concepts

	International Accounting Standards	**US Accounting Standards**
	Framework of IFRS, IAS 1	**SFAC No. 6**
1	An **asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	**Assets** are defined as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
2	A **liability** is a present obligation of the entity arising from the past events, the settlement of which is expected to result in	**Liabilities** are defined as probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other

	an outflow from the entity of resources embodying economic benefits.	entities in the future as a result of past transactions or events.
3	**Equity** is the residual interest in the assets of the entity after deducting all its liabilities.	**Equity** is the residual interest in the assets of an entity that remains after deducting its liabilities: Equity = Assets – Liabilities
4	**Financial capital maintenance.** Under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.	**Investments by owners**. Investments by owners are increases in equity of a particular business enterprise resulting from transfers to the enterprise from other entities of something of value to obtain or increase ownership interests (or equity) in it.
5		**Distribution to owners.** Distribution to owners is a decrease in equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distribution to owners decrease ownership interest (or equity) in the enterprise.
6	IAS 1 now requires: (a) all changes in equity arising from transactions with owners in their capacity as owners (ie owner changes in equity) to be presented separately from non-owner changes in equity. An entity is not permitted to present components of **comprehensive income** (ie non-owner changes in equity) in the statement of changes in equity. The purpose is to provide better information by aggregating items with shared characteristics and separating items with different characteristics (see paragraphs BC37 and BC38 of the Basis for Conclusions). (b) income and expenses to be presented in one statement (a statement of comprehensive income) or in two statements (a separate income statement and a statement of comprehensive income), separately from owner changes in equity (see paragraphs BC49–BC54 of the Basis for Conclusions). (c) components of other comprehensive income to be displayed in the statement of comprehensive income. (d) total comprehensive income to be presented in the financial statements.	**Comprehensive income**. Comprehensive income is the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances **from nonowner sources**. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.
7	**Income is** increases in economic benefits during an accounting period in the form of	**Revenues**. Revenues are inflows or other enhancements of assets of an entity or

	inflows or enhancements of assets, or decrease of liabilities that result in increases in equity, other than those relating to contributions from equity participants.	settlements of its liabilities (or combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
8	**Expenses:** decreases in economic benefits during an accounting period in the form of outflows, or depletions of assets or incurrences of liabilities that result in decreases in equity. However, these don't include the distributions made to the equity participants.	**Expenses**. Expenses are outflows or other consumption or using up of assets or incurrences of liabilities (or combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.
9	**Gains** represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element in this *Conceptual Framework*. Gains include, for example, those arising on the disposal of non-current assets. The definition of income also includes unrealised gains; for example, those arising on the revaluation of marketable securities and those resulting from increases in the carrying amount of long-term assets. When gains are recognized in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Gains are often reported net of related expenses.	**Gains**. Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.
10	**Losses** represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the entity. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this *Conceptual Framework*. Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of non-current assets. The definition of expenses also includes unrealised losses, for example, those arising from the effects of increases in the rate of exchange for a foreign currency	**Losses**. Losses are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.

	in respect of the borrowings of an entity in that currency. When losses are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Losses are often reported net of related income.	

Source: SFAC 6, Framework of IFRS, IAS 1.

2.3 Measurement Attributes

The Conceptual Framework for Financial (IASB, 2012) includes the following concepts:

Par. 4.55. A number of different measurement bases are employed to different degrees and in varying combinations in financial statements.

(a) **Historical cost**. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) **Current cost**. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) **Realizable (settlement) value**. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

(d) **Present value**. Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

Par. 4.56. The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value, marketable securities may be carried at market value and pension liabilities are carried at their present value. Furthermore, some entities use the current cost basis as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

Five different measurement attributes used in practice in the United States are following (SFAC No 5):

1. Historical cost
2. Current cost
3. Current market value
4. Net realizable (settlement value)

5. Present (discounted value) of future cash flows.

SFAC No 5. Par. 67. Five different attributes of assets (and liabilities) are used in present practice:

a. **Historical cost** (historical proceeds). Property, plant, and equipment and most inventories are reported at their historical cost, which is the amount of cash, or its equivalent, paid to acquire an asset, commonly adjusted after acquisition for amortization or other allocations. Liabilities that involve obligations to provide goods or services to customers are generally reported at historical proceeds, which is the amount of cash, or its equivalent, received when the obligation was incurred and may be adjusted after acquisition for amortization or other allocations.

b. **Current cost**. Some inventories are reported at their current (replacement) cost, which is the amount of cash, or its equivalent, that would have to be paid if the same or an equivalent asset were acquired currently.

c. **Current market value**. Some investments in marketable securities are reported at their current market value, which is the amount of cash, or its equivalent, that could be obtained by selling an asset in orderly liquidation. Current market value is also generally used for assets expected to be sold at prices lower than previous carrying amounts. Some liabilities that involve marketable commodities and securities, for example, the obligations of writers of options or sellers of common shares who do not own the underlying commodities or securities, are reported at current market value.

d. **Net realizable (settlement) value**. Short-term receivables and some inventories are reported at their net realizable value, which is the nondiscounted amount of cash, or its equivalent, into which an asset is expected to be converted in due course of business less direct costs, if any, necessary to make that conversion. Liabilities that involve known or estimated amounts of money payable at unknown future dates, for example, trade payables or warranty obligations, generally are reported at their net settlement value, which is the nondiscounted amounts of cash, or its equivalent, expected to be paid to liquidate an obligation in the due course of business, including direct costs, if any, necessary to make that payment.

e. **Present (or discounted) value of future cash flows**.

Long-term receivables are reported at their present value (discounted at the implicit or historical rate), which is the present or discounted value of future cash inflows into which an asset is expected to be converted in due course of business less present values of cash outflows necessary to obtain those inflows. Long-term payables are similarly reported at their present value (discounted at the implicit or historical rate), which is the present or discounted value of future cash outflows expected to be required to satisfy the liability in due course of business.

Link: SFAC No 5

http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220132773&acceptedDisclaimer=true

Example 1. Lower-of Cost or Net Realizable Value

A company is manufacturing one product.		
	Selling Price	100
	Estimated cost of completion	20
	Estimated selling cost	10
	Cost of unfinished inventory	85
(a) Calculate net realizable value.		
(b) Calculate Loss on Inventory Write-Down		

Solution		
(a)		
	Selling Price	100
	Less: Estimated cost of completion	-20
	Less: Estimated selling cost	-10
	Net realizable value	70
Inventories should not be reported at amounts higher than their expected revenues.		
(b)		
	Cost of unfinished inventory	85.000
	Less: Estimated selling cost	-70.000
	Loss on Inventory Write-Down	**15.000**
A company should charge the loss against revenues in the period in which a loss occurs.		

2.4 Financial Statements

Financial statements include:

1. income statement,
2. statement of retained earnings,
3. balance sheet,
4. cash flow statement.

Financial statements will be discussed in the following lectures.

2.5 Auditor's Report

An auditor (certified public accountant) conducts an independent examination of the accounting information provided by a company and issues an auditor's report. The responsibility for the preparation of financial statements rests with management of the company. The auditors have the responsibility to express an opinion on financial statements based on the audit.

Audit opinions are classified as follows:

1. Unqualified (clean) opinion. It states the financial statements present fairly, in all material aspects, the financial position, results of operation, and cash flows of the entity, in conformity with generally accepted accounting principles.
2. Qualified opinion. It states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material aspects, the financial position, results of operation, and cash flows of the entity, in conformity with generally accepted accounting principles.
3. Adverse opinion. It states that the financial statements do not present fairly the financial position, results of operation, and cash flows of the entity, in conformity with generally accepted accounting principles.
4. Disclaimer of opinion. It states that the auditor does not express an opinion on the financial statements.

Task 2

1. Go to the SEC site
http://www.sec.gov/
2. Under Filings, click on "Company Filings Search".
3. Under "Fast Search" enter a code of a company chosen in Task 1.

If You choose a company name You may encounter search problems because a company may have subsidiaries with very similar names.
So the best idea is to choose ticker symbol or CIK (Central Index Key, for a Coca Cola Co CIK is 21344).
During my lectures I will analyze Coca Cola Company. I'm choosing KO.

4. Find the latest Annual report and click "Interactive Data".
5. Click "View Excel Document". Save a Financial_Report.xlsx on a disk. This file will be used in a financial analysis.
6. Look at spreadsheets and compare with a financial company report found in Task 1.