

Chapter 5



Communicating and Interpreting Accounting Information

Players in the Accounting Communication Process

Management
Preparation
CFO, CEO, Accounting Staff
Guided by GAAP



Independent Auditors
Verification
Partners, Managers, Staff
Guided by GAAS



An **unqualified** opinion states that the financial statements are fair presentations in all material respects in conformity with GAAP.

Players in the Accounting Communication Process

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Preparation
CFO, CEO, Accounting Staff
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Independent Auditors
Verification
Partners, Managers, Staff
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Information Intermediaries
Analysis and Advice
Financial analysis,
Information services

**Financial analysts
make predictions
concerning
companies' future
earnings and stock
prices.**



Players in the Accounting Communication Process

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Information Intermediaries
Analysis and Advice
Financial analysis,
Information services

Government Regulators
Verification
SEC
Guided by SEC regs.

Users
Analysis and Decision
Investors, Lenders, etc.

Public
companies only

Guiding Principles for Communicating Useful Information

Primary Objective of External Financial Reporting

To provide

The full-disclosure principle requires

ers for

Rele

(a) a complete set of financial statements

Value

and

e

(b) notes to the financial statements.

Consistency: Over time

The Disclosure Process

Press Releases are used to announce quarterly and annual earnings as soon as the verified figures are available.

Real World Excerpt

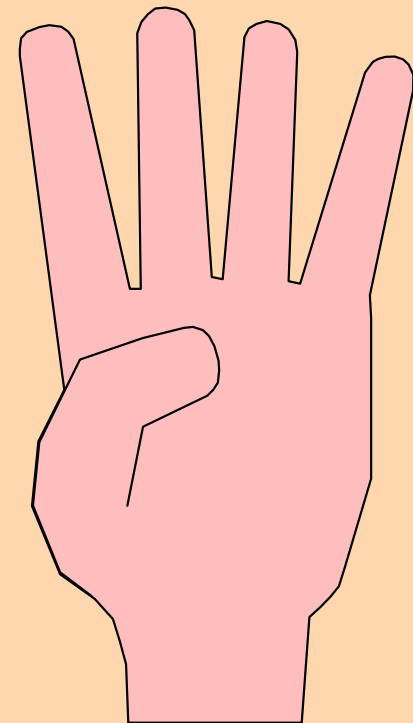
The San Diego Union-Tribune, January 30, 1998

Shareholders disappointed by Callaway Golf's lower-than-expected earnings whacked the stock yesterday, sending the price about 10 percent lower in a sell-off triggered by the company's first financial bogey. . . .

Annual Reports

For **privately** held companies, annual reports are simple documents that include:

- **Four basic financial statements**
- **Related footnotes**
- **Report of independent accountants (auditor's opinion)**



Annual Reports

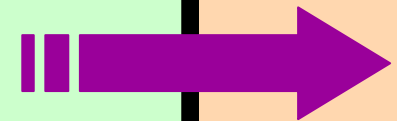
For **public** companies, annual reports are more elaborate with greater SEC requirements:

- **A Nonfinancial Section**

A letter to the stockholders, a description of management's philosophy, products, successes, etc.

- **A Financial Section**

See next slide for a detailed listing . . .



Annual Reports

The Financial Section of a public company's annual report includes:

- Summarized financial data
- Management Discussion and Analysis
- The four basic financial statements
- Notes
- Independent Accountant's Report

- Recent stock price information
- Summaries of the unaudited quarterly financial data
- Lists of directors and officers of the company and relevant addresses

SEC Reports

Form 10-K Annual Report

- Due within 90 days of the fiscal year-end
- Must be audited



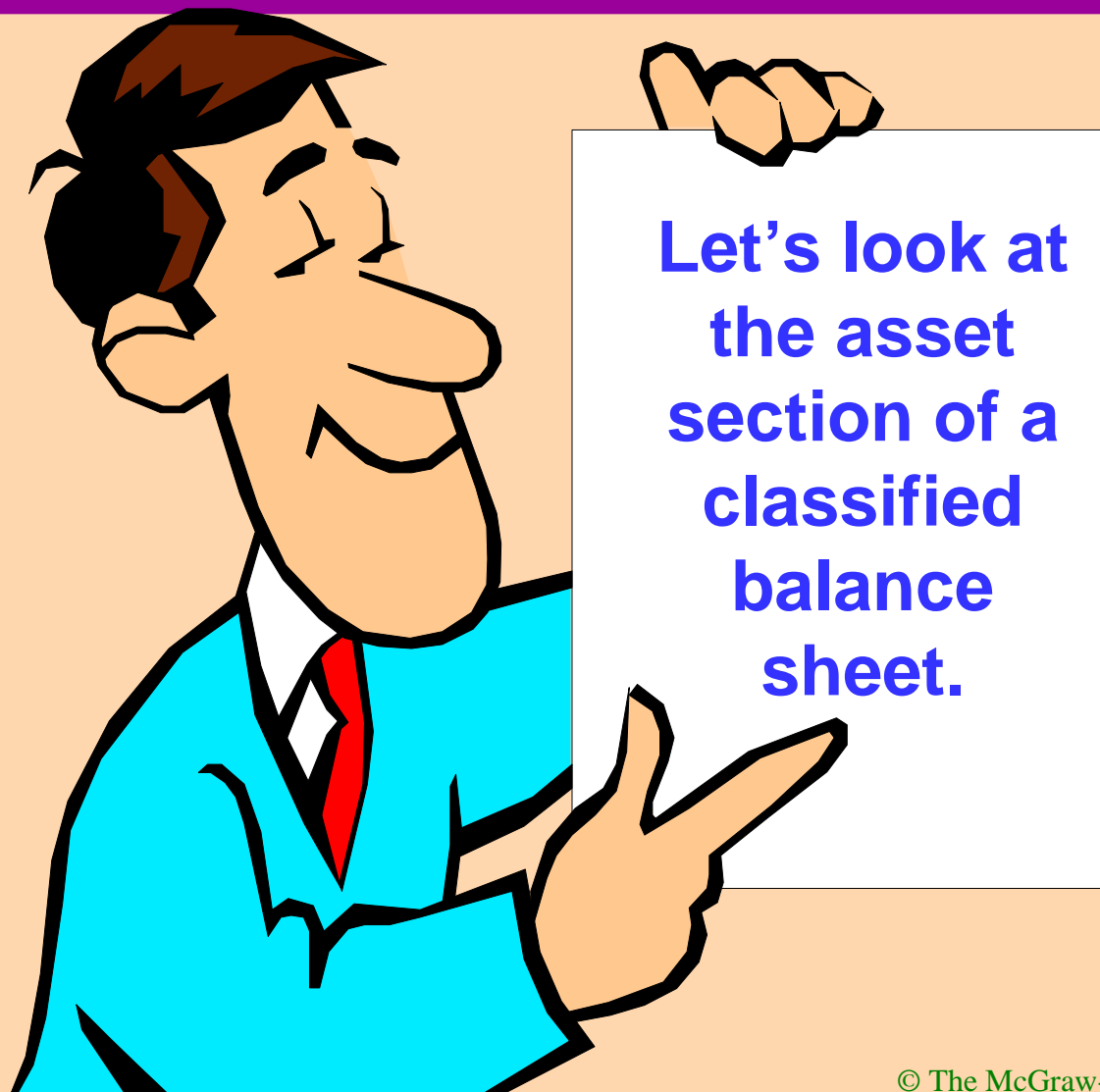
Form 10-Q Quarterly Report

- Due within 45 days of the end of the quarter
- Can be unaudited

Form 8-K Current Report

- Due within 15 days of the event date
- Can be unaudited

Financial Statement Formats



**Let's look at
the asset
section of a
classified
balance
sheet.**



Consolidated Balance Sheet

(in thousands, except share data and per share data)	December 31,	
	1997	1996
ASSETS		
Current assets:		
Cash & cash equivalents	\$ 26,204	\$ 108,457
Accounts receivable, net	124,470	74,477
Inventories, net	97,094	98,333
Deferred taxes	23,810	25,948
Other current assets	10,208	4,298
Total current assets	<u>281,786</u>	<u>311,513</u>
Property, plant and equipment, net	142,503	91,346
Intangible assets, net	112,141	4,277
Other assets	25,284	21,292
	<u>\$ 561,714</u>	<u>\$ 428,428</u>



Consolidated Balance Sheet

December 31,

(in thousands, except share data and per share data)

ASSETS

Current assets:

Cash & cash equivalents

Accounts receivable, net

Inventories, net

Deferred taxes

Other current assets

Total current assets

Property, plant and equipment, net

Intangible assets, net

Other assets

Current assets are assets that will be turned into cash or expire (be used up) within the longer of one year or the operating cycle.

25,284

21,292

\$ 561,714 \$ 428,428



Consolidated Balance Sheet

(in thousands, except share data and per share data)

ASSETS

Current assets:

Cash & cash equivalents

Accounts receivable, net

Inventories, net

Deferred taxes

Other current assets

Total current assets

Property, plant and equipment, net

Intangible assets, net

Other assets

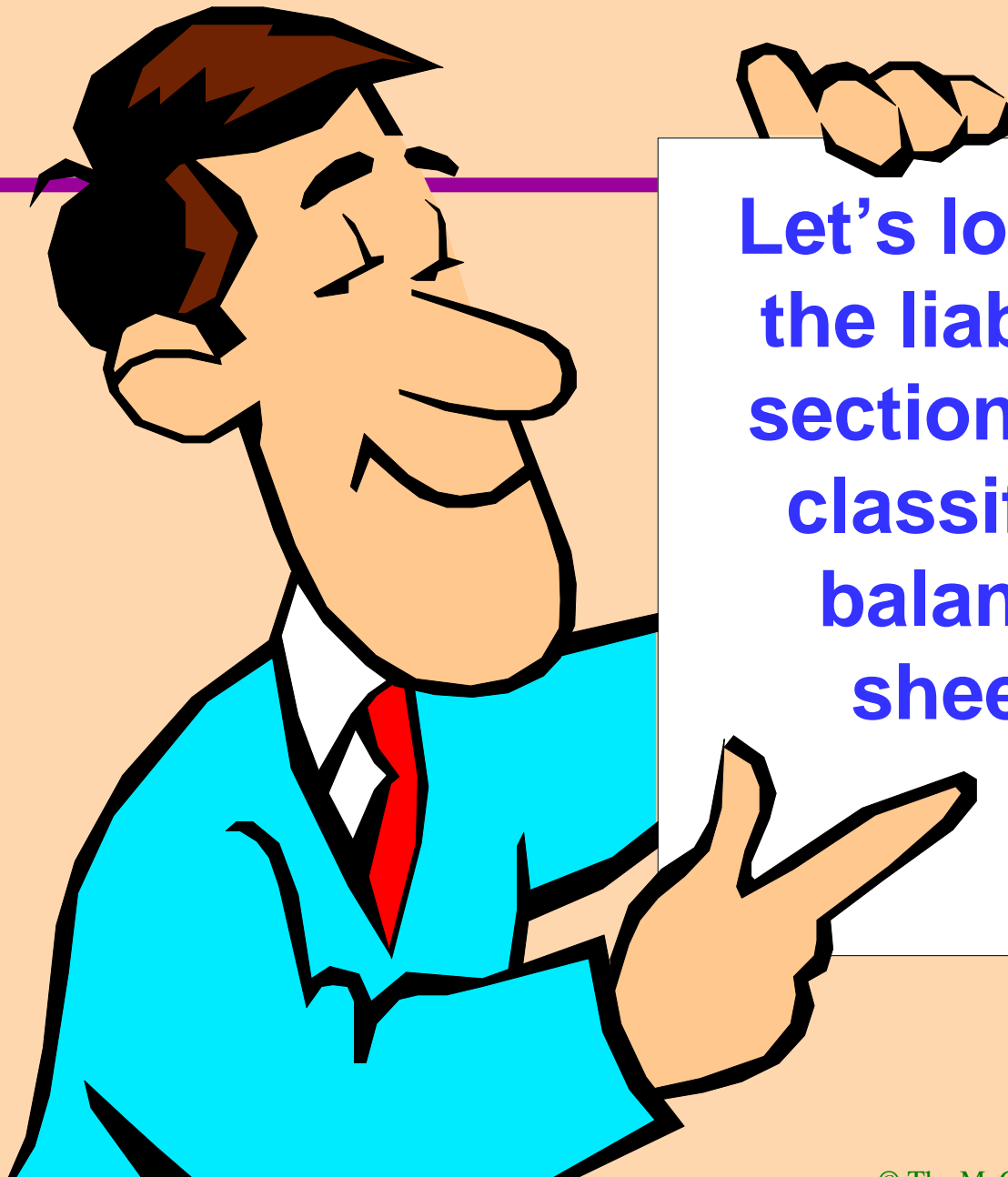
Property, plant and equipment includes assets with useful lives of more than one year acquired for use in the business rather than for resale.



Consolidated Balance Sheet

	December 31,	
(in thousands, except share data and per share data)	1997	1996
ASSETS		
Current assets:		
Cash & cash equivalents		
Accounts receivable, net		
Inventories, net		
Deferred taxes		
Other current assets		
Total current assets		
Property, plant and equipment, net		
Intangible assets, net		
Other assets		
	<u>\$ 561,714</u>	<u>\$ 428,428</u>

**Other assets
may include
intangible
assets such as
patents,
goodwill,
copyrights, etc.**



**Let's look at
the liability
section of a
classified
balance
sheet.**



Consolidated Balance Sheet

	December 31,	
(in thousands, except share data and per share data)	1997	1996
LIABILITIES & STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable & accrued expenses	\$ 30,063	\$ 14,996
Accrued employee compensation & benefits	14,262	16,195
Accrued warranty expense	28,059	27,303
Income taxes payable		2,558
Total current liabilities	<u>72,384</u>	<u>61,052</u>
Long-term liabilities (Note 7)	7,905	5,109



Consolidated Balance Sheet

December 31,

(in thousands, except share data and per share data) 1997 1996

LIABILITIES & STOCKHOLDERS' EQUITY

Current Liabilities:

Accounts payable & accrued expenses	\$ 30,063	\$ 14,996
Accrued employee compensation & benefits	14,262	16,195
Accrued warranty expense	28,059	27,303
Income taxes payable		2,558

Long-

Current liabilities are obligations that will be paid with current assets, normally within one year.



Consolidated Balance Sheet

December 31,

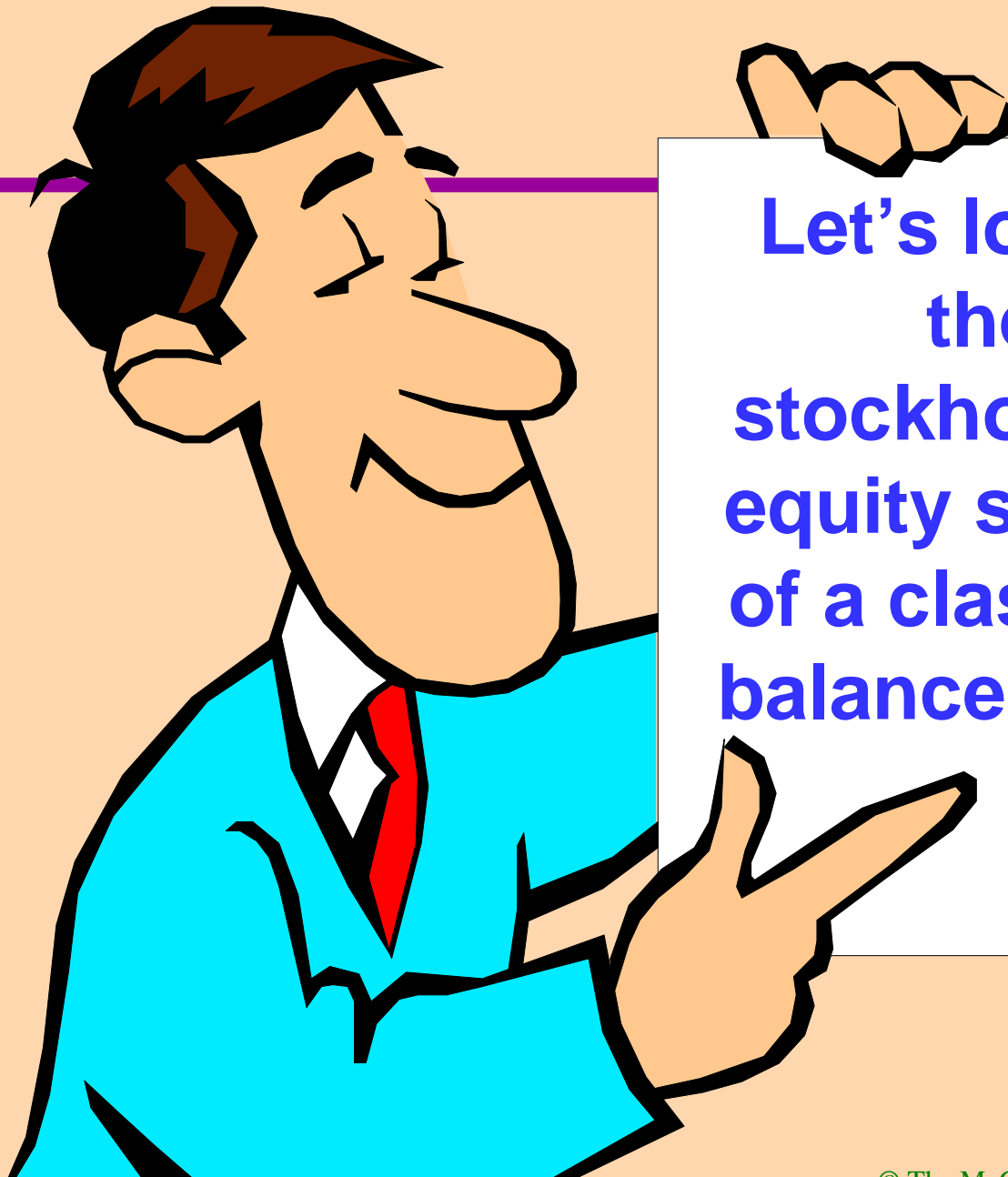
(in thousands, except share data and per share data) 1997 1996

LIABILITIES & STOCKHOLDERS' EQUITY

Current Liabilities:

Long-term liabilities are debts that have maturity dates extending beyond one year from the balance sheet date.

Long-term liabilities (Note 7)	7,905	5,109
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**Let's look at
the
stockholders'
equity section
of a classified
balance sheet.**



Consolidated Balance Sheet

Contributed capital is often shown in two separate accounts . . .

↪ **Common stock**

✦ **Paid-in capital**

Common stock, \$.01 par value, 240,000,000 shares authorized, 74,251, 664 and 72,855,222 issued and outstanding at December 31, 1997 and 1996 (Note 4)	\$	743	\$	729
Paid-in capital		182,513		123,189
Accumulated other comprehensive income		(559)		236
Retained Earnings		298,728		238,113
Total shareholders' equity		481,425		362,267
	\$	561,714	\$	428,428



Consolidated Balance Sheet

December 31,

1997

1996

(in thousands, except share data and per share data)

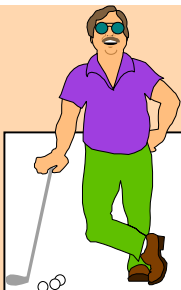
LIABILITIES & STOCKHOLDERS' EQUITY

Shareholders' equity:

Preferred Stock, \$.01 par value, 3,000,000
shares authorized, none issued and
outstanding at December 31, 1997 and
1996

**Comprehensive income includes gains
and losses not included in the
computation of net income.**

Accumulated other comprehensive income	(559)	236
Retained Earnings	298,728	238,113
Total shareholders' equity	481,425	362,267
	<u>\$ 561,714</u>	<u>\$ 428,428</u>



Consolidated Balance Sheet

December 31,

1997

1996

(in thousands, except share data and per share data)

LIABILITIES & STOCKHOLDERS' EQUITY

Shareholders' equity:

Preferred Stock, \$.01 par value, 3,000,000 shares authorized, none issued and outstanding at December 31, 1997 and 1996

Common stock, \$.01 par value,

Retained earnings is the accumulated earnings of the company less the accumulated dividends declared.

Accumulated other comprehensive income	(559)	238
Retained Earnings	298,728	238,113
Total shareholders' equity	481,425	362,267
	<u>\$ 561,714</u>	<u>\$ 428,428</u>



Consolidated Balance Sheet

December 31,

1997

1996

(in thousands, except share data and per share data)

LIABILITIES & STOCKHOLDERS' EQUITY

Shareholders' equity:

Preferred Stock, \$.01 par value, 3,000,000 shares authorized, none issued and outstanding at December 31, 1997 and 1996

Common stock, \$.01 par value, 240,000,000 shares authorized, 74,251,664 and 72,855,222 issued and outstanding at December 31, 1997 and 1996 (Note 4)

Paid-in capital

Accumulated other comprehensive income

Retained Earnings

Total shareholders' equity

	\$	743	\$	729
		182,513		123,189
		(559)		236
		298,728		238,113
		<u>481,425</u>		<u>362,267</u>
	\$	<u>561,714</u>	\$	<u>428,428</u>

Liquidity

Liquidity refers to a company's ability to meet its current maturing debts.

Tests of liquidity include:

Current Assets
- Current Liabilities

Working Capital

Current Assets
÷ Current Liabilities

Current Ratio

Debt Contracts

When companies enter into a debt contract, they often agree to specific restrictions to protect the creditors.

Examples include maintaining a specified cash balance or current ratio.



Classified Income Statement

Income statements have up to five major sections:

- **Continuing operations**
- ✦ **Discontinued operations**
- ✦ **Extraordinary items**
- ⊗ **Cumulative effect of changes in accounting methods**
- ⌘ **Earnings per share**





Consolidated Statement of Income

(in thousands, except per share data)

	1997		1996	
Net sales	\$ 842,927	100%	\$ 678,512	100%
Cost of goods sold	400,127	47%	317,353	47%
Gross profit	442,800	53%	361,159	53%
Selling expenses	120,589	14%	80,701	12%
General & Admin. expenses	70,724	8%	74,476	11%
Research and development costs	30,298	4%	16,154	2%
Litigation settlement	12,000	1%		
Income from operations	209,189	25%	189,828	28%
Interest and other income, net	4,576		5,767	
Income before income taxes	213,765	25%	195,595	29%
Provision for income taxes	81,061		73,258	
Net income	\$ 132,704	16%	\$ 122,337	18%
Earnings per common share				
Basic	\$ 1.94		\$ 1.83	
Diluted	\$ 1.85		\$ 1.73	
Common equivalent shares				
Basic	68,407		66,832	
Diluted	71,698		70,661	



Income from operations is computed by subtracting operating expenses from gross profit.

Consolidated Statement of Income

(in thousands, except per share data)

	1997		1996	
Net sales	\$ 842,927	100%	\$ 678,512	100%
Cost of goods sold	400,127	47%	317,353	47%
Gross profit	442,800	53%	361,159	53%
Selling expenses	120,589	14%	80,701	12%
General & Admin. expenses	70,724	8%	74,476	11%
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Diluted	\$ 1.85		\$ 1.73	
Common equivalent shares				
Basic	68,407		66,832	
Diluted	71,698		70,661	



**The percentages
are based on
Net sales each
year and are
used to produce
Common-sized
Income
Statements.**

Consolidated Statement of Income

(in thousands, except per share data)

	1997		1996	
Net sales	\$ 842,927	100%	\$ 678,512	100%
Cost of goods sold	400,127	47%	317,353	47%
Gross profit	442,800	53%	361,159	53%
Selling expenses	120,589	14%	80,701	12%
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Litigation settlement	12,000	1%		
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Continuing Operations

Now, let's look at two common formats for presenting the continuing operations section.

↪ Single-step

✦ Multiple-step



Single Step

(in thousands, except per share data)

	1997
Net sales	\$ 842,927
Interest income and other income, net	4,576
Total revenues	847,503
Cost of goods sold	400,127
Selling expenses	120,589
General & Administrative expenses	70,724
Research and development costs	30,298
Litigation settlement	12,000
Total expenses	633,738
Income before income taxes	213,765
Provision for income taxes	81,061
Net income	\$ 132,704

In the *single-step* format,
all revenues, income,
and gains are listed first.

Costs, expenses, and
losses were listed
second and then
subtracted from Total
revenues to get to Net
income.

Net sales are gross sales minus any discounts, returns, and allowances during the period.

Cost of goods sold is the cost of inventory sold during the period.

Selling expenses include all amounts incurred related to sales activities.

General & admin. expenses include all amounts incurred for the overall business.

The provision for income taxes represents the tax expense related to the continuing operations of the company.

Multiple Step

(in thousands, except per share data)

	1997
Net sales	\$ 842,927
Cost of goods sold	400,127
Gross Profit	442,800
Selling expenses	120,589
General & Administrative expenses	70,724
Research and development costs	30,298
Litigation settlement	12,000
Income from Operations	209,189
Interest income and other income, net	4,576
Income before income taxes	213,765
Provision for income taxes	81,061
Net Income	\$ 132,704

Classified Income Statement

Now that we have discussed the continuing operations section, let's discuss the other major sections of the income statement.



Discontinued Operations

Sale or abandonment of a segment of a business.

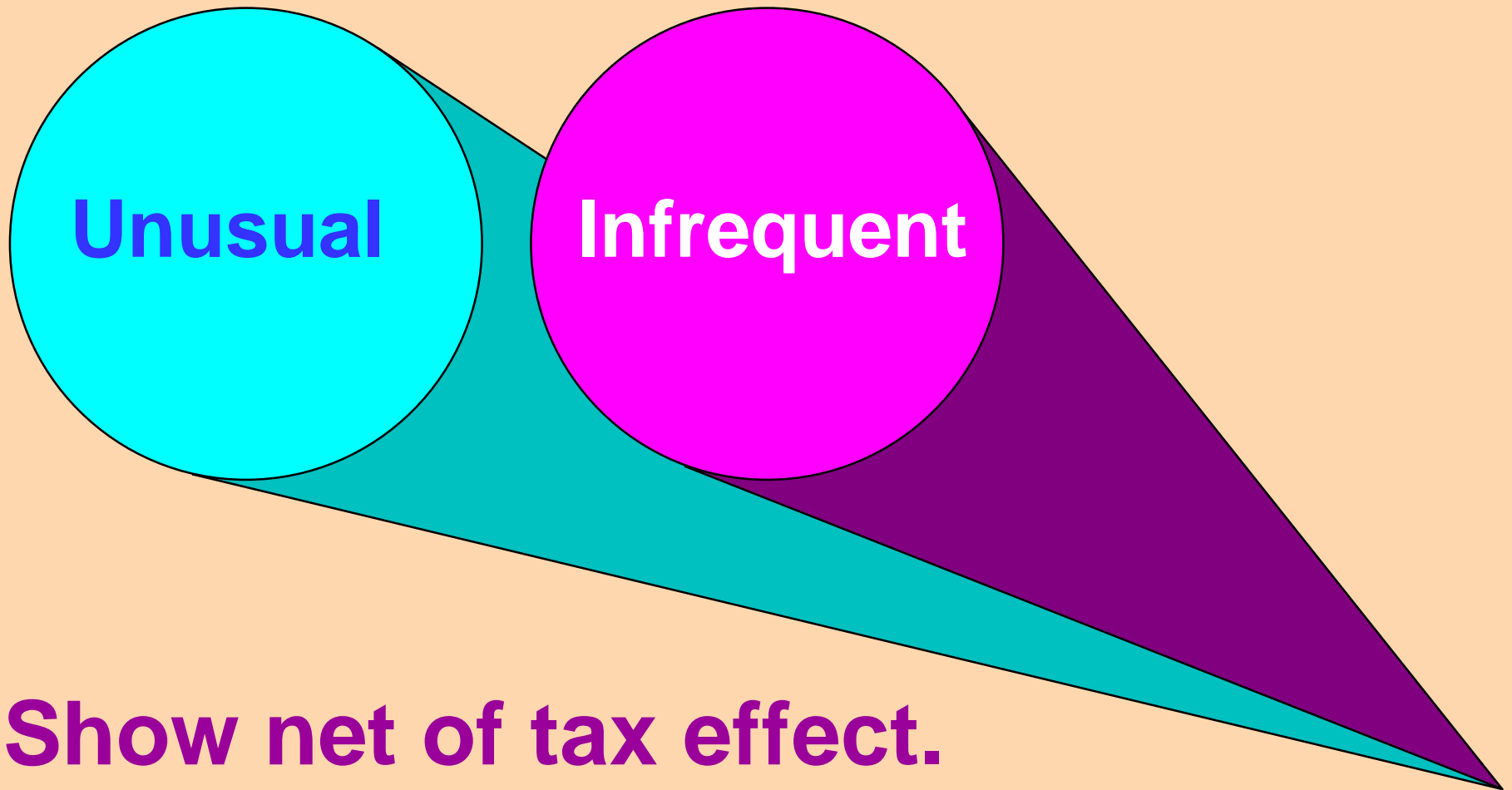
```
graph TD; A["Sale or abandonment of a segment of a business."] --> B["Income or loss on segment's operation for the period."]; A --> C["Gain or loss on disposal of the segment."];
```

Income or loss on segment's operation for the period.

Gain or loss on disposal of the segment.

Show net of tax effect.

Extraordinary Items



Show net of tax effect.

Cumulative Effect of Changes in Accounting Methods

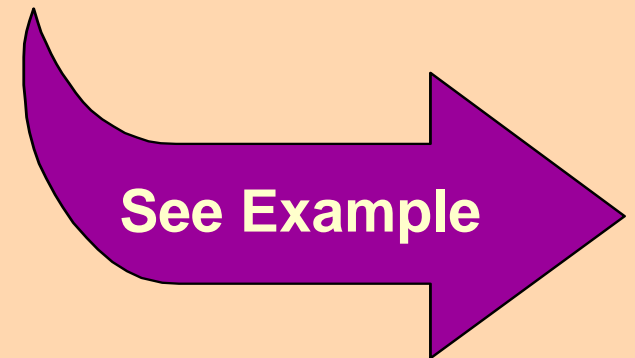


Changes must be to a preferable method and must be disclosed in notes to financial statements.

Show net of tax effect.

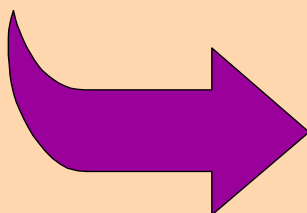
Earnings Per Share (EPS)

$$\text{EPS} = \frac{\text{Net Income Available to Common Shareholders}}{\text{Weighted Average Number of Shares Outstanding During the Reporting Period}}$$





Earnings per share



Consolidated Statement of Income

(in thousands, except per share data)

	1997		1996	
Net sales	\$ 842,927	100%	\$ 678,512	100%
Cost of goods sold	400,127	47%	317,353	47%
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Earnings per common share				
Basic	\$ 1.94		\$ 1.83	
Diluted	\$ 1.85		\$ 1.73	
Common equivalent shares				
Basic	68,407		66,832	
Diluted	71,698		70,661	

The End of Chapter 5

Maybe I should issue a
press release to disclose
my identity!

