BASIC FINANCIAL STATEMENTS

When you have mastered the numbers, you will in fact no longer be reading numbers, any more than you read words when reading books. You will be reading meanings.

–Harold Geneen, Managing, 1984

When you first see a set of financial statements for a modern organization, you might find them a bit overwhelming. They seem long and complicated. They are written in a technical vocabulary that you aren't really familiar with yet–words like "depreciation" and "amortization" and "intangible assets" and "deferred taxes" that don't have intuitively obvious definitions. And they have pages upon pages of numbers, followed by pages and pages of footnotes. What does it all mean?

One of the reasons you are learning about *Core Concepts of Accounting Information* is to help you understand more about the information you can find in financial statements. You shouldn't expect to become a sophisticated reader of financial statements overnight, but you can expect to gain a basic understanding of the purpose and formats of financial statements fairly quickly. Then, as you continue your education about accounting, you will come to understand more and more about financial statements. The words and numbers will cease being just words and numbers and become meaningful accounting information that you can use to make decisions.

In the sections below, we'll take a look at the financial statements of 2 businesses (Colgate-Palmolive Company and Hongkong Telecom), and a not-for-profit organization (The American Institute of Certified Public Accountants). Before we proceed, here's a little background about these 3 entities:

- **Colgate-Palmolive.** Colgate-Palmolive's common and preferred stock is traded on the New York Stock Exchange, as well as on exchanges in Amsterdam, Frankfurt, London, Paris, and Zurich. The company employs about 38,000 people to conduct its business around the world.

  The company began in 1806 when 23-year-old William Colgate opened a "Soap, Mould & Dipt Candles" factory and store about 2 blocks from where New York's World Trade Center building stands today. By 1906, the company was making 160 kinds of soap, 625 perfumes and 2,000 other products (including toothcare products). In 1928, the company merged with the Palmolive-Peet Company, manufacturer of a best-selling soap made of palm and olive oil, forming Colgate-Palmolive-Peet Company (shortened to Colgate-Palmolive in 1953).

  Today, Colgate-Palmolive has 2 major lines of business. The first is oral, personal, and household care products–such as Colgate toothpaste, Mennen deodorant sticks, and Ajax cleanser. The company also produces pet nuitrition products, such as Science Diet and Prescription Diet pet foods.

- <u>**Hongkong Telecom.**</u> Hong Kong Telecommunications Limited's stock is traded on the Hong Kong Stock Exchange. The company, popularly known as Hongkong Telecom, is also listed on both the New York and Pacific Stock Exchanges as **American Depository Receipts** or "**ADRs**" (negotiable receipts that are traded in lieu of the actual foreign securities to avoid some of the complications of transferring certificates overseas, converting currencies, and so on). The company's largest major shareholders are Cable and Wireless (a U.K. telecommunications company) and the Chinese government.

  Hongkong Telecom employs about 14,000 people. Most of its operations are in Hong Kong, where its subsidiaries provide local and international telephone services, sell and rent telecommunications equipment, and provide computer, engineering and other services to customers.

- <u>**AICPA.**</u> The American Institute of Certified Public Accountants (AICPA) is a national professional organization for certified public accountants (CPAs). At the start of 1999, about 332,000 CPAs belonged to the organization. About 40% of the members work in public accounting firms, about 44% work in business and industry, and the rest work in education or government, or are retired.

  As a nonprofit organization, the AICPA has different goals than either Colgate-Palmolive or Hongkong Telecom. In addition to serving members, the AICPA recognizes a mission of assuring that CPAs serve the public interest by performing the highest quality professional services. Among its programs, the AICPA prepares and administers the Uniform CPA Examination, a national test used as one of the requirements for licensing in all the states of the U.S. The organization also provides continuing education courses for its members (and others) and represents members' interests on national issues by such activities as testifying before Congress on legislation affecting CPAs.

To begin your study of financial statements, it helps to remember that the basic set of statements is designed to provide information to help answer 4 questions:

- What are the results of the organization's operations (or its activities, for not-for-profit organizations) for a particular period?
- How have the retained earnings (or stockholders' equity or, for nonprofits, net assets) changed over a particular period?
- What is the financial position of the organization at a particular date?
- What were the organization's sources and uses of cash over a particular period?

The following 4 sections explore how financial statements help answer these questions.

Results of Operations or Activities

Suppose you are an owner or creditor of an organization. You would like to know what the results of recent operations have been--Is the organization operating at a profit or loss? Are the organization's costs in line with the revenues it brings in? Are one or more segments of the organization more successful than others? How much of the income comes from operating activities that are expected to continue into the future? Answers to these questions may be found in a **statement of operations**, also variously known as an **income statement**, an **earnings statement**, or a **profit and loss statement** (sometimes referred to as "the **P&L**"). Constituents of a nonprofit organization can find information about operations in a **statement of activities**.

Take a close look at Figure I-3-7 on the next page, where you will find a statement showing the recent results of operations of Colgate-Palmolive Company. As you begin to learn how to read financial statements, there are 4 important things (discussed further below) to note about Colgate-Palmolive's income statements:

- they are consolidated,
- they are comparative,
- they follow a basic format for computing net income, and
- they include a measure of earnings per share.

<u>Consolidated Statements.</u> The title of the statement is "Consolidated Statements of Income." The word "consolidated" refers to the fact that the results for all of Colgate-Palmolive's subsidiary companies (such as Hills Pet Nutrition) are combined. Thus, the 1998 reported net sales revenues of $9 billion ($8,971.6 million per the top line of the statement) mix together sales of its Softsoap Enterprises, Inc. business in the United States, its Oraltech oral care products business in the British Virgin Islands, its Mennen Company shaving products in the United States, its Cristasol glass cleaners business in Spain, and so on. **Consolidated statements** present accounting information about a related group of legally separate companies (usually referred to as a **parent company** and its **subsidiaries**) that operate as a single economic entity. The parent company is the controlling company; the subsidiaries are the controlled companies.

Given the amount of information aggregated together in consolidated financial statements, investors and creditors might well be interested in a further breakdown of the information. So, for U.S. companies, operating information for each major segment of the business is disclosed elsewhere in the financial report--usually in the management discussion and analysis section, the footnotes, or a separate schedule.

Figure I-3-7

Consolidated Statements of Income

COLGATE-PALMOLIVE COMPANY

Dollars in Millions Except Per Share Amounts	1998	1997	1996
Net sales	**$8,971.6**	$9,056.7	$8,749.0
Cost of sales	**4,290.3**	4,461.5	4,451.1
Gross profit	**4,681.3**	4,595.2	4,297.9
Selling, general and administrative expenses	**3,197.1**	3,237.0	3,052.1
Other expenses, net	**61.2**	72.4	93.8
Interest expense, net	**172.9**	183.5	197.4
Income before income taxes	**1,250.1**	1,102.3	954.6
Provision for income taxes	**401.5**	361.9	319.6
Net income	**$ 848.6**	$ 740.4	$ 635.0
Earnings per common share, basic	**$ 2.81**	$ 2.44	$ 2.09
Earnings per common share, diluted	**$ 2.61**	$ 2.27	$ 1.96

According to U.S. and international accounting standards, companies must disclose key financial information about the **segments** of their business–that is, the major operating components for which separate accounting information is produced for management decision-making. Businesses may define their segments in several ways–for example, by industry, by geographic area or by major customer groups. Colgate-Palmolive defines its segments by both industry and geography. By industry, the company categorizes its many products into 2 segments:

- *oral, personal and household care products*, which covers toothpaste and toothbrushes, bar and liquid soaps, shampoos and conditioners, deodorants and antiperspirants, baby products, shaving products, laundry and dishwashing detergents, fabric softeners, and cleansers and bleaches; and
- *pet nutrition products*, which includes pet food products sold primarily to veterinarians and specialty pet retailers.

By geographic region, the company further categorizes each of the industry segments into 4 areas: North America, Europe, Latin America, and Asia /Africa. Here, for example, is some of the accounting information about Colgate-Palmolive's 2 industry segments and 4 regions:

Worldwide Net Sales and Earnings by Business Segment and Geographic Region	**1998**	1997	1996
Worldwide Net Sales:			
Oral, Personal and Household Care			
North American (1)	$ **2,047.5**	$ 1,992.5	$ 1,869.0
Latin America	**2,407.9**	2,363.8	2,124.8
Europe	**2,067.7**	2,078.8	2,173.4
Asia/Africa	**1,452.6**	1,656.3	1,713.1
Total Oral, Personal and Household Care	$ **7,975.7**	$ 8,091.4	$ 7,880.3
Total Pet Nutrition (2)	**995.9**	965.3	868.7
Total Net Sales	$ **8,971.6**	$ 9,056.7	$ 8,749.0
Worldwide Earnings:			
Oral, Personal and Household Care			
North American	$ **395.5**	$ 312.6	$ 258.2
Latin America	**502.0**	483.0	410.7
Europe	**317.5**	283.5	280.7
Asia/Africa	**158.6**	178.3	215.3
Total Oral, Personal and Household Care	**1,373.6**	1,257.4	1,164.9
Total Pet Nutrition	**173.8**	162.5	127.3
Corporate	**(124.4)**	(134.1)	(140.2)
Earnings Before Interest and Taxes	**1,423.0**	1,285.8	1,152.0
Interest Expense, Net	**(172.9)**	(183.5)	(197.4)
Income Before Income Taxes	$ **1,250.1**	$ 1,102.3	$ 954.6

[1] Sales in the United States for Oral, Personal and Household Care were $1,799.6, $1,756.1 and $1,610.4 in 1998, 1997 and 1996, respectively.

[2] Sales in the United States for Pet Nutrition were $688.6, $689.4 and $630.1 in 1998, 1997 and 1996, respectively.

From the segment information, you can easily see that the pet nutrition business is far smaller than the oral, personal and household care business. You can also make performance comparisons such as:

Q: What is the worldwide segment profit margin (segment earnings as a percentage of sales) for the industry groups for the years reported?

A: *Oral, Personal and Household Care*
1996: $1,164.9 million ÷ $7,880.3 million = 14.8%
1997: $1,257.4 million ÷ $8,091.4 million = 15.5%
1998: $1,373.6 million ÷ $7,975.7 million = 17.2%

Pet Nutrition and Other
1996: $127.3 million ÷ $868.7 million = 14.7%
1997: $162.5 million ÷ $965.3 million = 16.8%
1998: $173.8 million ÷ $995.9 million = 17.5%

From this comparison, you can see that profitability per dollar of sales of pet nutrition products is as good or a bit better than profitability on oral, personal and household care products–something you might not realize if you just looked at total sales. Further analysis of the geographic region disclosures in the annual report would reveal other interesting information, such as the fact that growth rates differ by region.

To assess relative profitability, you needed to perform some simple **ratio** calculations (that is, one number divided by another). Ratios are often used to aid the interpretation of financial statement information because they are "scale free"–that is, they allow comparisons over different time periods, companies of different sizes, and values measured in different currencies. Ratios are one of the primary tools of financial statement analysis, a topic explored further in Theme II.

Comparative Statements. The results of operations are presented for several periods (in this case, for 3 years)--this is known as presenting "**comparative financial statements**." Comparative financial statements give the user information about trends, providing another form of financial statement analysis. Comparative statements increase the understandability of accounting information by providing historical benchmarks to use in evaluating the current results.

But while the ratios and trends computed from a single set of financial statements can be helpful, they still do not give you a complete picture. To fully interpret the ratios and trends, you need to put them into a broader context. How, for example, has the organization performed in relation to other organizations in the same industry?

External benchmarks--such as performance averages for comparable companies or an industry group–help the user understand the accounting information contained in an organization's financial statements. Performance information about comparable companies can be obtained from other companies' financial statements. There are several computerized databases that provide financial statement information about public companies and a few services that sell information about private companies.

Bear in mind, however, the old warning not to compare "apples and oranges"--in other words, be sure you are using benchmarks for truly similar companies or industry groups. With large companies like Colgate-Palmolive that operate in several lines of business, you're not likely to find truly comparable companies to use as benchmarks for *consolidated* operating results. However, you could find good comparisons for each *segment* of Colgate-Palmolive's business. For example, you could compare the trend for Colgate-Palmolive's pet nutrition segment to the pet nutrition segment of the Ralston Purina Company, the manufacturer of Purina Dog Chow, Tender Vittles cat food, and other pet nutrition products. Or, you might compare the results of the pet nutrition segment to industry averages for all leading companies that make and market pet nutrition products.

When choosing comparison company and industry group benchmarks, you also need to keep the "apples and oranges" problem in mind. Since Colgate-Palmolive is a market leader in pet nutrition, the industry performance averages for large companies might be a more meaningful benchmark than the performance averages for the entire industry. Published industry averages usually include a range of norms. For example, Dun and Bradstreet reports industry ratios for the upper and lower quartiles (top and bottom 25%) of the industry, as well as the median for each industry group.

You should also bear in mind that ratios and trends tell you what has happened in the past, which may or may not reflect what will happen in the future. To interpret ratios and trends, you also need information about economic and industry conditions which may affect future performance. Is the economy stable, improving, or declining? Is the industry becoming more competitive or less competitive? You also need information about the organization's future plans. Is the organization planning to expand or contract? Are there any expected changes (such as retirements) in the top management group? Finally, you need to consider whether anything that happened in recent years is unlikely to occur again in the future.

Format of the Statement. Look back again at Figure I-3-7 and you will see that the basic format of Colgate-Palmolive's income statement is:

Net sales
− Cost of sales
Gross profit
− Other operating
Income *before* income
− Income taxes
Net income

Be aware, however, that there are many acceptable variations of the general format of the income statement. For example, companies need not use the identical expense categories and they need not compute the sub-total known as gross profit. There are also multiple terms for some of these items. For instance, cost of sales may also be termed cost of goods sold, and gross profit may also be termed gross margin. But if you look beyond these superficial differences, you will find that the underlying structure of most income statements is much like the one used by Colgate-Palmolive.

As another format variation, a company may separately report **operating** revenues and expenses related to main business activities and **non-operating** results from transactions that are peripheral or incidental to the company's main business activities. For instance, many manufacturing companies report interest received on investments as *non-operating* income because investing isn't their main business activity.

Also, the income statement format will vary if some activities or events of the current period are not expected to continue in the future. In this case, the statement first shows a computation of "income from continuing operations" (which includes deducting taxes related to this income) and then reports the other non-continuing items. These items include any income or loss from **discontinued operations** (such as a subsidiary that was sold during the period) or **extraordinary items** (gains or losses that are both unusual and infrequent, such as a major casualty loss).

Finally, the format may vary if there have been changes in accounting policies. Generally accepted accounting principles are not static. From time to time, the rules of the game may change as new accounting standards are published. Also, even if accounting standards haven't changed, sometimes a company will voluntarily choose to use a different accounting policy from among the set of policies allowed. In either case, there is the potential that net income will be affected in the year of the change.

Whatever its exact form, a business's income statement always ends in a "**bottom line**"–the "**net income or loss.**" The term "net," which Herbert Casson once called "the biggest word in the language of business," comes to us from a Middle English word which meant "trim" or "clean." In accounting, "net" means the number being reported has been trimmed or cleaned of everything but its essentials. Thus, **net income** means income after all revenues, expenses, gains, losses and taxes have been considered. "**Net sales**" means the sales revenue after deducting **sales returns** (refunds for products brought back by customers), **discounts and allowances** (price reductions given to encourage prompt payment or satisfy customer complaints). In contrast, "**gross sales**" means sales revenue *before* adjustments for returns, discounts or allowances.

As you might expect for a major manufacturer, among Colgate-Palmolive's costs and expenses, the largest is its **cost of sales,** also known as **cost of goods sold**. This is the cost of manufacturing the products the company sold to customers. As an intermediate step in calculating net income, Colgate-Palmolive shows a subtotal, known as the as **gross margin** or **gross profit**. The gross profit shows how much the selling price of goods exceeded their cost, and thus how much the sales contributed toward covering the other expenses of the company.

When it comes to other operating costs and expenses, Colgate-Palmolive spent the most on **selling, general and administrative expenses. Selling expenses** are the costs of selling or marketing an organization's products or services–such as advertising costs and sales commissions. **General and administrative expenses** are the costs of operating the overall organization, including the salaries of top management and their clerical staff and other costs of running the corporate headquarters.

Details about major categories of costs and expenses (or any of the other significant items reported in the financial statements) may be found in the footnotes which are attached to any set of financial statements. In the footnotes to Colgate-Palmolive's statements, for example, you could find that the company spent $592.2 million during 1998 for media advertising costs.

Earnings Per Share. Below the bottom line, the statement also includes 2 figures reporting different measures of "Earnings per common share," otherwise known as **earnings per share (EPS)**. Earnings per share is a ratio that is an important measure of performance for owners of common stock. The ratio reflects the amount of net income attributable to each share of common stock. In its simplest form, known as "basic" earnings per share, EPS is computed as follows:

$$\textbf{Basic EPS} = \frac{\textbf{Net Income - Preferred Stock Dividends}}{\textbf{Weighted Average Number of Shares of Common Stock Outstanding}}$$

Take a look at Colgate-Palmolive's basic EPS and you will see that it increased each year from 1996 to 1998. Colgate-Palmolive also shows a second EPS measure, labeled "diluted." Diluted EPS reflects the possibility that a common stockholder's proportionate share of ownership in the company could be reduced (diluted) in the future. Note that Colgate-Palmolive's diluted EPS is always lower than basic EPS.

In companies with complex capital structures, there may be some outstanding financial instruments–such as stock options, rights or warrants–which give holders the right to purchase a specific number of shares of common stock at a set price and time in the future. Some debt or preferred stock that is "convertible" may also be turned into common stock in the future. *If* these changes occur, the current owners will end up with a smaller proportionate ownership share in the company. **Diluted EPS** shows the earnings per common share that would result if every possible convertible security, option, right, warrant or other potential diluter were turned into common stock.

In Colgate-Palmolive's case, the company has a significant amount of preferred stock which is convertible into common stock, so it must compute and disclose *both* EPS numbers. While you need not concern yourself at this stage with the calculation of these 2 EPS figures, you should understand the different information they convey. Basic earnings per share shows the situation with the capital structure as it existed at the balance sheet date. Diluted earnings per share reflects a worst-case scenario from a common shareholder's point of view. It shows the earnings per share that a current common shareholder would have if every possible dilution occurred.

Other Examples of Operating Statements: The AICPA. Now that you have had a chance to read one company's income statement, it is time to take a look at how other organizations' operating statements appear. Read the **Statement of Activities** of the American Institute of Certified Public Accountants (in Figure I-3-8 on the following page) and see if you can find at least 3 similarities and 3 differences between the AICPA's statements of activities and Colgate-Palmolive's income statements.

You should have spotted several similarities, including:

- **Consolidated statements**: Like Colgate-Palmolive, the AICPA reports the results for a related group of organizations that operate as a single economic entity. The "*Combined* Statements of Activities" include the revenues and expenses of the national professional organization (the AICPA) and 4 related organizations, including the AICPA Benevolent Fund (an organization that provides financial assistance to needy AICPA members and their families) and the Accounting Research Association (an organization that raises money to support financial and government accounting standard-setting).
- **Comparative statements**: Both organizations report several years of results so readers can compare operating performance over time.
- **Basic format**: The basic format of revenue (and gains) less expenses (and losses) is similar, although not identical, for the two organizations.

However, you should also have spotted some important differences, including:

- **A service-orientation, rather than a profit orientation:** The users of a business's income statement are focused on whether or not the company made a profit during the year. To a business, more earnings are always preferable to less; the business's goal is to maximize profit. But a nonprofit organization isn't trying to maximize profit; it has a service objective, rather than a profit objective. In a sense, the target a nonprofit organization usually shoots for is to have a "bottom line" that is close to *zero*--that is, the organization strives to generate enough revenues to cover operating expenses. The users of a nonprofit's statement of activities want to know whether the organization has been able to operate within its available resources.

Figure I-3-8

American Institute of Certified Public Accountants and Related Organizations

Combined Statements of Activities
Year Ended July 31

	1998	1997
	($000)	
Changes in unrestricted net assets:		
Operating revenue:		
Dues	**$ 57,338**	$ 55,851
Publications and software	**38,457**	37,276
Professional development and member service conferences	**25,474**	24,572
Investment and sundry income	**11,541**	10,704
Professional examinations	**8,879**	8,587
Contributions	**1,635**	1,546
Total operating revenue	**143,324**	138,536
Operating expenses:		
Program services:		
Publications and software produced for sale	**23,970**	24,630
Professional development and member service conferences	**24,342**	24,136
Member services:		
Regulation and legislation	**14,210**	13,510
Technical	**14,707**	11,956
Publications	**6,550**	6,283
Other	**9,030**	6,881
Professional examinations	**8,952**	8,344
Communications and public relations	**6,479**	6,386
Support and scholarships	**5,914**	5,957
Assistance programs	**1,167**	1,159
Supporting activities:		
General management	**16,985**	16,059
Organization and membership development	**8,658**	6,753
Technology	**4,650**	2,934
Total operating expenses	**145,614**	134,988
Excess of operating revenue over expenses (expenses over revenue)	**(2,290)**	3,548
Gains (losses) on marketable securities:		
Realized	**11,092**	3,758
Unrealized	**(6,707)**	7,274
Totals	**4,385**	11,032
Increase in unrestricted net assets	**2,095**	14,580
Unrestricted net assets, beginning of year	**45,408**	30,828
Unrestricted net assets, end of year	**$ 47,503**	$ 45,408

The accompanying notes to financial statements are an integral part of these statements.

For a nonprofit, any "**surplus**" from operations (an excess of revenue over expenditures–as the AICPA had in 1997) may be used to provide a cushion for the future. But, beyond a certain point, too large a surplus is not considered optimum. The organization's constituencies might question why the organization is accumulating funds in excess of its needs, or why it isn't finding a way to make more effective use of its funds. For example, AICPA members might regard too large a surplus as a sign that the organization doesn't really "need" their membership dues.

On the other hand, a "**deficit**" from operations (meaning expenditures exceed revenue–as the AICPA had in 1998) usually has the same interpretation for a nonprofit organization as for a business organization. The larger the deficit, the greater the signs of financial difficulty.

Notice that the AICPA doesn't present an earnings per share figure because nonprofit (and government) entities have no shareholders. In fact, the term "net income" isn't even used, reflecting the fact that the AICPA's goals aren't primarily focused on making profits. Instead, the "bottom line" of the activities statement, which a business would term "income," is instead labeled "**increase in unrestricted net assets.**"

- **The possibility of donor-imposed restrictions:** In the AICPA's case, the bottom line each year was an increase in "unrestricted net assets." The term "**unrestricted**" indicates that the AICPA's management team is free to use the fund balance on whatever projects or activities the management team chooses. In addition to unrestricted funds, many nonprofit organizations have some **restricted** funds–that is, funds which may only be used for a specified purpose. For example, suppose some donors to a college specify that their donations are to be used for scholarships. The college is not free to use the scholarship fund balance for any other purpose. Restrictions on funds may be temporary (after a period of time, the restriction is removed) or permanent. When a nonprofit organization has several types of funds, its financial reports show details for each type of net assets (permanently restricted, temporarily restricted, and unrestricted), as well as a total for the organization as a whole.

- **Different revenue and expense classifications:** The AICPA presents a statement with the simple format:

(Revenue — Expenses) + (Gains — Lossses) = Increase in unrestricted net assets

While the basic format of the income statements and activities statements are similar for Colgate-Palmolive and the AICPA, there are some key differences. For instance, the AICPA's statement has no intermediate calculation of gross profit as in Colgate-Palmolive's multi-step income statement. This, of course, is because gross profit is not relevant for a nonprofit organization. The categories of revenue and expenses on the statements also differ because the nature of the organizations differ.

Take a close look at the revenue classifications. Colgate-Palmolive is a business; it gets its revenue exclusively from sales to customers. The AICPA is a not-for-profit organization that gets its revenue from several sources, including membership dues, sales to customers (publications and software), fees for the CPA exam, and contributions from donors.

Now take a look at the expense classifications. Remember that for Colgate-Palmolive's income statement, details were available in the footnotes about *what* kind of expenses were incurred for operations. For example, the reader could find out how much the company had spent on advertising during the year. Accountants call this "**natural classification**" of expenses because the categories tell you the nature of what was bought.

On the other hand, the AICPA's statement does not tell readers *what* expenses were incurred for operations–for example, it doesn't tell the reader how much was spent on things like salaries, advertising, or printing costs. Instead, the expenses are classified by *activity*–such as member service activities, professional examinations, assistance programs, and so on–which tells us *why* the expenses were incurred. Accountants call this "**functional classification**" of expenses because the categories tell you why funds were expended. The "why" information is particularly relevant to constituents of nonprofit organizations; this information helps constituents assess how the organization used its available resources to provide services during the year.

Accounting standards require all nonprofit organizations to report expenses by functional classification. Nonprofits may also disclose information about the natural classification of expenses, but only voluntary health and welfare organizations are required to do so. For these organizations (commonly referred to as "charities"), financial statement users do care about *why* expenses were incurred, but also want some information about *what* the funds were spent on--for example, they are interested in how much of the donated funds were spent on administrators' salaries.

Other Examples of Operating Statements: Hongkong Telecom. Next, try comparing Colgate-Palmolive's income statement to the way Hongkong Telecom reports its operating results, which you can see in Figure I-3-9 on the next page. Hongkong Telecom's "Consolidated Profit and Loss Account" statement has some similarities and some differences with the income statement of Colgate-Palmolive. In terms of similarities, note that Hongkong Telecom also presents consolidated comparative results and includes an earnings per share figure. In terms of differences, there are a few important format and terminology variations, as well as a difference in reporting period.

Figure I-3-9

Hong Kong Telecommunications Limited's Income Statement

Consolidated profit and loss *account*

For the year ended 31 March 1998

Note		1998 $M	1997 $M
3	**Turnover**	**35,041.0**	32,577.8
4	Operating costs	**21,790.5**	20,375.0
	Operating profit	**13,250.5**	12,202.8
7	Exceptional items	**4,558.0**	–
	Profit on ordinary activities before net interest and other income	**17,808.5**	12,202.8
8	Net interest and other income	**1,064.4**	706.1
	Profit on ordinary activities before taxation	**18,872.9**	12,908.9
9	Taxation	**1,808.2**	1,690.4
	Profit on ordinary activities after taxation	**17,064.7**	11,218.5
	Minority interests	**37.2**	40.8
10	**Profit attributable to shareholders**	**17,027.5**	11,177.7
	Appropriations		
11	Dividends	**10,137.9**	8,855.4
21	**Retained profit for the year**	**6,889.6**	2,322.3
12	**Earnings per share**	**143.8¢**	97.2¢
12	**Earnings per share before exceptional items**	**105.3¢**	97.2¢

Terminology Differences. You should note a few terminology differences between the U.S. and Hongkong systems. In particular, the term "**Turnover**" in the Hongkong system means the same thing as "**Sales Revenue**" in the U.S. This specific terminology difference, which extends to many other countries as well, can be especially confusing because the term "turnover" is used in the U.S. to mean the frequency with which an item is replaced during an accounting period. Thus, if a U.S. company reports an **inventory turnover** of 6.0, it means that the inventory is replaced an average of 6 times per year (once every 2 months). So, with international companies, you need to interpret the term "turnover" within the appropriate context.

The term "**exceptional items**" on Hong Kong Telecom's income statement would probably be referred to as "**extraordinary items**" by a U.S. company, but either term means the same thing–something unusual and nonrecurring has happened. Hong Kong Telecom had an agreement with the Chinese government to surrender the company's exclusive international phone service license and open the market up to competition on March 31, 1998. As a result, the company received a large sum of tax-free cash, but also suffered a loss of value of some assets. The net of these amounts, $4,558 million was a source of 1998 profit that is not expected to be repeated in future operations.

Minority Interests. When a parent company controls a subsidiary but owns less than 100% of its common stock, the remaining shareholders in the subsidiary are called the "**minority interest.**" Consolidated income statements include all the operating results of the subsidiary, but then subtract out the share of the net income or loss that belongs to the other (minority) stockholders. This is the reason for the $40.8 million reduction of Hongkong Telecom's 1997 net income for "minority interests" and the $37.2 million reduction for 1998. Colgate-Palmolive also has minority interests, but they are small enough that the company includes them in its "other expenses" footnote disclosures, rather than separately reporting them.

Fiscal Years. There's one other small difference you might note in Hongkong Telecom's P&L statement. While Colgate-Palmolive's income statement covers a calendar-year reporting period that ends on December 31), Hongkong Telecom's statement is dated "for the year ended 31 March." Hongkong Telecom, like many organizations throughout the world, uses a "fiscal year" rather than a calendar year to define its financial accounting periods. A **fiscal year** is any 12-month period that an organization consistently uses for accounting purposes.

Why would an organization choose a fiscal year different from the calendar year? Sometimes, there are practical reasons. For example, department stores often avoid a December 31 year-end because December is part of their busiest retail season. It's much easier to go through the process of preparing financial reports at a less busy time of year. So, many department stores have fiscal years ending in late January; others choose July, another fairly calm point in the year. Sometimes there are also tax advantages associated with particular year-end dates.

You may need to take note of fiscal year-end dates when comparing performance results between companies. Suppose you are comparing a company with a 1999 fiscal year ending March 31 and a company with a 1999 calendar year report. If significant developments occurred between March 31 and December 31, you should take them into account when doing your analysis. For example, suppose the 2 companies are airlines and a fare war (deep price-cutting by competitors) broke out in June 1999. The sales pattern for the company with the December 31 year end may be affected by the price cuts, but the sales pattern for the other company will not be affected.

Results of Operations or Activities: A Brief Recap. Now you've seen statements reporting the results of operations for 2 businesses and activities for 1 not-for-profit organization. You know that consolidated statements report on an entire economic entity and comparative statements include results for multiple periods to help make the accounting information more meaningful. You've been introduced to the importance of ratios, trends and external benchmarks in interpreting financial statements. You've also learned the basic format for a statement reporting the results of operations or activities, as well as some typical variations. You've seen some differences in statements of business organizations and nonprofit or government organizations–such as the inclusion of earnings per share information for businesses and its irrelevance for nonprofit and government entities. And you've seen some differences in financial statements prepared by organizations in different countries.

Changes in Retained Earnings, Equity or Net Assets

The Statement of Operations (or Income Statement or Statement of Activities) reports the results of an organization's operations for a particular period of time. Financial statement users may also be interested in knowing what has happened to the accumulated earnings of the organization: How much has the organization reinvested in itself? How much has been distributed to owners (if there are owners)? How have the retained earnings (or equity or net assets) changed over this period?

The basic set of financial statements for a business will include a Statement of Retained Earnings or a Statement of Stockholders' Equity. The **statement of retained earnings** reconciles the period's beginning balance and the period's ending balance of a business organization's retained earnings account. Alternatively, a business organization may choose to publish a **statement of stockholders' equity**, reconciling the beginning and ending balances of every equity account.

Nonprofit and government organizations, which have no owners to distribute earnings to, are not required to publish a statement of net assets. However, many nonprofit organizations show a reconciliation of unrestricted net assets at the bottom of their statement of activities.

Format of a Statement of Retained Earnings. The standard format for a Statement of Retained Earnings is simple:

Beginning retained earnings
+ Net income (or – net loss)
– Dividends
Ending retained earnings

Hongkong Telecom combined its income statement and statement of retained earnings (take a look back at Figure I-3-9 to see this). In 1996 and 1997, Colgate-Palmolive's statement of retained earnings followed the standard format exactly. In 1998, the company presented a more complex statement also showing the changes in other stockholders' equity accounts, but the retained earnings column of this statement followed the standard format exactly. Here is how a consolidated statement of retained earnings would look for Colgate-Palmolive for 1996-1998:

Consolidated Statements of Retained Earnings — *COLGATE-PALMOLIVE COMPANY*

Dollars in Millions	1998	1997	1996
Balance, January 1	$3,138.0	$2,731.0	$2,392.2
Add:			
Net income	848.6	740.4	635.0
	3,986.6	3,471.4	3,027.2
Deduct:			
Dividends declared:			
Series B Convertible Preference Stock, net of income taxes	20.4	20.6	20.9
Preferred stock	0.5	0.5	0.5
Common stock	324.7	312.3	274.8
	345.6	333.4	296.2
Balance, December 31	$3,641.0	$3,138.0	$2,731.0

The format of this statement reflects the meaning of retained earnings. Remember that when a business operates profitably, the owners benefit. The profits can either be distributed as dividends or reinvested in the business. The accumulated profits reinvested in the business are known as "**retained earnings.**" Retained earnings are part of the firm's equity because they are capital indirectly provided by owners, who forgo dividends today to help the firm prepare for the future.

On the other hand, when a business experiences a loss, the owners' ability to receive dividends or reinvest in the business is reduced. Thus, net losses are treated as reductions of retained earnings. If losses ever reach the point where they exceed accumulated retained earnings, there is said to be a "**retained deficit**." For example, new companies in the early stages of development may operate at a loss for several years, leading to a retained deficit. These companies hope to survive long enough to eventually make up their accumulated deficits with future profits.

A retained deficit indicates that a company is experiencing financial difficulty. If the deficit is large enough, the total equity of the organization may fall into a deficit position. As Gerald F. Lieberman once observed, "A deficit is what you have when you haven't got as much as you had when you had nothing." When there is a negative total equity, the company is in the unfortunate position of having liabilities greater than its assets. At that point, the company is insolvent.

Changes in Net Assets. Businesses are accountable to their stockholders–who are, after all, the *owners* of the company. So, it is natural to expect business financial statements to include a statement of retained earnings. But what about non-business entities, such as nonprofit and government organizations?

Nonprofit and government organizations recognize their accountability to different stakeholders by using a form of accounting known as "**fund accounting**." A "**fund**" represents resources intended to be used for a specific purpose. Each fund has its own set of self-balancing accounts, including fund assets, liabilities, revenues and expenses. A non-business organization will typically have several funds, each for a different purpose. For example, a university might have several funds, including a student loan fund to account for resources dedicated to providing loans to students; a general fund to account for the revenues (e.g., tuition) and expenses (e.g. faculty and staff salaries) associated with the ongoing educational mission of the university; and a plant fund to account for resources earmarked for the expansion or improvement of the university's buildings and other fixed assets (like laboratory equipment in science classrooms).

For financial reporting purposes, non-business organizations report a combined total for all funds. They may also provide details for individually important funds. Moreover, just as businesses provide a statement showing the changes in retained earnings, not-for-profit organizations may show the changes in net assets, although nonprofits do not typically use a separate statement to do this. If you look at the bottom portion of the AICPA's Statements of Activities, you will find the changes in net assets reported as follows:

	1998	1997
	($000)	
Increase in unrestricted net assets	2,095	14,580
Unrestricted net assets, beginning of year	45,408	30,828
Unrestricted net assets, end of year	$ 47,503	$ 45,408

Further details about the changes in net assets are included in the footnotes of the AICPA's financial statements. The footnotes provide information about how much of the net assets belong to each of the related organizations. For example, the Benevolent Fund had a balance of $3,358,000 at the end of fiscal year 1998.

Financial Position: The Balance Sheet

So far, the financial statements we've looked at have focused on what has happened to the organization over a particular recent period of time. But remember that the organization is long-lived. Its current financial position depends not just on the results of its operations in the immediate past, but on all the economic resources and obligations the organization has accumulated up to this point in its history.

The organization's economic resources and obligations also provide the key to its future. Consequently, many users of financial statements will want to know what the financial position of the organization is at this particular point in time–What kinds of economic resources does the organization have? Which of the economic resources are expected to be used up during the coming year? What kinds of obligations does the organization have to pay during the coming year? What is the balance between its debt financing and its equity financing? The balance sheet (also known as **the statement of financial position**) provides information to help answer these questions.

The **balance sheet** reports the assets, liabilities and equities of an entity on a particular date–that is, it gives a picture of the organization at a single point in time. The statement gets its name–and its basic format–from the natural balance that exists in the accounting equation:

Assets = Liabilities + Equity

Take a look, for example, at Colgate-Palmolive's balance sheet (Figure I-3-10 on the next page) and note that the total assets ($7,685.2 million as of December 31, 1998) equals the total of liabilities and equity at the same date.

<u>Assets.</u> **Assets** are the economic resources of the firm–the things the firm owns that are expected to be of benefit in the future. Take a closer look at the assets section of Colgate-Palmolive's balance sheet. You'll see that it's subdivided into 2 parts, following a format known as a "**classified balance sheet.**" The first part reports "**current assets**"–those assets expected to be used or consumed during the next year. The second (unlabeled) part reports "**non-current**" **(or long-term) assets**.

Current assets tend to be very liquid–they include cash and items which will soon be converted to cash, like **accounts receivable** (amounts due from customers) and **inventories** (stocks of goods held for sale). Some non-current assets may also be quite liquid–for example, long-term investments in securities may be readily converted to cash by selling the securities. Other non-current assets are less liquid–for example property, plant and equipment. Colgate-Palmolive's **property, plant and equipment** includes the land, buildings and machinery that the company uses in its business–things like the factories that manufacture toothpaste and the office buildings where the corporate headquarters are housed.

Figure I-3-10

Consolidated Balance Sheets

COLGATE-PALMOLIVE COMPANY

Dollars in Millions Except Per Share Amounts	1998	1997
Assets		
Current Assets		
Cash and cash equivalents	**$ 181.7**	$ 183.1
Marketable securities	**12.8**	22.2
Receivables (less allowances of $35.9 and $35.8, respectively)	**1,085.6**	1,037.4
Inventories	**746.0**	728.4
Other current assets	**218.8**	225.4
Total current assets	**2,244.9**	2,196.5
Property, plant and equipment, net	**2,589.2**	2,441.0
Goodwill and other intangibles, net	**2,524.1**	2,585.3
Other assets	**327.0**	315.9
	$7,685.2	$ 7,538.7
Liabilities and Shareholders' Equity		
Current Liabilities		
Notes and loans payable	**$ 175.3**	$ 158.4
Current portion of long-term debt	**281.6**	178.3
Accounts payable	**726.1**	716.9
Accrued income taxes	**74.2**	67.0
Other accruals	**857.2**	838.9
Total current liabilities	**2,114.4**	1,959.5
Long-term debt	**2,300.6**	2,340.3
Deferred income taxes	**448.0**	284.5
Other liabilities	**736.6**	775.8
Shareholders' Equity		
Preferred stock	**376.2**	385.3
Common stock, $1 par value (1,000,000,000 shares authorized, 366,426,590 shares issued)	**366.4**	366.4
Additional paid-in capital	**1,191.1**	1,027.4
Retained earnings	**3,641.0**	3,138.0
Cumulative translation adjustments	**(799.8)**	(693.7)
	4,774.9	4,223.4
Unearned compensation	**(355.5)**	(364.5)
Treasury stock, at cost	**(2,333.8)**	(1,680.3)
Total shareholders' equity	**2,085.6**	2,178.6
	$7,685.2	$ 7,538.7

Another category of non-current assets is "**intangible assets**"–economic resources that have value, but no tangible, physical existence. Some examples of intangible assets are **patents** (the exclusive right to make or sell a product, like a patent on a drug) and **trademarks** (an insignia or logo that identifies a product) that a company has purchased. Colgate-Palmolive's intangible assets also include "goodwill," which arose from some past acquisitions of other businesses. Sometimes an acquired business is worth more than the market values of its identifiable assets–perhaps because it has established an excellent reputation that enhances its earnings potential. The excess of the price paid for the business over the market value of its identifiable assets is known as "**goodwill**." According to U.S. accounting standards, purchased goodwill is initially booked as an asset, which is then amortized (allocated to expense) over a period of no more than 40 years.

Liabilities. **Liabilities** are the obligations the entity owes to its creditors. Colgate-Palmolive subdivides its liabilities into a **current** portion (obligations payable in 1 year or less) and a **non-current** portion. The classification of assets and liabilities into current and non-current portions is useful to creditors who are concerned with liquidity and solvency. As one measure of liquidity, they look at the entity's "**current ratio**," the ratio between its current assets and current liabilities. This ratio shows the organization's ability to pay its current debts out of current assets. At the end of 1998, Colgate-Palmolive's current ratio was 1.06–that is, current assets ($2,244.9 million) were 1.06 times as large as the current liabilities ($2,114.4 million). The current ratio, like all ratios, can be more meaningfully interpreted if you have external benchmarks, such as industry averages, for comparison. Additional ratios used to assess liquidity and solvency are discussed in the section on financial statement analysis in Theme II.

Equity. **Equity** is the residual ownership interest in the firm. Colgate-Palmolive's equity section reveals that the company is authorized to issue both preferred and common stock and that the common stock has a par value of $1 per share. You could also have figured this out by noting that the common stock account is valued at $366.4 million for 366,426,590 shares ($1 per share). There is a separate account showing **"Additional paid-in capital"** (also known as **"Capital in excess of par value"**) indicating that the stockholders paid more for their stock than its par value.

The equity section also reports the company's retained earnings. Over the course of its life, Colgate-Palmolive has accumulated $3,641.0 million of earnings that have not been distributed to stockholders as dividends. You should note that this retained earnings figure from the balance sheet agrees with the ending balance from Colgate-Palmolive's statement of retained earnings.

Several additional items are reported in the equity section, including:

- **Cumulative translation adjustments**: Colgate-Palmolive does business throughout the world so many subsidiaries and branches have assets and liabilities valued in the currencies of the countries where they are located. When the consolidated financial statements are prepared, the foreign currency amounts must be translated into U.S. dollars. Since the value of the dollar fluctuates against these currencies, there may be a gain or loss on the translation. As of December 31, 1998, the translation adjustments have amounted to $799.8 million.

- **Treasury stock**: The "treasury stock" represents previously issued Colgate-Palmolive stock that the company has repurchased. Companies may either cancel their repurchased stock or hold it "in the treasury" for later resale or use as an award to high-performing employees. The cost of treasury stock is shown as a *reduction* of equity because the shares aren't currently in the hands of stockholders.

International Differences in Balance Sheets. Now, take a look at Hong Kong Telecom's balance sheet, which appears in Figure I-3-11 on the following page. You'll note that while the statement reports assets, liabilities and equities, it does so in a very different format. For example, Hong Kong Telecom labels the bottom portion of its balance sheet "Financed By." This section includes the information about the company's equity capital; the company has no outstanding debt securities.

This title "Financed By" is a good descriptions of the distinction between assets, on the one hand, and liabilities and equities, on the other hand. Remember that all organizations need capital, which they either raise from investors (creating owners' capital or equity capital) or borrow from creditors (creating debt capital). Thus, every organization is "financed by" its owners and creditors. The capital the organization raises or borrows is used to acquire economic resources–that is, the organization employs its capital to garner assets.

You might also note that Hongkong Telecom presents its balance sheet for both the "Group" and the "Company." The group refers to the economic entity formed by the parent and subsidiaries; the company refers only to the parent corporation. As you would expect, the assets (and related liabilities and equities) of the parent company are smaller than those of the entire group. Additionally, if you remember that some of the subsidiaries of Hongkong Telecom were not wholly-owned, you shouldn't be surprised to see a "Minority Interests" value in the equity section for the group. Just as the minority stockholders own a share of the current profits or losses, they also own a share of the equity in the subsidiary.

One final thing to note about the Hongkong Telecom balance sheet: the company lists its *least* liquid assets first and then proceeds to the *more* liquid items. Thus, the report starts with fixed assets (its plant, property and equipment), then lists the parent company's investments in the subsidiaries (this only shows up in the "company" columns of the balance sheet as the "group" already includes both the parent and the

Figure I-3-11
Hong Kong Telecommunications Limited's Balance Sheet

Balance *sheets*
At 31 March 1998

		Group		Company	
		1998	1997	**1998**	1997
Note		**$M**	$M	**$M**	$M
13	Fixed assets	**28,404.1**	25,405.0	**60.9**	63.8
14	Interest in subsidiaries	**—**	—	**15,934.9**	7,734.9
15	Other investments	**658.4**	517.5	**260.9**	221.1
16	Other non current assets	**1,436.3**	2,053.4	**—**	—
17	Current assets	**23,679.6**	19,689.4	**17,205.8**	18,244.1
		54,178.4	47,665.3	**33,462.5**	26,263.9
18	Current liabilities	**16,387.3**	16,588.2	**26,443.9**	17,636.9
	Total assets less current liabilities	**37,791.1**	31,077.1	**7,018.6**	8,627.0
19	Deferred taxation	**739.1**	716.5	**—**	—
		37,052.0	30,360.6	**7,018.6**	8,627.0
	Financed by				
20	Share capital	**5,954.7**	5,846.7	**5,954.7**	5,846.7
21	Reserves	**30,992.0**	24,441.0	**1,063.9**	2,780.3
	Shareholders' funds	**36,946.7**	30,287.7	**7,018.6**	8,627.0
	Minority interests	**105.3**	72.9	**—**	—
		37,052.0	30,360.6	**7,018.6**	8,627.0

subsidiaries), then lists its other investments (like investments in securities), its other noncurrent assets, and finally its current assets. The footnotes provide additional information about each of these categories. For example, the current assets include cash, inventory and trade receivables, among other things.

After the assets are totaled (adding up to $54,178.4 million for the group at the end of fiscal 1998), the current liabilities are *deducted* from the total, yielding $37,791.1 million of total assets less current liabilities. Then deferred taxes of $739.1 million are subtracted to yield a "net assets" of $37,052.0 million. This figure balances with the total equity listed in the "Financed By" section.

Why does Hongkong Telecom subtract current liabilities from total assets instead of including them with other liabilities and equity? The Hongkong system of financial reporting, like the U.K. system it springs from, has traditionally placed great emphasis on the needs of creditors. To highlight liquidity, current liabilities are "**offset**" against (deducted from) either total assets–as in the Hongkong Telecom balance sheet–or, more frequently, current assets. Thus, Hong Kong and U.K. balance sheets emphasize the creditors' position more than U.S. balance sheets do, although both approaches present the same set of information.

Balance Sheets for Government and Nonprofit Entities. How do balance sheets for government and nonprofit entities compare to those of businesses? They typically follow the same basic format, except that "net assets" (or "fund balances") replace "equities." Thus, the basic format for a not-for-profit balance sheet becomes:

Assets = Liabilities + Net Assets

The balance sheet for the AICPA (see Figure I-3-12 on the following page) follows this basic format. Notice that the total net assets includes $648,000 of permanently restricted funds–these funds are restricted to support of the AICPA's library.

Financial Position: A Recap. In summary, a balance sheet shows the financial position of the organization on a particular date. The statement shows the economic resources (assets) of the entity and the relative positions of the providers of capital: the entity's creditors (to whom the organization owes liabilities) and its owners (who have an equity interest in the entity). For government and nonprofit organizations that do not have owners, the equity accounts are replaced by net assets (or fund balances).

To aid in the assessment of liquidity, the balance sheet may classify both assets and liabilities as current or non-current. Also, the format of the balance sheet may vary between countries, although all balance sheets report how capital was employed to garner economic resources (assets) and how capital was obtained (liabilities and equities).

Figure I-3-12

American Institute of Certified Public Accountants and Related Organizations

Combined Statements of Financial Position
July 31

	1998	1997
	($000)	
Assets:		
Cash	**$ 416**	$ 860
Marketable securities	**103,221**	93,078
Accounts and notes receivable (less an allowance for doubtful accounts: 1998: $1,188,000; 1997: $1,300,000)	**13,265**	13,883
Inventories	**2,028**	2,017
Deferred costs and prepaid expenses	**5,545**	3,866
Furniture, equipment, and leasehold improvements, net	**20,390**	21,557
Total assets	**$144,865**	$135,261
Liabilities and net assets:		
Liabilities:		
Accounts payable and other liabilities	**$ 15,941**	$ 17,419
Advance dues	**30,164**	28,415
Unearned revenue	**20,000**	13,995
Long-term debt	**1,200**	1,200
Deferred rent	**15,489**	15,649
Deferred employee benefits	**13,920**	12,527
Total Liabilities	**96,714**	89,205
Net assets:		
Unrestricted	**47,503**	45,408
Permanently restricted	**648**	648
Total net assets	**48,151**	46,056
Total liabilities and net assets	**$144,865**	$135,261

The accompanying notes to financial statements are an integral part of these statements.

Sources and Uses of Cash: The Statement of Cash Flows

We've already mentioned that creditors are particularly interested in the liquidity of an organization, which means that creditors are interested in cash flows. Owners tend to be more interested in assessing the profitability of the entity, but they too are interested in cash flow information because it helps them evaluate the entity's prospects for continuing profitability and for paying future dividends. What kind of cash flows does the organization have? Where does the organization's cash come from? How is it used? Do operating activities bring in more cash than they use? Information to answer these questions may be found in a Statement of Cash Flows.

How important are cash flows? In an interview with *Inc.* magazine, William McGowan, cofounder of MCI Communications Corporation, argued that cash flows are critical to an organization:

> *The only thing that matters is cash flow...where it's coming from and where its going and how much is left over. No company has ever gone bankrupt because it had a loss on its P&L.*

McGowan was speaking from experience, having succeeded in a venture that many people thought was impossible. In 1968, McGowan and Jack Goeken started a long-distance telephone company that seemed no match for the giant AT&T system. Yet, MCI grew into a huge company providing long-distance service throughout the U.S. and to over 50 foreign countries. While MCI eventually became very profitable, it was not at all profitable at its start. Companies can, and often must, endure without profits, but they cannot endure without cash. This is why McGowan believed so strongly in the importance of cash flow information.

McGowan's point is important. Management's goal may be to make a profit, but management must also control the organization's cash. Profit (or net income) and cash are *not* the same thing. Consider the following example:

> *Jeff is a college student who operates a baseball card business as a way to earn money for his tuition. At the beginning of December his inventory of cards includes several Rod Carew rookie cards that he bought for $75 each several years ago.*
>
> *During December, Susan, another student, asks if she can buy one of the Rod Carew cards to give to her friend Paul for a holiday gift. She's willing to pay Jeff's selling price of $450 for the card, but she can't pay him until January. Jeff agrees to the sale and gives Susan the card in December.*

If Jeff prepared an Income Statement for his baseball card business for the month of December, he would show a *profit* of $375–the difference between the Carew card's $450 selling price and its $75 cost. Yet, while the business made a profit in December, it had absolutely *no* cash flow during the month. No cash came in (Susan hasn't paid him yet) and no cash went out (he already owned the cards at the start of the month).

Now, obviously, there is a connection between profit and cash. Jeff's recognition of a December profit hinges on his belief that he will collect the cash from Susan in January. But, the flows of profits and cash are not identical. Profit is what the company earns through its operating and nonoperating activities–it's an economic concept that has no physical existence. On December 31, Jeff has a $375 profit, but nothing in his pockets. Cash, on the other hand, can be put in your pocket: cash is money that can be spent or locked in a safe or saved–it has a physical existence.

The **statement of cash flows** describes the impact on the organization's cash from the period's operating, financing and investing activities. **Operating activities** are the main activities of the organization–like manufacturing and selling toothpaste and other consumer products for Colgate-Palmolive or conducting conferences and preparing the CPA exam for the AICPA. **Financing activities** include raising equity or debt capital, or repaying amounts borrowed, or distributing returns to owners. **Investing activities** include acquiring or disposing of plant, property and equipment and acquiring or selling a business unit (like a subsidiary or division). In short, the statement of cash flows shows the movement of money into and out of the organization. The basic format of a statement of cash flows is:

Cash flows from operating activities
+ Cash flows from financing activities
+ Cash flows from investing activities
Net change in cash during period
+ Beginning cash balance
Ending cash balance

The same basic format is used by business, nonprofit and government entities. According to U.S. accounting standards, statements of cash flows are required for both business and not-for-profit organizations. The statement, however, is not required everywhere in the world.

Look at an excerpt from the AICPA's statement of cash flows (see Figure I-3-13 on the following page) and compare it to the organization's balance sheet (Figure I-3-12) and statement of activities (Figure I-3-8).

First, think about how the AICPA's statement of cash flows relates to its balance sheet. The reported *ending* balance of cash of $416,000 agrees with the cash total reported on the July 31, 1998 balance sheet. The reported *beginning* balance for 1998 ($860,000) is, as you would expect, the same as the amount of cash reported at the end of fiscal year 1997.

Figure I-3-13

American Institute of Certified Public Accountants and Related Organizations	Combined Statements of Cash Flows Year Ended July 31	
	1998	1997
	($000)	
Increase (Decrease) in Cash:		
Operating Activities:		
Cash received from members and customers	**$146,537**	$136,467
Interest and dividends received	**4,846**	3,349
Cash paid to suppliers, employees and others	**(142,261)**	(124,671)
Interest paid	**(60)**	(62)
Income taxes paid	**(626)**	(592)
Net cash provided by operating activities	**8,436**	14,491
Investing Activities:		
Payments for purchase of equipment	**(3,118)**	(2,595)
Payments for purchase of marketable securities	**(200,513)**	(118,190)
Proceeds from sale of marketable securities	**194,751**	106,524
Net cash used in investing activities	**(8,880)**	(14,261)
Net increase (decrease) in cash	**(444)**	230
Cash, beginning of year	**860**	630
Cash, end of year	**$ 416**	$ 860

The accompanying notes to financial statements are an integral part of these statements.

Now, we'll do something more difficult: consider how the AICPA's statement of cash flows relates to its statement of activities. But first, remember from the baseball card example that profits from a business are *not* the same thing as cash. For example, customers may owe the business cash for items they have purchased on credit. Even though the business can recognize revenue and earn profit on the sale to this customer, the cash has not yet come in. This will help you understand that increases in net assets for a not-for-profit organization also are *not* the same thing as cash. For example, the AICPA might sell publications on credit or buy some office supplies on credit–in either case, the effect on revenue and expenses would be different than the effect on the organization's cash.

Look back at the AICPA's 1998 Statement of Activities. It shows a $2,095,000 *increase* in unrestricted net assets for the year as a result of a net gain of $4,385,000 on marketable securities less a $2,290,000 operating deficit (an excess of expenses over revenues). Remember that this does *not* mean the AICPA had $2,095,000 more cash at the end of the year than at the start. In fact, the Statement of Cash Flows reveals a $444,000 net *decrease* in cash during the year. In Theme II, we will return to this difference between income and cash flows, which is one of the most difficult yet important concepts you need to master to understand accounting information.

Financial Statement Articulation

Now that you've had a chance to look at the set of basic financial statements, you've probably discovered several links between a typical income statement, statement of retained earnings, balance sheet and statement of cash flows. Figure I-3-14 (on the following page) illustrates how this set of financial statements interconnects or "**articulates**." No matter what the format of a particular set of financial statements, the set of statements will always contain important interconnections. The more you become aware of these relationships, the more you will begin to understand the meaning of financial accounting information.

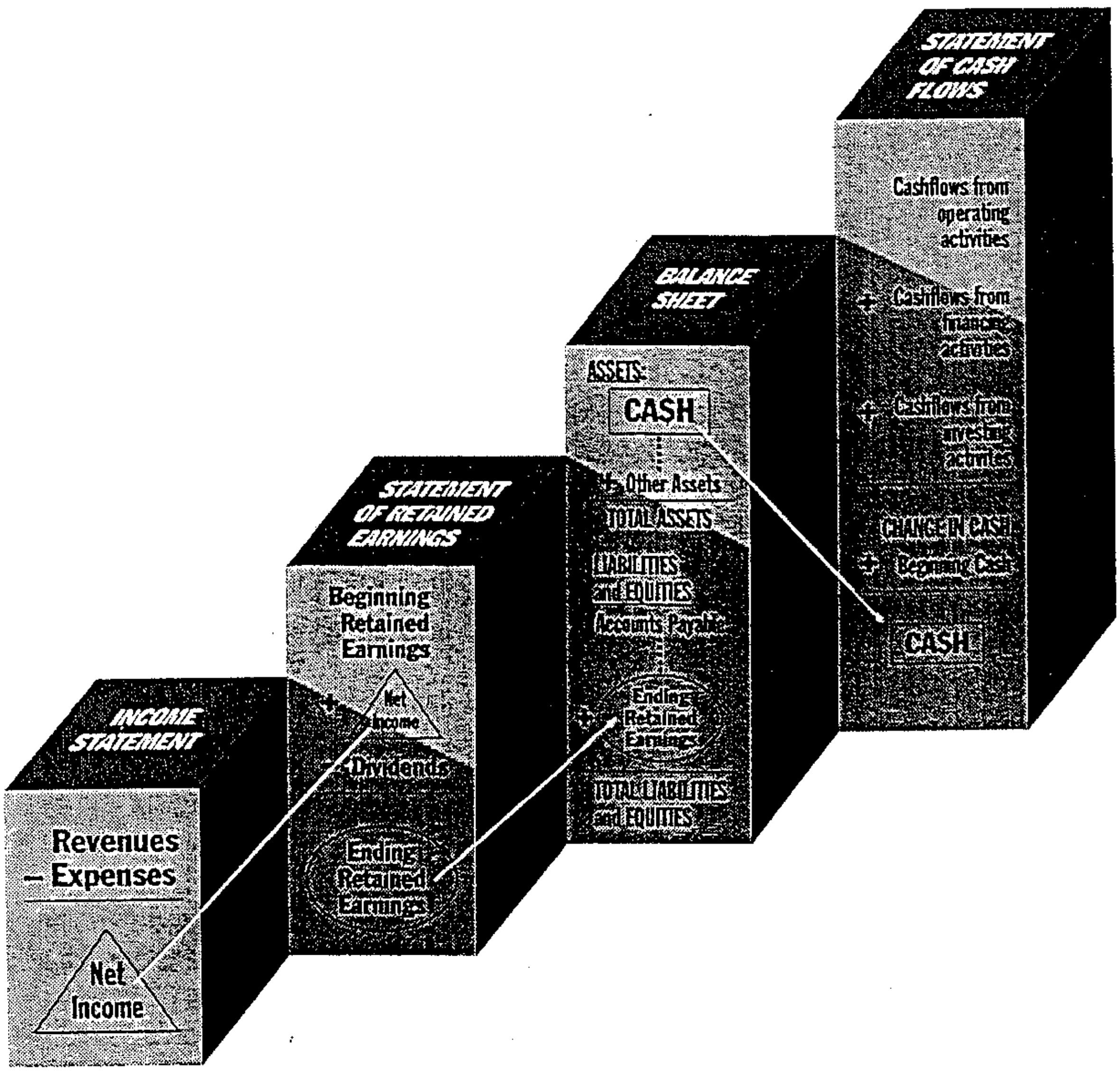
The Importance of Footnotes

There's another aspect of financial statements that also affects your ability to understand financial accounting information. Throughout our discussion of financial statements, there have been regular references to information that is found in the footnotes to the statements. The footnotes are an *integral part* of the statements–the numbers you find in the body of the statements cannot be meaningfully interpreted without the additional information contained in the footnotes.

Reading the footnotes can be a daunting task. The prose can be dense; the notes can be voluminous. Annual reports for government entities, for example, often contain dozens of pages of footnotes. One 1990 annual report had over 70 pages

Figure I-3-14

Building A Set of Financial Statements: How Financial Statements "Articulate"



of notes! Yet, if you don't read the footnotes, you may miss important information. Many financial writers, like Jane Bryant Quinn writing on *How To Read An Annual Report*, argue that the most important information may be "buried" in the notes:

> *So now [the company's] annual report is sitting in front of you ready to be cracked. How do you crack it?*
>
> *Where do we start? Not at the front. At the back! We don't want to be surprised at the end of this story....*
>
> *Stay in the back of the book and go to the footnotes. Yep! The whole profits story is sometimes in the footnotes.*

The complexity of footnotes is one reason why many individual investors choose to rely on investment advisors to help them make decisions. Financial analysts or other professional advisors devote a lot of effort to mining all the information in financial statements and other sources.

There are a few good reasons why footnotes are so hard to read. First, they often contain very complex information. There's no way, for instance, to explain a company's obligations under its complicated pension plan other than to write a complicated note. Second, footnotes often are worded formally or legalistically (and lawyers aren't known for their prose skills). For example, the footnote that describes the organization's potential liability arising from lawsuits is never going to say "We're being sued and we may lose a bundle." That kind of statement may be clearly written, but it could also damage the company's legal case. Consequently, while the footnote may imply that the company might lose a bundle, the wording will be much more technical and delicate.

Suppose you do decide to read the footnotes. What will you find? The first footnote typically describes the accounting policies used by the organization. There isn't always just one right way to account for a transaction; often there are several acceptable accounting methods that might yield different results.

For example, consider the intangible asset "goodwill" that we talked about earlier. For U.S. companies, purchased goodwill is initially recorded as an asset, but it doesn't remain an asset indefinitely. Instead, the cost is "**amortized**" (charged to an expense account) over a period of no greater than 40 years. Yet in some other countries goodwill can be left as an asset indefinitely. Thus, if a U.S. company and a non-U.S. company both have an equal amount of purchased goodwill, they may treat their goodwill very differently. If you read the footnotes, you will find out which accounting method each company is using. This knowledge will help you interpret the reported results. Moreover, even within a single country, there are often multiple acceptable accounting treatments for the same transaction. For example, U.S. companies may value their inventories using one of several different methods–each of which may yield a different value for their inventory and cost of goods sold.

Other footnotes will contain supplemental information about items reported in the body of the financial statements. The notes will include information about things such as current and potential lawsuits against the company; major acquisitions the company made during the period; the company's pension plan and stock option plans; details about the company's long-term debt obligations; information about financial position and operating results for each major segment of the company, and so on.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Figures are not always facts.
--Aesop, The Widow and the Hen

On first glance, financial statements appear very exact. After all, they focus on numbers--and figures, as Justice Louis Brandeis once said, are "a language implying certitude." But, for the most part, the numbers in financial statements aren't really to-the-penny-exact values. The numbers that appear in the financial statements are the product of a long series of financial accounting judgments.

Financial statements are the end product of financial accounting. To get from the raw data about an entity's economic transactions and events to the financial statements, financial accountants need to make many decisions. How do financial accountants know what events and transactions to measure? how to value them? and when and how to include them in financial reports? Financial accountants are guided in these decisions by a set of professional standards referred to as "**generally accepted accounting principles**" or **GAAP**.

Generally accepted accounting principles provide both detailed rules and standards and general guidance for making judgments in situations where no specific rules or standards exist. GAAP isn't a cookbook; it doesn't include the recipe for handling every conceivable economic transaction or event. Inevitably, the financial accountant must rely on his or her professional judgment, as well as on expert knowledge of the detailed rules that do exist. In Module 6 of this theme, you can learn about how generally accepted accounting principles are established and how they can differ between nations. Here, we'll start to explain GAAP with a brief overview of the important assumptions, principles and constraints that underlie financial accounting.

Basic Assumptions of Financial Accounting

Four basic assumptions (which are summarized in Figure I-3-15 on the following page) underlie financial statements for business, government and nonprofit organizations: economic entity, monetary unit, going concern and periodicity.

The Economic Entity Assumption. The first assumption is that financial statements report on the organization, not its individual members or owners. The organization itself is the economic entity the statements describe.

ASSIGNMENT I-3B-9: Basic Financial Statements: Preparing A City's Financial Statements

SETTING

You have just taken a job as a financial accountant with a municipal government. To orient yourself to the city, you decide to manually prepare a set of financial statements for the most recent six month period. You decide to start by preparing a balance sheet for the city's general fund.

The general fund is used to support most city services except for street maintenance, water and sewer, and solid waste disposal, which are accounted for in other funds, such as the street fund. While a portion of the general fund has already been committed ("reserved and designated") for particular future expenditures, the majority of the fund is unreserved.

ASSIGNMENT

Given the alphabetical listing of account balances (see the following page) as of June 30, the end of the city's most recent 6-month period, prepare a Balance Sheet for the city's general fund. Be sure to include appropriate headings, sub-totals and totals.

HINTS

1. Remember that the basic format of a balance sheet is embodied in the accounting equation, which, for a single fund of a government body is:

   Assets = Liabilities + Fund Balance

   You know your balance sheet can't be correct unless total assets are equal to the total of liabilities and fund balance (net assets).

2. Take a look at the financial statements reproduced in this module to get ideas on how to format the balance sheet. If you need additional examples, seek out your library's files of nonprofit and government annual reports or do some research to find such annual reports on the Internet.

3. Use your dictionary to check the definitions of any terms which are unfamiliar to you.

ACCOUNTS LIST

Accounts receivable	296,883
Accounts payable	863,045
Accrued expenses payable	741,258
Cash	235,730
Due from other governments	604,539
Due to other funds	71,306
Due from other funds	1,293,513
Escrow deposit liabilities	796,149
Investments	8,134,504
Prepaid expenses and other assets	180,901
Reserved and designated fund balance	1,032,101
Unreserved fund balance	7,242,211