Understanding Financial Statements & Reporting  
- Lecture 2 -

Clinton E. White, Jr  
Professor of Accounting & MIS  
College of B&E  
University of Delaware

Today’s Content
• Management’s additional information  
  – The Management Discussion & Analysis of Financial Condition & Results of Operations  
• The accounting & regulator authorities  
• The Notes to the Financial Statements  
• Management’s judgements & flexibility  
  – Depreciating an asset  
  – Quality of earnings

Financial Reporting
• Additional information management must publish  
  – A 5-year summary of financial information  
    • Net sales & operating revenue … income or loss from continuing operations … long term obligations … cash dividends  
  – High & low market prices for 2 years  
  – The “Management Discussion & Analysis of Financial Condition & Results of Operations”
### The MD&A

- A discussion of non-financial information about significant trends, events, changes, uncertainty, & plans
  - Changes in liquidity (cash position)
  - Major changes in operations
  - Significant non-recurring events
  - Events that can have major financial impacts
  - Plans for large scale projects

---

### The Authorities - The FASB

- The Financial Accounting Standards Board (FASB)
  - Establishes the accounting rules that US companies must follow
  - GAAP (Generally Accepted Accounting Principles)
    - Uniformity, consistency & comparability in financial reporting
    - Allow a tremendous amount of flexibility, interpretation, & discretion

---

### The Authorities - The SEC

- The Securities & Exchange Commission (SEC)
  - Oversees all companies that publicly trade stocks in the US
  - Requires all companies to file regular reports:
    - The annual audited 10K
    - The quarterly unaudited 10Q
    - The special events 8K
Depreciating An Asset

- An asset is something that is purchased or built by a company for a specific (verifiable) price at a specific point in time and will be used over a period of time
  - 10 laptops to be used by the Marketing dept.
  - Price: $2,000 each
  - All assets must be depreciated (their cost is allocated to expense on a regular basis) over their expected useful life

Depreciation Judgements

- Management makes three decisions about each type of asset:
  - What is the asset’s expected useful life?
  - Is there any salvage value?
  - What depreciation method shall we use?

Conservative Thinking

- Considering the laptops, a conservative management may reason as follows:
  - Computer technology changes rapidly but even old computers have a use and we can probably take a tax deduction of $200 each at the end of their useful lives
  - We should depreciate them using straight line over a four-year period
Example 1 Depreciation

- Balance sheet asset accounts at the end of one-year:
  - Assets (computers) $20,000
  - Less accumulated depreciation $4,500
    - Calculated: \(\frac{20,000 - (10 \times 200)}{4}\)
  - Net assets (book value) $15,500

More Aggressive Thinking

- A more aggressive management may reason as follows:
  - Computer technology changes rapidly and these laptops will be worthless in two years
  - We should depreciate them using straight line depreciation

Example 2 Depreciation

- Balance sheet asset accounts at the end of one-year:
  - Assets (computers) $20,000
  - Less accumulated depreciation $10,000
    - Calculated: \(\frac{20,000}{2}\)
  - Net assets (book value) $10,000
Asset Valuation & Management Discretion

- Even if two companies purchase the same assets at the same price, their financial statements can show very different results
  - Very simple example of management making different judgments about “useful life” & “salvage value”
  - And judgments are often a reflection of management’s overall philosophy

Judgments, Estimates & Choices

- Financial statements are full of judgments, estimates & choices
  - Very complex judgments & accounting methods … can defy logic
  - All acceptable under GAAP
  - Must understand the options & “look behind the numbers” to understand financial statements

The Matching Principle

- The GAAP “matching principle”
  - Must match expenses with revenues in the appropriate accounting period!
  - “Accrual” accounting (as opposed to “cash” accounting)
    - Recognizing expenses & revenues in the period in which they actually occur (not when cash is actually paid out or received)
Accural Accounting

• A software program (with the standard wording about breaking the shrink wrap) is sold to a client for $10,000
  – The client pays $2,000 up front and is extended credit for the rest … an “Account receivable” for $8,000
  – The selling company recognizes:
    • $10,000 in revenues
    • Any directly related sales expenses as well as any “matched” product costs

Judgment Opportunities

• Matching requires considerable estimation & judgments
• Many, many similar complications & issues:
  – Financial reporting vs. Tax reporting
  – Revenue recognition
  – The timing of expenditures
  – Off-balance sheet financing
  – Operating vs. non-operating items

The Quality of Earnings

• What is the “quality of earnings” of a particular company?
  – Are the financial statements clear, understandable, and a close representation of reality?
  – Is the MD&A clear, honest, and unambiguous?
  – Are important items hidden in the notes?
A Reflection of Management

- Financial statements are the responsibility of management
  - Financial statements and the additional accompanying information provide a reflection of the “quality of earnings” and are a reflection of the “quality of management”

Summary

- Financial statements + much more financial & non-financial information
- The regulatory authorities:
  - The FASB & the SEC
- Many, many judgments, estimates, & choices
  - Depreciating an asset
- The quality of earnings