PacificCPE

COURSE

21801A

# Financial Reporting Fundamentals and the Balance Sheet

Financial statements aren't always what they seem. This course opens with an eye-opening look at the adversarial nature of financial reporting—exploring why preparers and users of financial statements often have competing interests. From there, you'll dive into the balance sheet, learning how to read, interpret, and critically evaluate what's reported and what might be hidden. Ideal for CPAs and tax professionals who want a sharper, more skeptical eye when reviewing client or company financials.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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Final Exam Copy ↓

## Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

## Course Objectives

- Recall the characteristics of the Sarbanes-Oxley Act of 2002.
- Identify the basis for valuing nonfinancial assets.

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# Chapter 1: THE ADVERSARIAL NATURE OF FINANCIAL REPORTING

*Chapter Objective*

**After completing this chapter, you should be able to:**

- Recall the characteristics of the Sarbanes-Oxley Act of 2002.

Financial statement analysis is an essential skill in a variety of occupations, including investment management, corporate finance, commercial lending, and the extension of credit. For individuals engaged in such activities, or who analyze financial data in connection with their personal investment decisions, there are two distinct approaches to the task.

The first is to follow a prescribed routine, filling in boxes with standard financial ratios, calculated according to precise and inflexible definitions. It may take a little more effort or mental exertion than this to satisfy the formal requirements of many positions in the field of financial analysis. Operating in a purely mechanical manner, though, will not provide much of a professional challenge. Neither will a rote completion of all of the proper standard analytical steps ensure a useful, or even a nonharmful, result. Some individuals, however, will view such problems as only minor drawbacks.

This course is aimed at the analyst who will adopt the second and more rewarding alternative: the relentless pursuit of accurate financial profiles of the entities being analyzed. Tenacity is essential because financial statements often conceal more than they reveal. To the analyst who embraces this proactive approach, producing a standard spreadsheet on a company is a means rather than an end. Investors derive but little satisfaction from the knowledge that an untimely stock purchase recommendation was supported by the longest row of figures available in the software package. Genuinely valuable analysis begins *after* all the usual questions have been answered. Indeed, a superior analyst adds value by raising questions that are not even on the checklist.

Some readers may not immediately concede the necessity of going beyond an analytical structure that puts all companies on a uniform, objective scale. They may recoil at the notion of discarding the structure altogether when a sound assessment depends on factors other than comparisons of standard financial ratios. **Comparability**, after all, is a cornerstone of **generally accepted accounting principles** (**GAAP**). It might therefore seem to follow that financial statements prepared in accordance with GAAP necessarily produce fair and useful indications of relative value.

The corporations that issue financial statements, moreover, would appear to have a natural interest in facilitating convenient, cookie-cutter analysis. These companies spend heavily to disseminate information about their financial performance. They employ investor-relations managers, they communicate with existing and potential shareholders via interim financial reports and press releases, and their senior executives participate in lengthy conference calls with securities analysts. Given that companies are so eager to make their financial results known to investors, they should also want it to be easy for analysts to monitor their progress. It follows that they can be expected to report their results in a transparent and straightforward fashion...or so it would seem.

## THE PURPOSE OF FINANCIAL REPORTING

Analysts who believe in the inherent reliability of GAAP numbers and the good faith of corporate managers misunderstand the essential nature of financial reporting. Their conceptual error connotes no lack of intelligence, however. Rather, it mirrors the standard accounting textbook's idealistic but irrelevant notion of the purpose of financial reporting. Even the renowned consultant to investment managers and author Howard Schilit, an acerbic critic of financial reporting as it is actually practiced, presents a high-minded view of the matter:

> The primary goal in financial reporting is the dissemination of financial statements that accurately measure the profitability and financial condition of a company[1].

Missing from this formulation is an indication of *whose* primary goal is accurate measurement. Schilit's words are music to the ears of the financial statement users listed in this chapter's first paragraph, but they are not the ones doing the financial reporting. Rather, the issuers are for-profit companies, generally organized as corporations[2].

A corporation exists for the benefit of its shareholders. Its objective is not to educate the public about its financial condition, but to maximize its shareholders' wealth. If it so happens that management can advance that objective through "dissemination of financial statements that accurately measure the profitability and financial condition of the company," then in principle, management should do so. At most, however, reporting financial results in a transparent and straightforward fashion is a means unto an end.

Management may determine that a more direct method of maximizing shareholder wealth is to reduce the corporation's **cost of capital**. Simply stated, the lower the interest rate at which a corporation can borrow or the higher the price at which it can sell stock to new investors, the greater the wealth of its shareholders. From this standpoint, the best kind of financial statement is not one that represents the corporation's condition most fully and most fairly, but rather one that produces the highest possible credit rating (see Chapter 2 of course 21806B) and price-earnings multiple (see Chapter 1 of course 21807B). If the highest ratings and multiples result from statements that measure profitability and financial condition *inaccurately*, the logic of fiduciary duty

to shareholders obliges management to publish that sort, rather than the type held up as a model in accounting textbooks. The best possible outcome is a cost of capital lower than the corporation deserves on its merits. This admittedly perverse argument can be summarized in the following maxim, presented from the perspective of issuers of financial statements:

> The purpose of financial reporting is to obtain cheap capital.

Attentive course participants will raise two immediate objections. First, they will say, it is fraudulent to obtain capital at less than a fair rate by presenting an unrealistically bright financial picture. Second, some course participants will argue that misleading the users of financial statements is not a sustainable strategy over the long run. Stock market investors who rely on overstated historical profits to project a corporation's future earnings will find that results fail to meet their expectations. Thereafter, they will adjust for the upward bias in the financial statements by projecting lower earnings than the historical results would otherwise justify. The outcome will be a stock valuation no higher than accurate reporting would have produced. Recognizing that the practice would be self-defeating, corporations will logically refrain from overstating their financial performance. By this reasoning, the users of financial statements can take the numbers at face value, because corporations that act in their self-interest will report their results honestly.

The inconvenient fact that confounds these arguments is that financial statements do *not* invariably reflect their issuers' performance faithfully. In lieu of easily understandable and accurate data, users of financial statements often find numbers that conform to GAAP yet convey a misleading impression of profits. Worse yet, companies frequently bend and sometimes break the rules for financial reporting. Not even the analyst's second line of defense, an affirmation by independent auditors that the statements have been prepared in accordance with GAAP, assures that the numbers are reliable. Reported numbers can be invalidated by subsequent revisions, typically, if not always credibly, attributed to honest mistakes.

Alternatively, issuers may emphasize supplementary, non-GAAP numbers to steer analysts toward a more favorable view of their performance. In fairness, some of the alternative metrics disseminated by issuers increase the clarity of disclosure by addressing genuine shortcomings in the financial reporting rules. The rule makers, after all, have found it challenging to keep accounting standards up to date with changes in the way corporations create wealth. Those changes are a consequence of the shift in the economy from traditional manufacturing to knowledge-based industries. At the same time, the lack of standardization in non-GAAP reporting enables issuers that are so inclined to exaggerate their financial performance.

The following case study demonstrates how an overly trusting user of financial statements can be misled.

**Mattel's Accounting Games**

On August 2, 2019, PricewaterhouseCoopers (PwC), Mattel's outside auditor, received a whistleblower letter suggesting that accounting errors had occurred in earlier periods and questioning whether PwC was truly independent. The toymaker disclosed the letter's receipt on August 8, 2019, and the following day its stock plunged by 15.8 percent while the Standard & Poor's 500 Index registered a minor decline of 0.7 percent. Mattel's board directed the audit committee to investigate the matter.

The investigation found that income tax expense was understated by $109 million in 2017's third quarter and overstated by the same amount in the fourth quarter, resulting in no impact for the full year. Disclosing these findings on October 29, 2019, Mattel pointed out that the errors were noncash and did not affect operating income or **EBITDA** for 2017. The company acknowledged material weaknesses in its internal control over financial reporting but said that the audit committee concluded that PwC's objectivity and impartiality were unimpaired. Mattel further announced plans to restate its 2018 Form 10-K to restate 2017's final two quarters and strengthen its internal financial reporting controls.

Details of the findings included the disturbing fact that after the errors came to light they were not disclosed to Mattel's chief executive officer and the audit committee. The internal investigation did not find that management engaged in fraud, instead blaming mishandling of the discovery of the accounting error on "a confluence of one-time events, management's reliance on the accounting advice sought and received on the error from the lead audit engagement partner of Mattel's outside auditor, and lapses in judgment by management[3]."

Mattel's audit committee determined that many of the whistleblower's allegations about PwC's independence were unfounded. In conjunction with a separate investigation by PwC, however, the audit committee concluded that the lead audit partner for Mattel violated Securities and Exchange Commission rules on auditor independence by recommending candidates for the company's senior finance positions and providing feedback on senior finance employees. PwC replaced some members of the audit team assigned to Mattel, including the lead partner, who was placed on administrative leave. (One commentator on accounting issues characterized him as the fall guy in the affair[4].)

The bland tone of Mattel's disclosure likely reassured investors whose confidence in the company's financial reporting had been shaken by the August 8 revelations. In the following month, however, the *Wall Street Journal* presented details of what happened when Mattel's tax team discovered the accounting error in early 2018, several months before the news reached the audit committee[5].

Brett Whitaker, who was director of tax reporting at the time, said the company's finance team discussed correcting the error and restating earnings, expecting that Mattel would have to come clean about flaws in its accounting procedures. According to Whitaker and documents that the *Wall Street Journal* reviewed, senior company finance executives and PwC decided instead to change the

accounting treatment of the *Thomas & Friends* cartoon series, starring a talking locomotive. That action effectively buried the problem.

Whitaker, who stated that he was not the whistleblower, characterized the senior executives' response as a coverup and said it dumbfounded his team. He reported that one of PWC's tax partners was high-fiving people in the hallway after the decision was made to change the accounting, relieving the auditing firm of the need to admit its error. Whitaker resigned from Mattel in March 2018. Mattel, for its part, replaced its chief financial officer but said the change in accounting treatment was appropriate.

Following this blow to its credibility with investors, one might have expected a chastened Mattel to be on its best behavior with respect to financial reporting. Only a year-and-a-half after the public learned of the accounting error in the 2017 statements, however, the Securities and Exchange Commission ordered the company to stop using a non-GAAP measure it employed in the discussion and analysis section of its 2019 financial statement. "Gross sales" excluded adjustments such as trade discounts. Mattel applied it to overall revenue as well as its "power brands," namely, Barbie, Hot Wheels, Fisher Price – and Thomas the Tank Engine and his pals. Mattel agreed to switch to "gross billings," the amounts invoiced to customers.

The context of these events is instructive for users of financial statements. Mattel's share price fell by 50.2 percent between year-ends 2014 and 2017. In 2018 Mattel lost $531 million on sales of $4.5 million. The company was plagued by declining sales, particularly in the Fisher-Price and American Girl Lines. In addition, Mattel recalled all 4.7 million Rock 'n' Play Sleeper products after the U.S. Consumer Products Safety Commission reported that they were associated with more than 30 infant deaths since their 2009 introduction. (The company said it was not at fault and that the fatalities resulted from customers disregarding safety warnings and instructions.) Seasoned observers of financial reporting notice that errors frequently occur in conjunction with depressed share prices. On January 4, 2021, when the Securities and Exchange Commission ordered Mattel to stop highlighting the non-GAAP gross sales number, its share price was still 44.3 percent below its year-end 2014 level.

Mattel's story is just one of many in this course that should dispel any illusions that financial statements are always completely reliable. The outside auditor's stamp of approval is no guarantee that reported earnings accurately reflect actual results. Auditing firms, no less than corporate issuers of financial statements, are for-profit businesses with incentives to sweep their failings under the rug. Users of the statements must employ the best analytical techniques available to identify signs that the reported numbers are out of line with the company's true performance or financial condition.

**THE FLAWS IN THE REASONING**

As many examples that follow demonstrate, neither fear of antifraud statutes nor enlightened self-interest invariably deters corporations from cooking the books. The reasoning by which these two forces ensure honest accounting rests on hidden assumptions. None of the assumptions can stand up to an examination of the organizational context in which financial reporting occurs.

To begin with, corporations can push the numbers pretty far out of joint before they run afoul of the accounting standards, much less open themselves to prosecution for fraud. When deliberate financial reporting violations come to light, as in most other kinds of white-collar crime, the real scandal involves what is *not* forbidden. In practice, generally accepted accounting principles countenance a lot of measurement that is decidedly inaccurate, at least over the short run.

For example, corporations routinely and unabashedly smooth their earnings. That is, they create the illusion that their profits rise at a consistent rate from year to year. Corporations engage in this behavior, with the blessing of their auditors, because the appearance of smooth growth receives a higher price-earnings multiple from stock market investors than the jagged reality underlying the numbers.

Suppose that, in the last few weeks of a quarter, earnings threaten to fall short of the programmed year-over-year increase. The corporation simply borrows sales (and associated profits) from the next quarter by offering customers special discounts to place orders earlier than they had planned. *Higher*- than-trendline growth, too, is a problem for the earnings-smoother. A sudden jump in profits, followed by a return to a more ordinary rate of growth, produces volatility, which is regarded as an evil to be avoided at all costs. Management's solution is to run up expenses in the current period by scheduling training programs and plant maintenance that, while necessary, would ordinarily be undertaken in a later quarter.

These are not tactics employed exclusively by fly-by-night companies. Blue chip corporations openly acknowledge that they have little choice but to smooth their earnings, given Wall Street's allergy to surprises. In past years officials of General Electric indicated that when a division was in danger of failing to meet its annual earnings goal, it was accepted procedure to make an acquisition in the waning days of the reporting period. According to an executive in the company's financial services business, he and his colleagues hunt for acquisitions at such times, saying, "Gee, does somebody else have some income[6]? Is there some other deal we can make?" The freshly acquired unit's profits for the full quarter could be incorporated into GE's, helping to ensure the steady growth so prized by investors.

Why do auditors not forbid such gimmicks? They hardly seem consistent with the ostensible purpose of financial reporting, namely, the accurate portrayal of a corporation's earnings. The explanation is that sound principles of accounting theory represent only one ingredient in the stew from which financial reporting standards emerge.

Along with accounting professionals, the issuers and users of financial statements also have representation on the **Financial Accounting Standards Board** (**FASB**), the rule-making body that operates under authority delegated by the Securities and Exchange Commission. When FASB identifies an area in need of a new standard, its professional staff typically defines the theoretical issues in a matter of a few months. Issuance of the new standard may take several years, however, as the corporate issuers of financial statements pursue their objectives on a decidedly less abstract plan.

From time to time, highly charged issues, such as executive stock options and mergers, lead to fairly testy confrontations between FASB and the corporate world. The compromises that emerge from these dustups fail to satisfy theoretical purists. On the other hand, rule making by negotiation heads off all-out assaults by the corporations' allies in Congress. If the lawmakers were ever to get sufficiently riled up, they might drastically curtail FASB's authority. Under extreme circumstances, they might even replace FASB with a new rule-making body that the corporations could more easily bend to their will.

There is another reason that enlightened self-interest does not invariably drive corporations toward candid financial reporting. The corporate executives who lead the battles against FASB have their own agenda. Just like the investors who buy their corporations' stock, managers seek to maximize their wealth. If producing bona fide economic profits advances that objective, it is rational for a chief executive officer (CEO) to try to do so. In some cases, though, the CEO can achieve greater personal gain by taking advantage of the compensation system through financial reporting gimmicks.

Suppose, for example, the CEO's year-end bonus is based on growth in earnings per share. Assume also that for financial reporting purposes, the corporation's **depreciation** schedules assume an average life of eight years for fixed assets. By arbitrarily amending that assumption to nine years (and obtaining the auditors' consent to the change), the corporation can lower its annual depreciation expense. This is strictly an accounting change; the actual cost of replacing equipment worn down through use does not decline. Neither does the corporation's tax deduction for depreciation expense rise nor, as a consequence, does cash flow (see Chapter 2 of course 21802B)$_7$. Investors recognize that bona fide profits (see Chapter 1 of course 21803B) have not increased, so the corporation's stock price does not change in response to the new accounting policy. What *does* increase is the CEO's bonus, if it is tied to the highly manipulable earnings per share figure.

This example explains why a corporation may alter its accounting practices, making it harder for investors to track its performance, even though the shareholders' enlightened self-interest favors straightforward, transparent financial reporting. The underlying problem is that corporate executives sometimes put their own interests ahead of their shareholders' welfare. They beef up