QUESTIONS AND DISCUSSION

1. What are “consolidated financial statements”?
2. What is meant by the term “group financial statements”?
3. The balance sheet (or statement of financial position) is often referred to as a “snapshot.” Why?
4. If the balance sheet is a snapshot, how would you describe the income statement and the statement of cash flows?
5. Why must the statement of financial position (i.e., the balance sheet) balance?
6. What is the purpose of the auditor’s opinion?
7. What is Sarbanes-Oxley, and how has it affected corporate financial reporting?
8. Describe the limitations of the financial reporting process.
9. Financial accounting = Economic truth + error + manipulation. Explain.
10. Can you think of instances in which the creation of bias or error in the financial statements might be justified?
11. Describe how the three principle financial statements are linked.
12. What role is played by the notes in the financial reporting process?
13. What is the primary purpose of the statement of changes in shareholders’ equity?
14. What is meant by the term accounting choice, and why is the concept so important in financial accounting?
15. What is meant by the term “earnings management”?

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1. The combined financial statements of a parent company and its subsidiaries.
2. Group financial statements *are* consolidated financial statements. The former term tends to be preferred in some parts of the world, especially Europe.
3. Because it reflects financial performance at a point in time.
4. You could call them “videos,” in that they describe performance over a period of time.
5. Because shareholders’ equity represents a residual claim against the assets of the firm. Therefore, it will expand or contract to whatever size it needs to be to ensure that the two sides of the balance sheet are equal.
6. It’s an attestation by independent public accountants on the reliability of a company’s financial statements. The auditor tell us whether the financial statements were prepared in accordance with GAAP or IFRS, and therefore whether readers can rely on them in making economic decisions such as whether or not to invest in the firm.
7. A law that was passed in the U.S. in the aftermath of the Enron scandal. Among other things it requires all companies (including non-American) that file with the Securities and Exchange Commission to provide an attestation on the trustworthiness of the company’s financial statements from the CEO, the CFO, and maybe the chief accountant. A statement is also required on the quality of the company’s internal

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controls. Similar requirements have since been imposed in several other countries, although they tend to be less onerous than Sarbanes-Oxley.

8. The first issue is the sheer volume of information readers and analysts must contend with. The obvious risk is one of information overload, and determining which of the many pieces of data are truly important for gaining an accurate understanding of a company's financial strength and performance. Second, accounting choice can profoundly impact the figures reported on the financial statements. The implication is that financial accounting is a far from being an objective discipline. Three, financial statements can be manipulated. Fourth, the financial statements, and even the accompanying notes, can exclude critical attributes of a company that will profoundly influence future performance. Examples include investment in intellectual capital or brands. Current accounting practice is limited in what it can tell the reader about such assets.
9. Financial accounting exists to help us understand the underlying economic truth of a company. That way, the world's scarce resources are allocated more efficiently, with the result being greater wealth creation. However, because so much estimation and judgment is required in the accounting process, error is inevitable. Some of that error arises from good faith mistakes on the part of managers who are trying their best to come up with the right numbers. But a lot of that error can be deliberate. This happens when managers deliberately bias accounting numbers upwards or downwards to achieve certain financial reporting goals.
10. Although financial reporting under GAAP and IFRS is separate from tax reporting, companies will often choose financial reporting practices to support a controversial tax position. For example, it may be difficult to defend a position that leads to lower income than the tax authorities believe is reasonable when GAAP or IFRS lead to far higher profits. In such cases, the biasing of accounting numbers to yield lower profits may result in tax savings. We'll leave the ethics of this behavior to another day. Also, companies may bias accounting numbers to avoid the violation of restrictive covenants in debt contracts. Such violations can be costly, because they may lead to debt getting called in by the bank or a renegotiation of the debt on more onerous terms.
11. They are linked in many ways, but three obvious links are (1) the reconciliation of beginning and ending cash from the balance sheet on the statement of cash flows, (2) the net income figure on the income statement which serves to reconcile beginning and ending retained earnings, and (3) the reconciliation between net income and cash flow from operations.
12. The notes provide amplifying details on financial statement line items. Placing all of that detail on the face of the statements would render them confusing and difficult to read. So the details are reported in the notes that follow the financial statements. An example would be financial details on operating divisions. Another example would be the detailed breakdowns for debt, provisions and income taxes. The notes also describe the accounting policy choices made by management, allowing the reader to better understand the reporting assumptions that underlie the financial statements.

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13. To reconcile beginning and ending balances for every account in the shareholders' equity section of the balance sheet. In this way, the way can see the movements into and out of those accounts.
14. Although GAAP and IFRS provide guidelines for financial reporting, many choices must be made by management. For example, what depreciation method to use, the estimated useful lives of depreciable assets, etc. Will we revaluate property, plant & equipment, or continue to use acquisition cost? What will be the specific policies we adopt regarding revenue recognition? Managers have some latitude in making these decisions. This is what is meant by "accounting choice." The concept is not only important for business managers but for financial statement readers too. Different policy choices can lead to very different outcomes on the financial statements. The reader must be aware of these choices and determine whether the choices made by the management of a particular firm were appropriate.
15. Earnings management is the conscious act of biasing accounting numbers to achieve specific financial reporting results. Such acts are often driven by executive bonus plans linked to specific accounting numbers, such as EPS or operating income, or by a desire to manage or finesse the company's share price. Planned public offerings or management buyouts can also create incentives for earnings management.

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