

Stock Prices

HEWLETT PACKARD CO (NYSE: HPQ)

After Hours: **52.51** ↓ **-0.06 (-0.11%)** 4:45pm ET

Last Trade:	52.57	Day's Range:	52.53 - 52.83
Trade Time:	4:00pm ET	52wk Range:	25.39 - 52.94
Change:	↓ 0.19 (0.36%)	Volume:	6,965,648
Prev Close:	52.76	Avg Vol (3m):	14,534,700
Open:	52.62	Market Cap:	124.28B
Bid:	N/A	P/E (ttm):	16.73
Ask:	N/A	EPS (ttm):	3.143
1y Target Est:	58.93	Div & Yield:	0.32 (0.60%)



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Explanation of Table

Shown above is part of a typical page from finance.yahoo.com showing stock price information for Hewlett Packard Co. The stock-listing format shown is the same for securities traded on the New York Stock Exchange, American Stock Exchange and Nasdaq National Market Issues. The table is an example of how current day prices would be indicated. Some of the explanations shown below are adapted from [The Wall Street Journal Educational Edition](#).

Name of the Company	Self explanatory
Name of Stock Market (e.g., NYSE)	Indicates where the stock is listed for trading: New York Stock Exchange (NYSE), American Stock Exchange (AMEX) or the NASDAQ stock market.
Ticker Symbol (e.g., HPQ)	This ticker symbol is used to identify the stock when looking it up on various computer databases or electronic-information systems. If you do not know a company's ticker symbol, you may go to symbol lookup at the top of the page.
Last trade	This is the price at which the most recent trade was executed. At the end of a trading day the last trade price would be called the closing price. The closing price is used for valuing portfolios and other purposes.

Change	The "change" is the difference between the current price (Last trade) and the previous day's closing price.
Previous Close	The "previous close" price was the last trade price that occurred on the previous trading day.
Open	This price represents the selling price for the first stock sale on a particular trading date.
Bid	This is the highest price that someone is willing to pay to buy shares of stock. This also means that this is the highest price you can expect to get for your shares of stock when selling them.
Ask	The ask price is the lowest price you can pay for the stock. This is because it's the lowest price any seller is offering their shares of stock for.
1y Target Est	The 1 year target price estimate represents the median target price as forecast by analysts covering the stock.
Day's Range	These numbers indicate the highest and lowest prices paid for the stock during the particular trading date.
52-week Range	These numbers indicate the highest and lowest prices paid for the stock over the past 52 weeks.
Volume	This number indicates the number of shares traded so far on the particular trading date.
Average Volume	This number indicates the average number of shares traded during the past three months for this particular stock.
Market Capitalization	Represents the total dollar market value of the shares of stock outstanding. This number would be obtained by taking the total number of shares held by stockholders multiplied by the current selling price.

<p>Price-Earnings Ratio</p>	<p>The P-E, or price-earnings, ratio is the result of dividing the latest closing price by the latest available earnings per share. (Earnings per share is profit divided by the number of shares outstanding.)</p> <p>The P-E ratio is used as an indicator of relative stock performance. High P-E figures indicate a stock price that represents a high multiple of a company's earnings, and suggest that investors are more optimistic about the stock's prospects. Low P-E stock, on the other hand, trade at a lower multiple of earnings, and often represent lower investor favor. But there isn't any "best" ratio. Reasons for high and low P-Es include the company's growth outlook, the industry the company is engaged in, accounting policies, riskiness or the stability of earnings.</p>
<p>EPS (ttm)</p>	<p>Earnings Per Share (EPS) is stated for the most recent 12 months (ttm, trailing twelve months). It represents primary earnings from continuing operations attributable to each share of common stock outstanding.</p>
<p>Dividend & Yield</p>	<p>The dividend number represents the stock's annual cash dividend, if any, based on the rate of the last quarterly payout to shareholders. The percentage dividend yield is obtained by dividing the cash dividend by the closing price of the stock. This enables dividend yields to be compared with other stocks and with the interest paid on debt instruments. Please observe that the yield does not consider the effects of changes in the market price of the security.</p>

FOREIGN CURRENCY Watching Exchange Rates

Adapted from The Wall Street Journal Educational Edition

A Foreign Exchange table gives the exchange rates prevailing at 3 p.m. Eastern time; expressed both as dollars per unit of foreign currency and as units of foreign currency per dollar. The former is the U. S. way of looking at things, the latter is the foreign way. Readers may encounter both ways. These rates apply to transactions among banks in amounts of \$1 million or more. Rates for smaller transactions will be less favorable. Banks usually offer individuals better rates than commercial establishments do.

Some currencies, such as the Belgian franc, have different rates for financial or commercial transactions. For some major currencies, such as the German mark, rates also are given for future delivery.

Exchange rates between important currencies used to be fixed, with sudden large changes forced only by the pressures of crises. Eventually the pressures became too great and too persistent, so rates now vary daily among major currencies. The system is known as floating exchange rates.

American Dollar	1 USD	in USD
Argentine Peso	3.86085	0.25901
Australian Dollar	1.11335	0.89819
Brazilian Real	1.7345	0.576535
British Pound	0.625442	1.59887
Bulgarian Lev	1.35509	0.737958
Canadian Dollar	1.03922	0.96226
Chilean Peso	507.809	0.00196924
Chinese Yuan	6.82942	0.146425
Colombian Peso	2048.23	0.000488226
Croatian Kuna	5.06132	0.197577
Danish Krone	5.15589	0.193953
Estonian Kroon	10.8409	0.0922433
Euro	0.692857	1.4433
Hong Kong Dollar	7.7557	0.128937
Hungarian Forint	188.831	0.00529574
Iceland Krona	125.725	0.00795387
Indian Rupee	46.6847	0.0214203
Israeli New Shekel	3.79468	0.263527
Japanese Yen	91.7619	0.0108978

Source: <http://www.x-rates.com/d/USD/table.html>

Using values from Tuesday, December 29, 2009

For example, if a Japanese supplier sent a bill to our company for 50,000 Yen, the company would owe $50,000 \times 0.0108978 = \544.89^1

¹ An alternative calculation would be $50,000 \div 91.7619 = \$544.89$

The Accounting Profession

Accounting has evolved, as have medicine, law, and other professions, in response to the social and economic needs of society. For the most part, early accounting dealt only with meeting the financial information needs of a relatively few owners of business enterprises. As business and society became more complex over the years, the accounting function expanded in order to meet the needs of a variety of interested parties. The two major users of accounting information may be referred to as internal users and external users. The management of the entity is an internal user; all other users, such as investors, creditors, labor, and governmental bodies, are external users of accounting information. The different information needs of the various decision makers results in two related, but different accounting reporting systems. The accounting system used to provide information to the management of an entity is referred to as **managerial accounting**. The accounting system used to provide information to external users is referred to as **financial accounting**. It should be pointed out that there is not a complete separation between the managerial and financial accounting systems. The primary accounting records are for the preparation of the financial statements, which are directly or indirectly required by law. Much of the accounting information for managerial decision making comes from those records. Moreover, management is responsible for the content of financial accounting statements. Also, management is obviously concerned about the financial statements, since these statements are often used to evaluate management. In addition, external users would probably want to have much of the economic information referred to as managerial accounting, but such information is not provided externally because it would be available to competitors; hence it is viewed as confidential information. Finally, the term financial accounting is somewhat misleading because all accounting is financial in that it is stated in monetary terms.¹

In our society, the various functions of accounting are performed by accountants employed in (1) public accounting, (2) private accounting, (3) governmental accounting, or (4) accounting education. Members of these accounting fields have formed many accounting organizations in attempts to advance, in some way, the accounting profession. A description of the various fields of accounting and the most prominent organizations and their publications will now be discussed.

Public Accounting

Let us suppose that you were a loan officer for a bank, and representatives of the Apex Company came to you requesting a loan of \$10,000. They presented the following information to you:

¹ Glenn L. Johnson and James A. Gentry, Finney and Miller's Principles of Accounting: Introductory, 8th ed., (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1980), pp. 15-16

Apex Company
Balance Sheet
December 31, 20x1

<u>Assets</u>		<u>Liabilities & Owner's Equity</u>	
Cash	\$2,500,000	Notes Payable	\$ 500,000
Inventories	1,000,000	Owner's Equity	4,500,000
Plant and Equipment	<u>1,500,000</u>		
Total	\$5,000,000	Total	<u>\$5,000,000</u>

Apex Company
Income Statement
For the Year Ended December 31, 20x1

Sales	\$6,000,000
Costs and Expenses	<u>3,500,000</u>
Income Before Taxes	\$2,500,000
Applicable Income Taxes	<u>1,250,000</u>
Net Income	\$1,250,000

If you had to make a loan decision based solely upon the financial information given, what would you do? Should you grant the loan? As a means of helping you answer this first question, let me pose another question. Let us consider what you would do if a complete stranger, appearing to be more than slightly intoxicated, were to enter your office claiming that he had five million in assets, had only one-half million dollars in debt, and that he had a profit for the past year of one and one-quarter million dollars. Would you lend him the “small” \$10,000 loan that he was seeking to “tide him over”? At the very least, you would probably want some “verification” of the authenticity of the information that he was providing. While each lending institution could attempt to document the authenticity of a prospective borrower’s financial status, it would probably be easier if an independent third party would study the operations of an entity and disclose its findings to all interested parties. This function of checking, reviewing, testing, and verifying the accounting work of other, generally with the objective of expressing a formal opinion on the fairness of the resulting information is called **auditing**. The major purpose of the audit process is to increase the credibility of the financial reports issued by an entity. The audit function, frequently referred to as the “attest function” -- that is attesting to the fairness of an entity’s financial statements, is the primary service of public accountants.

Public accountants are individuals who offer their professional accounting services and those of their employees to the public for a fee.² In addition to performing the auditing

²Kermit D. Larson and William W. Pyle, Financial Accounting, 3rd ed., (Homewood, Illinois: Richard D. Irwin,

function, public accountants also perform two other major services; management advisory services and tax services.

Management advisory services (MAS) basically involve the conduct of a management consulting practice for clients. In performing the audit function, the auditor is in an excellent position to obtain an intimate knowledge of the audited company's accounting procedures and operations. The auditor is thus in an excellent position to offer constructive suggestions for improving both the accounting procedures as well as other facets of the company's operations. The accountant may advise the client in many business areas including systems design, financial planning, mergers and acquisitions, marketing, forecasting and inventory pricing and control. Because much of the work goes beyond traditional accounting matters, the larger public accounting firms have hired specialists for various consulting areas. For example, the accounting firms may hire computer experts, engineers, and mathematicians.

The third service provided by public accountants is **tax service**. Public accountants often are called upon for expert advice regarding the preparation and filing of federal, state, and local tax returns. The object here is to use legal means to minimize the amount of taxes paid. An equally important service is that of tax planning. Proper tax planning requires that the tax effect, if any, of every business decision be known fully and understood before the decision is made.

Recognizing the need for the performance of accounting services to be of the highest caliber, all of the states provide for the licensing of **certified public accountants (CPAs)**. The requirements to become a CPA differ among the various states. Most states require four years of college, with a specified minimum number of credits in accounting and other business courses. The states also have varying residency and experience requirements. All states require that a candidate pass an examination prepared by the Board of Examiners of the American Institute of Certified Public Accountants. The CPA examination, which is uniform in all states, is administered twice a year, in May and November. The two and one-half day exam covers four different topics: accounting practice, auditing, business law, and accounting theory. In addition, some states require the candidates to take an additional examination in an area such as economics.

The number of CPAs has increased significantly in recent decades. In 1944, fifty years after the enactment of the first CPA law, there were approximately 25,000 CPAs in the United States. During the next four decades the number increased tenfold, and currently the number exceeds 300,000.³

It should be noted that the practice of public accounting is not restricted to CPAs.

Inc., 1986), p. 7

³ Philip E. Fess and Carl S. Warren, Accounting Principles, 16th ed., (Cincinnati, Ohio: South-Western Publishing Co., 1990), p. 3

Accountants who are not certified may also make their services available to the public. However, only a CPA may issue a certified audit opinion.

Public accounting firms include partners, who must be CPAs, and staff accountants. The size of these firms varies from small one or two person firms to the very large international firms employing thousands of accountants. The largest public accounting firms, which are frequently referred to as the **Big Five**, are as follows:

Arthur Andersen & Co.
Deloitte and Touche
Ernst & Young
KPMG Peat Marwick
PricewaterhouseCoopers

The American Institute of Certified Public Accountants

The **American Institute of Certified Public Accountants (AICPA)**, formed in 1887 and originally called the American Institute of Accountants, is the primary organization representing public accountants. The **Journal of Accountancy**, a monthly publication of the AICPA, was first issued in 1905, and serves as a means of communicating to its members the problems, proposed solutions, challenges and responsibilities faced by the profession. Two additional publications of general interest to accountants are **Accounting Trends and Techniques** and the **Accountants' Index**. **Accounting Trends and Techniques** is an annual publication containing a survey of the accounting and reporting practices of 600 large industrial and commercial corporations. It presents statistical tabulations on specific practices, terminology, and disclosures together with illustrations taken from individual annual reports. The **Accountants' Index** is a series published each quarter (with annual summaries) in which the literature pertaining to accounting for the period covered is indexed.

The accounting profession recognizes that it must play an important role in combating “white collar” fraud, and its response to criticisms in this area has been direct and immediate. For example, the AICPA established a new Accounting Firms Division (in addition to the existing division for individual AICPA members) with two sections: one for firms auditing SEC clients (called the **SEC Practice Section**) and the other for firms auditing privately owned, non-SEC clients (called the **Private Companies Section**). CPA firms that audit SEC registered firms must join the SEC Practice Section and therefore must comply with more comprehensive practice requirements (such as compulsory peer practice review) than those of the Private Companies Section. To help assure the public that the SEC Practice Section is meeting its responsibilities, the AICPA established as part of this structure an independent **Public Oversight Board**. The Board, composed of distinguished nonaccountants, has its own staff and is free to conduct its own inquiries and

to report publicly as it wishes.⁴

Each of the states has a counterpart professional organization concerned with addressing state and local issues, interacting with the state's board of accountancy, and providing professional journal and/or technical meeting forums for members to exchange insights and ideas. These groups tend to call themselves associations, societies, or institutes, e.g., Maryland Association of Certified Public Accountants, New Jersey Society of Certified Public Accountants, and Pennsylvania Institute of Certified Public Accountants.

Private Accounting

Accountants employed by a not-for-profit organization or a particular business firm, other than an accounting firm, are said to be engaged in industrial or **private accounting**.⁵ More accountants are employed as private accountants than in any other field of accounting.

Included in the many functions performed by private accountants are the following:

Basic Recording and Reporting - involves the recording of transactions and the periodic preparation of various reports from such records

Budgeting - involves the preparation of a formal financial plan showing how the entity's resources are to be acquired and used over a specified period of time

Cost Accounting - the phase of accounting that involves collecting, determining, and controlling costs, particularly costs of providing a given product or service

Internal Auditing - involves the examination of the records and activities of an entity to make sure that management policies, pertaining to accounting and general operations, are being followed throughout the company

Information Systems Design - the phase of accounting concerned with the design and installation of the various aspects of the information system including the nature and flow of accounting forms as well as the manner of processing accounting data (manual, internally computerized, or use of an external computer service)

Tax Services - involves both the preparation of tax returns and tax planning

The Institute of Management Accountants, the Institute of Internal Auditors, and the Financial Executives Institute are major national organization representing the interests of private accountants.

⁴ Donald E. Kieso and Jerry J. Weygandt, Intermediate Accounting, 7th ed., (New York: John Wiley & Sons, Inc., 1992), p. 20

⁵ Fess and Warren, Accounting Principles, p. 10

The Institute of Management Accountants

The **Institute of Management Accountants (IMA)**, formerly the National Association of Accountants, has been interested in research primarily in cost accounting and managerial accounting since its origin in 1919. Its monthly publication, **Management Accounting**, has traditionally dealt mainly with problems involving information systems and the use of accounting data within the business organization. Because a firm's information system can provide information for both internal and external users, the NAA is concerned about the relationship of accounting principles for internal reporting to those for external reporting.⁶

The Institute of Certified Management Accountants, which is an affiliate of the Institute of Management Accountants, grants the certificate in management accounting (CMA) as evidence of professional competence in that field. Requirements for the CMA designation include the baccalaureate degree or equivalent, two years of experience in management accounting, and successful completion of examinations occupying two and one-half days. Participation in a program of continuing professional education is also required for renewal of the certificate.⁷

The Institute of Internal Auditors

The **Institute of Internal Auditors** administers a program, similar to the certification program of the Institute of Management Accounting, for internal auditors. Accountants qualifying under this program are entitled to use the designation Certified Internal Auditor (CIA).⁸

The Financial Executives Institute

The **Financial Executives Institutes (FEI)** is an organization established in 1931 whose members are primarily financial policy-making executives.⁹ Members of this organization are an important subset of *preparers* of financial statements. Slightly more than 13,000 financial officers, representing approximately 7,000 companies in the United States and Canada, comprise its membership. Through its Committee on Corporate Reporting and other means, the FEI is very effective in representing the views of the private financial sector to the FASB and to the Securities and Exchange Commission and other regulatory agencies.¹⁰ The **Financial Executive** is the monthly journal providing

⁶ Kieso and Weygandt, Intermediate Accounting, p. 14

⁷ Fess and Warren, Accounting Principles, p. 10

⁸ Ibid., pp. 10-11

⁹ Roger H. Hermanson and James Don Edwards, Financial Accounting, 5th ed., (Homewood, Illinois: Richard D. Irwin, Inc.) p. 11

¹⁰ Ibid., pp. 11-12

information on all aspects of corporate financial matters.

Governmental Accounting

Accountants employed by federal, state, and local governments perform the same functions as accountants in private business -- basic recording and reporting, budgeting, information systems design, tax services, and internal auditing. Such services are intended to aid government officials in directing the activities of their governmental unit. The Association of Government Accountants is a major organization representing government accountants.

Accounting Education

In order to obtain qualified government, private, and public accountants there is a need to properly educate these people. Accounting educators also contribute to the advancement of the practice of accounting through their research activities. The major organization of accounting educators is the **American Accounting Association (AAA)**.

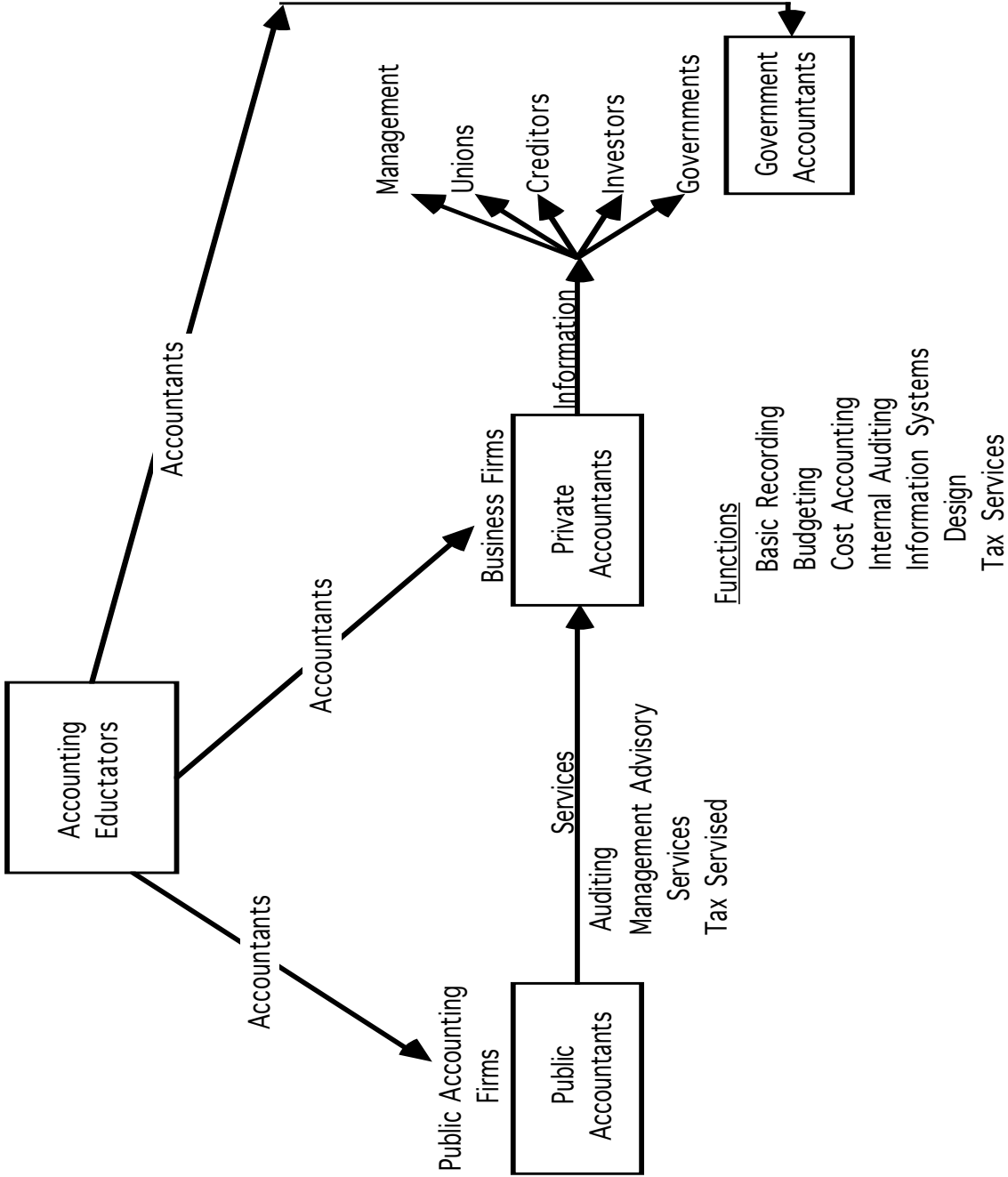
The American Accounting Association was founded in 1935, succeeding the American Association of University Instructors in Accounting, which was started in 1916. This group has an academic and theoretical point of view.¹¹ While the AAA is an organization primarily for accounting educators, its membership also includes accountants in public practice, industry, and not-for-profit organizations.¹² The oldest regular publication of the AAA is a quarterly research journal, **The Accounting Review**.¹³ Articles in **The Accounting Review** generally discuss matters of accounting theory as compared with articles in the Journal of Accountancy that are primarily concerned with matters of accounting practice. During the past two decades the AAA has given greater emphasis and encouragement to independent research in all areas of accounting through an ambitious program of financing research and sponsoring publication of results. The first of the AAA **Studies in Accounting Research**, published in 1969, initiated a continuing series of contributions to accounting theory.¹⁴

¹¹ Belverd E. Needles, Jr., Henry R. Anderson, and James C. Caldwell, Principles of Accounting, (Boston, Houghton Mifflin Company: 1990), p. 12

¹² Thomas R. Dyckman, Roland E. Dukes, and Charles J. Davis, Intermediate Accounting, Revised Edition, (Homewood, Illinois: Richard D. Irwin, Inc., 1992), p. 17

¹³ Jay M. Smith and K. Fred Skousen, Intermediate Accounting, 11th ed., (Cincinnati, Ohio: South-Western Publishing Co., 1992), p. 17

¹⁴ Kieso and Weygandt, Intermediate Accounting, p. 14



The Development of Accounting Standards

The Development of Accounting Standards in the United States

Before 1900 the economy of the United States required a relatively unsophisticated type of accounting function, and an accounting profession per se was virtually nonexistent. Single ownership was the predominant form of business organization in our economy. Accounting reports emphasized solvency and liquidity and were limited to internal use and scrutiny by banks and other lending institutions. From 1900 to 1929 the growth of large corporations, with their absentee ownership and the increasing investment and speculation in corporate stocks, created a demand for greater disclosure and a change from the concern with solvency to a concern with income-producing ability. The constitutional amendment in 1913 authorizing the federal government to impose an income tax on businesses and individuals intensified the emphasis on income measurement. As a result of the stock market crash of 1929, the Great Depression, and widespread dissatisfaction with accounting reports, the federal government, the stock exchanges, and the accounting profession made efforts to improve accounting.¹ Since that time the accounting profession has been continually engaged in the critical analysis and re-examination of fundamental accounting theory and practices in an attempt to establish a body of theory and practice that could serve as a general guide. Its efforts have resulted in the adoption of a set of accounting concepts, standards, and procedures commonly referred to as generally accepted accounting principles (GAAP).

Many groups have played important roles in the development and the expression of accounting principles and practices. Some of the more prominent organizations will be discussed below.

The American Institute of Certified Public Accountants

The efforts of the American Institute of Certified Public Accountants (AICPA) have been vital to the development of “generally accepted accounting principles” in the United States. The organization was formed in 1887 and was originally named the American

¹ Donald E. Kieso and Jerry J. Weygandt, Intermediate Accounting, 8th ed., (New York: John Wiley & Sons, 1995) p. 10.

Institute of Accountants.² In 1930 the Institute appointed a special committee to work in conjunction with the New York Stock Exchange on matters of common interest to investors, accountants, and the exchanges. The Committee on Accounting Procedure (CAP) was an outgrowth of this special committee.

The Committee on Accounting Procedure

The CAP was composed of 21 volunteer AICPA members, most of whom were practicing accountants. The CAP's purpose was to further the development of accounting principles, primarily by reducing the number of alternatives available for a given type of transaction or item. During the years 1939 to 1959 the CAP issued 51 Accounting Research Bulletins.³ In 1953, the first 42 ARB's were revised and reissued as Accounting Research Bulletin No. 43. The committee published eight more ARB's before it was dissolved in 1959.⁴ Those ARBs, which have not been superseded by professional pronouncements, are still important sources of generally accepted accounting principles.⁵

Even though the ARBs helped to improve the quality of accounting practice, the CAP was criticized for several reasons. The primary criticism was the committee's failure to develop a coherent framework of objectives and broad principles within which to resolve specific accounting problems. Instead the CAP followed a more expedient "piecemeal" approach, trying to resolve immediate problems on a case-by-case basis. A result was that the ARBs were sometimes inconsistent with one another. Other major criticisms were that the CAP permitted too many alternative accounting principles to exist, did not move quickly enough, and did not support conclusions with research.⁶

The Accounting Principles Board

In 1959 the Accounting Principles Board (APB) was formed to overcome some of the

² Jay M. Smith, Jr. and K. Fred Skousen, Intermediate Accounting, 8th ed., (Pelham Manor, N.Y: South-Western Publishing Co., 1984), p. 11.

³ Jan R. Williams, Keith G. Stanga, and William W. Holder, Intermediate Accounting, 4th ed. (New York: Harcourt Brace Jovanovich, Inc., 1992) pp. 12-13.

⁴ Jan R. Williams, Keith G. Stanga, and William W. Holder, Intermediate Accounting, (New York: Harcourt Brace Jovanovich, Inc., 1984) p. 12.

⁵ Williams, Stanga, and Holder, Intermediate Accounting, 4th ed., p. 13.

⁶ Ibid.

weaknesses of the Committee on Accounting Procedure. While the Board's 18 to 21 members were selected primarily from public accounting, representatives from industry and the academic community were also included. All of the members of the APB were members of the AICPA, they continued their affiliations with their firms or institutions, and they served on a part time basis without pay.

The APB, according to its initial charter, was to differ in two important respects from the Committee on Accounting Procedure. First, it was to establish a comprehensive structure of accounting theory, beginning with a set of basic postulates, followed by a set of broad principles, and ending with a set of rules to guide the application of the principles in specific situations. Second, the process of developing this theoretical structure was to be based on a comprehensive research program.⁷

In order to achieve the second objective, the AICPA expanded its research efforts by establishing the Accounting Research Division. Research studies, sponsored by the Accounting Research Division, were made by independent investigators or by members of the research staff. Upon completion of a research project, the results of the investigation and the conclusions were published as Accounting Research Studies (ARS). These ARS were not official pronouncements of the Institute but were published to stimulate interest and discussion before the Accounting Principles Board made a pronouncement on the subject. Unfortunately only 15 studies were published.

Between 1959 and 1964, the APB directed much of its effort toward finding a conceptual framework for the development of accounting principles. Despite all of the good intentions, the APB attempt to develop a conceptual framework never came to fruition, partly because of the length of time involved in research projects and partly because of the difficulties inherent in the task itself. By the middle of the 1960's, an increasing number of financial reporting problems had developed in the securities market, and the work of the APB thus changed from an attempt to develop theory to the solution of pressing, day-to-day problems, often in a piecemeal manner.⁸

The APB issued pronouncements called Opinions. These opinions presented the

⁷ Sidney Davidson, Clyde P. Stickney, and Roman L. Weil, Intermediate Accounting: Concepts, Methods and Uses, 1980/81 ed., (Hinsdale, Illinois: The Dryden Press, 1980), p. 1-13.

board's views concerning proper accounting in areas such as income taxes, earnings per share, and intangible assets. Issuance of an opinion required a two-thirds vote of the APB's members. From 1959 to 1973 the board issued 31 opinions. Although the Financial Accounting Standards Board replaced the APB in 1973, opinions that have not been superseded are still important sources of generally accepted accounting principles.⁹

During the early years of the APB's existence, the AICPA could not require practitioners to comply with APB Opinions. In October 1964, however, the AICPA's governing council adopted a recommendation that AICPA members "should see to it that departures from Opinions of the Accounting Principles Board (as well as effective Accounting Research Bulletins issued by the former Committee on Accounting Procedure) are disclosed, either in footnotes to financial statements or in the audit reports of members in their capacity as independent auditors."¹⁰

By the end of the 1960's public confidence in the integrity of financial reporting decreased, and the APB was severely criticized. Among other things, some persons felt that the APB did not take a strong enough position in certain areas, that it took a position before hearings had been held on exposure drafts of proposed pronouncements and that research activities needed more adequate supervision.¹¹ These criticisms as well as dissatisfaction with the part-time nature of these boards, their failure to act promptly to some issues, and the lack of broad representation on the boards because membership was restricted to members of the AICPA, led to the formation in 1972 of a special AICPA committee to study the organizational structure for establishing accounting principles. The former commissioner of the Securities and Exchange Commission Francis M. Wheat chaired this special AICPA committee. The committee recommended the creation of an organization that became known as the Financial Accounting Standards Board.

The Financial Accounting Standards Board

⁸ Loudell O. Ellis and Ronald J. Thacker, Intermediate Accounting, (New York: McGraw-Hill Book Company, 1980), p. 15.

⁹ Williams, Stanga, and Holder, Intermediate Accounting, 4th ed., p. 13.

¹⁰ AICPA Special Bulletin, Disclosure of Departures from Opinions of Accounting Principles Board, par. 1 quoted in Williams, Stanga, and Holder, Intermediate Accounting, 4th ed, p. 14.

¹¹ Ellis and Thacker, Intermediate Accounting, p. 15.

The recommendations of the Wheat Committee, which were accepted by the AICPA, called for the establishment of:

- a Financial Accounting Foundation
- a Financial Accounting Standards Board
- a Financial Accounting Standards Advisory Council¹²

The Financial Accounting Foundation (FAF) is the parent organization. It is governed by a 16-member Board of Trustees appointed from the memberships of eight organizations interested in the formulation of accounting principles. The primary responsibilities of the FAF are to raise funds for the operations of the organization, provide general oversight to its operations, and appoint the members of the Financial Accounting Standards Advisory Council (FASAC) and the FASB.¹³

The Financial Accounting Standards Board (FASB) differs structurally from the APB in two important respects. First, there are seven members of the FASB. They serve on a full-time basis and must sever all relations with their previous employers. This severance of relations increases the independence of Board members, and reduces chances for undue influence by their previous employers. Second, the FASB may have as members individuals with backgrounds in corporate controllership, academia, government services, and financial markets as well as former practicing CPAs. Furthermore, the FASB is not an organ of any single professional organization.¹⁴

The Financial Accounting Standards Advisory Council is composed of approximately 35 members who respond to proposed standards as well as advise the FASB concerning topics to be considered.

The process used by the FASB to establish its own standards represents an acknowledgement that the standard-setting process is a political one. To improve the likelihood that the business community will accept its pronouncements, the FASB attempts to involve in its standard-setting process representatives of all parties who have an interest in financial reporting. The process usually adhered to by the FASB includes

¹² Davidson, Stickney, and Weil, Intermediate Accounting: Concepts, Methods, and Uses, p. 1-14.

¹³ Loren A. Nikolai and John D. Bazley, Intermediate Accounting, 3rd ed., (Boston: PWS-Kent Publishing Company, 1991), p. 9.

¹⁴ Davidson, Stickney, and Weil, Intermediate Accounting: Concepts, Methods, and Uses, p. 1-14.

the following steps:

- the issuance of a discussion memorandum which summarizes the issues involved in a particular project
- conducting a public hearing on the subject
- the issuance of an exposure draft of a proposed statement
- the adoption of a final statement of financial accounting standard

In addition to statements of financial accounting standard, the FASB may issue interpretations of a particular statement. The statements establish new standards or modify existing ones; the interpretations are issued in order to clarify previously issued pronouncements, including those of the FASB's predecessors.

The FASB may also issue statements of financial accounting concepts. The intended purpose of these statements is to set forth fundamental accounting concepts that the Board may use in establishing future standards of financial accounting.

The first action of the FASB was a decision that the previous Accounting Research Bulletins approved by the APB and the Opinions of the APB (as amended) would continue in force.

Recent Role of the AICPA

For several decades the AICPA provided the leadership in the development of accounting principles and rules; it regulated the accounting profession and developed and enforced accounting practice more than did any other professional organization. When the Accounting Principles Board was dissolved and replaced with the FASB, the AICPA established the Accounting Standards Division to act as its official voice on accounting and reporting issues.

The Accounting Standards Executive Committee (AcSEC) was established within the Division and was designated as the senior technical committee authorized to speak for the AICPA in the area of financial accounting and reporting. It does so through various written communications:

- Issues Papers. A major role of AcSEC has become one of providing guidance for specific industry situations through the development of issues papers. Issues papers identify current financial reporting problems and present alternative

treatments of the issue.

- **Statements of Position.** In some cases, the FASB decides not to add the subject of the issues paper to its agenda; as a result, AcSEC may subsequently decide to issue a Statement of Position (SOP) on the matter. SOPs involve a reporting issue in a given industry.
- **Practice Bulletins.** AcSEC also issues Practice Bulletins that indicate how the AICPA believes a given transactions should be reported.
- **Industry Accounting and Auditing Guides.** Finally, the AICPA issues Industry Accounting and Auditing Guides, which provide specific guidance in a given industry. Examples are accounting for casinos, airlines, colleges and universities, banks, insurance companies, and many others.¹⁵

In 1972, the AICPA issued Rule 203 of the AICPA Code of Professional Conduct. It prohibited an AICPA member from expressing an opinion that financial statements conform with GAAP if the statements contained a material departure from an accounting principle established by the Financial Accounting Standards Board (as well as accounting principles established by effective ARBs and APB Opinions), unless the member could prove that because of unusual circumstances, following such a principle would result in misleading financial statements.¹⁶ Thus the policy of persuasion (requesting) gave way to one of professional compulsion (required for membership in AICPA).

Current Source of GAAP

On July 1, 2009, the Financial Accounting Standards Board (FASB) instituted a major change in the way accounting standards are organized. On that date, the *FASB Accounting Standards Codification*TM (FASB Codification) became the single official source of authoritative, nongovernmental U.S. generally accepted accounting principles (U.S. GAAP). Now, only one level of authoritative U.S. GAAP exists, other than guidance issued by the Securities and Exchange Commission (SEC). All other literature will be non-authoritative. The FASB will still have primary responsibility for issuing GAAP.

¹⁵ Kieso and Weygandt, *Intermediate Accounting*, p. 17.

¹⁶ *AICPA Professional Standards - Volume 2* (Chicago: Commerce Clearing House), ET Sec. 203.01 quoted in Williams, Stanga, and Holder, *Intermediate Accounting*, 4th ed, p. 14.

Securities and Exchange Commission

The Securities and Exchange Commission (SEC) was created as a result of the Great Depression of the 1930s, which resulted in the widespread collapse of businesses and the securities market. The SEC is an agency of the federal government.¹⁷ This government intervention and regulation resulted from a concern about financial statements and accounting standards.¹⁸ A direct result of this concern was the enactment of the Securities Act of 1933 and the Securities and Exchange Act of 1934 by which Congress accepted the ultimate legal authority for prescribing the methods of accounting used in preparing financial statements for shareholders of publicly held corporations. Congress, however, has delegated its authority to the Securities and Exchange Commission (SEC), an independent regulatory agency of the United States government.¹⁹ During the years from 1936 to 1938, the Commission engaged in heated controversy regarding whether or not it should promulgate a set of accounting principles to be followed by all firms filing reports with it. Due in large part to the persuasiveness of the Chief Accountant, the Commission decided in 1938 to permit the profession to lead the way in the formulation of accounting principles. The Commission has, however, at various times put pressure on the profession to reduce the areas of differences in accounting practice with the threat that if the profession did not do so, the SEC would.²⁰

To obtain permission to sell an issue of securities, a company must secure SEC approval of a prospectus, which becomes a public record. The prospectus, which is prepared only when there is a new security issuance, reports extensive information about a company, its officers, securities, and financial affairs. An independent CPA must audit the financial portion of the prospectus. After receiving permission to sell securities, the company must file with the Commission, as a matter of public record, audited financial statements each subsequent year (10-K reports) and unaudited quarterly statements (10-Q reports). The Commission, which prescribes the form of the financial statements submitted to it, requires more information in the annual financial 10-K reports than is typically included

¹⁷ Kieso and Weygandt, Intermediate Accounting, p. 17.

¹⁸ Kieso and Weygandt, Intermediate Accounting, 4th ed., p. 13.

¹⁹ Davidson, Stickney, and Weil, Intermediate Accounting: Concepts, Methods and Uses, p. 1-12.

²⁰ Eldon S. Hendriksen, Accounting Theory, 3rd ed., (Homewood, Illinois: Richard D. Irwin, Inc., 1977) p. 69.

in the “published financial statements” furnished to the shareholders.²¹

The primary official pronouncements of the SEC include

- Regulation S-X -- a document specifying the form and content of financial statements required to be filed with the SEC
- Financial Reporting Releases (FRRs) -- a series of opinions on accounting principles that deal with non-enforcement (nondisciplinary) matters. For many years, the SEC issued a single series of pronouncements entitled Accounting Series Releases (ASRs), which consisted of opinions on accounting principles. The ASRs and Regulation S-X comprised the primary pronouncements on the form and content of financial statements to be filed with the Commission. In 1982, the Commission codified certain ASRs and instituted two new series of pronouncements, one of which dealt with non-enforcement (nondisciplinary) related pronouncements (FRRs). The first FRR is a codification of the entire applicable prior ASRs. Since the codification supersedes all of the previously issued nonenforcement-related releases, there is no need to refer to previous ASRs.²²
- Accounting and Auditing Enforcement Releases (AAERs) -- this series of pronouncements originated in 1982 and deals with enforcement (disciplinary) matters. Prior enforcement related ASRs continue to be in effect.
- Staff Accounting Bulletins -- a series of reports, that provide examples, in question and answer format, of responses given by the SEC staff in specific situations.

Internal Revenue Service

The Internal Revenue Service (IRS) administers the provisions of the Internal Revenue Code enacted by Congress. Federal income tax laws have had a significant impact upon reporting practices since they were first enacted in 1913.²³ Although the

²¹ Glenn A. Welsch, Charles T. Zlatkovich, and Walter T. Harrison, Jr., Intermediate Accounting, 6th ed., (Homewood Illinois: Richard D. Irwin, Inc., 1982), p. 5.

²² Kieso and Weygandt, Intermediate Accounting, p. 11.

²³ Loren A. Nikolai, John D. Bazley, Richard G. Schroeder, and Isaac N. Reynolds, Intermediate Accounting, 2nd ed., (Boston: Kent Publishing Company, 1983), p. 9.

Internal Revenue Code does not directly affect financial accounting theory, business managers, in an effort to lessen the impact of taxes, and to avoid keeping two sets of books, have frequently adopted “acceptable” accounting procedures that minimize taxable income. Because the objectives of the tax law differ from the objectives of financial accounting, however, “good tax accounting” is not necessarily “good financial accounting.”²⁴

Cost Accounting Standards Board

The Cost Accounting Standards Board (CASB) was established in 1970 as an agency of the Congress of the United States. It was charged with the responsibility of promulgating cost accounting standards designed to achieve uniformity and consistency in the cost accounting principles followed by defense contractors and subcontractors under negotiated federal contracts. The CASB was responsible only for negotiated defense contracts and issued several Cost Accounting Standards in this regard. The CASB was abolished in 1980 when Congress failed to vote funds for its operations.²⁵ It was later re-established in 1988.²⁶ Its standards are still in effect. Since the basis for external financial statements in many cases is the internal cost accounting procedures employed, these cost accounting standards occasionally influence external reporting.²⁷

The Development of International Accounting Standards

Accompanying the movement to a global economy has been the development of an international capital market. A U.S. company in need of funds, for example, may seek financing in one or more foreign countries, or a foreign company may seek financing in the United States. Similarly, a U.S. investor may invest in foreign securities, or a foreign investor may invest in U.S. securities. The movement of capital across borders is sizable.²⁸ In 1991, it was estimated that, worldwide, one of every seven stock trades had a foreign

²⁴ Kieso and Weygandt, Intermediate Accounting, p. 16.

²⁵ Nikolai, Bazley, Schroeder, and Reynolds, Intermediate Accounting, pp. 8-9.

²⁶ Williams, Stanga, and Holder, Intermediate Accounting, 4th ed., p. 22.

²⁷ Nikolai, Bazley, Schroeder, and Reynolds, Intermediate Accounting, pp. 8-9.

²⁸ Ernest I. Hanson, James C. Hamre, and Paul H. Walgenback, Principles of Accounting, (New York: The Dryden Press, 1993), p. 478.

investor on the other side.²⁹ A major problem that exists relates to differences in accounting principles and practices, which are peculiar to a particular foreign country in which operations are conducted. Significant advantages are expected to be achieved if a universally applicable system of accounting principles were adopted.

Advantages of Universally Applicable Standards

Accounting's role in the allocation of resources in capital markets is to provide investors and creditors with relevant and reliable financial information so that informed decisions may be made as to where resources should be allocated. If the underlying accounting data are not comparable across countries, then it is likely that investors and creditors at present are not making the optimal allocation decisions.³⁰ Despite this and other benefits that could be achieved by the international harmonization of accounting practices, those attempting to achieve an internationalization of accounting standards have encountered numerous barriers.

Efforts to Develop Worldwide Accounting Standards

Most countries recognize the need for more uniform accounting standards. Probably the best hopes for finding areas of agreement among all the different countries are the International Accounting Standards Committee (IASC) and the International Federation of Accountants (IFAC). The IASC was formed in 1973 as a result of an agreement by accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States. More than one hundred professional accountancy bodies from over seventy countries now support the IASC. The role of the IASC is to contribute to the development and adoption of accounting principles that are relevant, balanced, and comparable throughout the world by formulating and publicizing accounting standards and encouraging their observance in the presentation of financial statements. Large multinational companies that are clients of international accounting firms generally follow the standards issued by the IASC. The

²⁹ "The Forthcoming 1990s New Issue Boom: Will Smart Money Head to the US?" (Salomon Brothers Inc., March 12, 1991) as quoted in Hanson, Hamre, and Walgenback, Principles of Accounting, p. 478.

³⁰ Hanson, Hamre, and Walgenback, Principles of Accounting, pp. 478-9.

IASC has been especially helpful to companies in developing economies that do not have the financial history or resources to develop accounting standards.³¹

The IFAC, which was formed in 1977 and also consists of most of the world's accountancy organizations, fully supports the work of the IASC and recognizes the IASC as the sole body having responsibility and authority to issue pronouncements on international accounting standards. The IFAC's objective is to develop international guidelines for auditing, ethics, education, and management accounting.³²

Barriers to Harmonization

The most serious barriers to harmonization of accounting standards are

- cultural differences -- Countries differ in economic environment, political structure, and language. These differences contribute to the diversity in accounting principles among countries, and this diversity makes it harder to agree on a common set of principles. An economic environment with a high rate of inflation, for example, may generate an accounting principle that requires inflation adjustments to the financial statements, but a country with a low inflation rate may not require such adjustments. Some political systems place more emphasis on private ownership of property than do other systems, and this may lead to differences in accounting principles. The relationship between tax law and accounting principles also differs among countries. In some countries, financial statements must conform to tax returns, but in other countries, tax returns and financial statements may differ significantly. Language differences also create problems in establishing a uniformly understood set of international accounting principles. Accounting contains many technical terms and not all languages can easily assimilate the fine points of technical definitions.
- difference in national principle-setting bodies -- The nature of the group with primary responsibility for formulating accounting principles varies from one country to the next. The group may be a committee in the private sector, or it

³¹ Belverd E. Needles, Jr., Financial Accounting, 5th ed., (Princeton: Houghton Mifflin Company, 1995), pp. 740-1.

³² Needles, Financial Accounting, p. 741.

may be a governmental body. The group's membership may consist of accountants only, or it may be a mix of accountants and nonaccountants. A governmental body containing nonaccountants is likely to have a different perspective about appropriate accounting principles than is a private-sector committee composed of accountants only.

- nationalism -- A strong national principle-setting group, for example, may not want its role to be only that of advocate for its country's interests at the international level. Concerns about compromise and future roles create a tendency in principle-setting bodies to resist, or slow down, the movement toward international harmonization of accounting principles.³³
- legal enforcement -- The IASC has no legal power to establish accounting standards and therefore must rely on the voluntary actions of member bodies and other groups to support and enforce its standards.

The road to international harmony is a difficult one. However, there is reason for optimism because an increasing number of countries are recognizing the appropriateness of international accounting standards in international trade and commerce.³⁴ In recent years the United States has adopted, or moved closer to adoption of, international accounting rules.

³³ Hanson, Hamre, and Walgenback, Principles of Accounting, pp. 479-481.

³⁴ Needles, Financial Accounting, p. 741.

Foreword

SEC filings contain vital information about public companies whose stock is traded on the New York Stock Exchange, American Stock Exchange, NASDAQ or Over-the-Counter. These public companies file with the Securities and Exchange Commission (SEC). Among the items reported are:

- Financial statements
- Description of business
- Location and character of principal properties
- Auditors and opinions
- Material legal proceedings
- Directors and officers
- Stock options and compensation of top executives
- Proposed offerings of securities
- Number of employees
- Number of shareholders
- Material agreements such as employment, financing, option and benefit plans, leases, etc.

This guide explains the information that is contained in these reports and the frequency with which they are filed. This guide is not a comprehensive listing of all documents filed with the SEC; rather, it lists the most frequently requested documents.

SEC Disclosure Statute

The purpose of the federal securities laws is to provide disclosure of financial material and other information on companies seeking to raise capital through the public offering of their securities, as well as companies whose securities are already publicly held. This enables investors to evaluate the securities of these companies on an informed and realistic basis.

The Securities Act of 1933 is a disclosure statute. It generally requires that, before securities may be offered to the public, a registration statement must be filed with the Commission disclosing prescribed categories of information. Before the sale of securities can begin, the registration statement must become "effective," and investors must be furnished a prospectus containing the most significant information about the securities offering.

The Securities Exchange Act of 1934 deals in large part with securities already outstanding and requires the registration of securities listed on a national securities exchange, as well as Over-the-Counter securities in which there is a substantial public interest. Issuers of registered securities must file annual and other periodic reports designed to provide a public file of current material information.

The Exchange Act also requires disclosure of material information to holders of registered securities in solicitations of proxies for the election of directors or approval of corporate action at a shareholders meeting, or in attempt to acquire control of a company through a tender offer or other planned stock acquisitions. It provides that insiders of companies whose equity securities are registered must report their holdings and transactions in all equity securities of their companies.

Periodic Financial Reports

10-K

This report provides a comprehensive overview of the registrant. The report must be filed within 90 days after close of company's fiscal year and contains the following items of disclosure:

Items Reported

Cover Page

- Lists fiscal year end, state or other jurisdiction of incorporation or organization, title of each class of securities and the exchange on which it is registered and the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date (date is commonly the filing date, NOT the time period covered in the document).

Part I

- *Item 1 Business.* Identifies principal products and services of the company, principal markets and methods of distribution and, if "material," competitive factors, backlog and expectation of fulfillment, availability of raw materials, importance of patents, licenses, and franchises, estimated cost of research, number of employees, and effects of compliance with environmental laws.

If there is more than one line of business, a statement is included for each of the last three years. The statement includes total sales and net income for each line which, during either of the last two fiscal years, accounted for 10 percent or more of total sales or pretax income.

- *Item 2 Properties.* Location and character of principal plants, mines, and other important properties and if held in fee or leased.
- *Item 3 Legal Proceedings.* Brief description of material legal proceedings pending.

Part I (continued)

- *Item 4 Submission of Matters to a Vote of Security Holders.* Information relating to the convening of a meeting of shareholders, whether annual or special, and the matters voted upon.

Part II

- *Item 5 Market for the Registrant's Common Stock and Related Security Holder Matters.* Includes principal market in which voting securities are traded with high and low sales prices (in the absence thereof, the range of bid and asked quotations for each quarterly period during the past two years) and the dividends paid during the past two years. In addition to the frequency and amount of dividends paid, this item contains a discussion concerning future dividends.
- *Item 6 Selected Financial Data.* These are five-year selected data including net sales and operating revenue; income or loss from continuing operations, both total and per common share; total assets; long-term obligations including redeemable preferred stock, and cash dividend declared per common share. This data also includes additional items that could enhance understanding of trends in financial condition and results of operations. Further, the effects of inflation and changing prices should be reflected in the five-year summary.
- *Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations.* Under broad guidelines, this includes: liquidity, capital resources and results of operations; trends that are favorable or unfavorable as well as significant events or uncertainties; causes of any material changes in the financial statements as a whole; limited data concerning subsidiaries, and discussion of effects of inflation and changing prices.
- *Item 8 Financial Statements and Supplementary Data.* Two-year audited balance sheets as well as three-year audited statements of income and cash flow statement.
- *Item 9 Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.*

Part III¹

- *Item 10 Directors and Executive Officers.* Name, office, term of office and specific background data on each.
- *Item 11 Remuneration of Directors and Officers.* List of each director and highest paid officers with aggregate annual remuneration exceeding \$40,000. Also includes total paid all officers and directors as a group.
- *Item 12 Security Ownership of Certain Beneficial Owners and Management.* Identification of owners of 5 percent or more of registrant's stock in addition to listing the amount and percent of each class of stock held by officers and directors.
- *Item 13 Certain Relationships and Related Transactions.*

Part IV

- *Item 14 Exhibits, Financial Statement Schedules and Reports on Form 8-K.* Complete, audited annual financial information and a list of exhibits filed. Also, any unscheduled material events or corporate changes filed in an 8-K during the year.

Form 10-K Schedules (when applicable)

1. Investments other than investments in affiliates
2. Receivables from related parties and underwriters, promoters and employees other than affiliates
3. Condensed financial information
4. Indebtedness of affiliates (not current)
5. Property, plant and equipment
6. Accumulated depreciation, depletion and amortization of property, plant and equipment
7. Guarantees of securities of other issuers
8. Valuation and qualifying accounts
9. Short-term borrowings
10. Supplementary income statement information
11. Supplementary profit and loss information
12. Income from dividends (equity in net profit and loss of affiliates)

¹ Disclosure normally made via a proxy statement may in some cases be made using Part III of Form 10-K.

10-KSB

10-K filed by small business

10-K405

10-K with a positive response to box on cover concerning rule 16 delinquent filers

Annual Report to Shareholders

The Annual Report to Shareholders is the principal document used by most major companies to communicate directly with shareholders. Since it is not a required, official SEC filing, companies have considerable discretion in determining what types of information this report will contain and how it is to be presented.

In addition to financial information, the Annual Report to Shareholders often provides non-financial details of the business which are not reported elsewhere. These may include marketing plans and forecasts of future programs and plans.

10-Q

This is the quarterly financial report filed by most companies, which although unaudited, provides a continuing view of a company's financial position during the year. The 10-Q report must be filed 45 days after close of fiscal year quarter.

Items Reported

Cover Page

- Lists time period represented, state of incorporation, former name, address and fiscal year if changed since last report, whether the registrant filed any 1934 Act reports during the past 12 months and has been subject to such filing requirements for the past 90 days, whether the registrant has filed all documents and reports required under the Securities Exchange Act of 1934 subsequent to the distribution of securities, and the number of shares outstanding of each of the company's classes of common stock as of the last practicable date (date is commonly the filing date, NOT the time period covered in the document).

10-Q (continued)

Part I

- Financial Statements
- *Item 1 Quarterly Financial Statements*
- *Item 2 Management Discussion and Analysis.* Material changes in the amount of revenue and expense items in relation to previous quarters, including the effect of any changes in accounting principles.

Part II

- *Item 1 Legal Proceedings.* Brief description of material legal proceedings pending; when civil rights or environmental statutes are involved, proceedings must be disclosed.
- *Item 2 Changes in Securities.* Material changes in the rights of holders of any class of registered security.
- *Item 3 Defaults Upon Senior Securities.* Material defaults in the payment of principal, interest, sinking fund or purchase fund installment, dividend, or other material default not cured within 30 days.
- *Item 4 Submission of Matters to a Vote of Security Holders.* Information relating to the convening of a meeting of shareholders, whether annual or special, and the matters voted upon, with particular emphasis on the election of directors.
- *Item 5 Other Materially Important Events.* Information on any other item of interest to shareholders not already provided for in this form or reported in an 8-K.
- *Item 6 Exhibits and Reports on Form 8-K.* Any unscheduled material events or corporate changes reported in an 8-K during the prior quarter.

10-QSB

10Q filed by small business.

Proxy Statement

A proxy statement provides official notification to designated classes of shareholders of matters to be brought to a vote at a shareholders meeting. Proxy votes may be solicited for changing the company officers, or many other matters. Disclosures normally made via a proxy statement may in some cases be made using Part III of Form 10-K.

Registration of Securities

Registration Statements

Registration statements are of two principal types: (1) "offering" registrations filed under the Securities Act of 1933, and (2) "trading" registrations filed under the Securities Exchange Act of 1934.

"Offering" registrations are used to register securities before they are offered to investors. Part I of the registration, a preliminary prospectus or "red herring," contains preliminary information that will be in the final prospectus. Included in Part I (or incorporated by reference) in many registration statements are:

- Description of Securities to be Registered
- Use of Proceeds
- Risk Factors
- Determination of Offering Price
- Potential Dilution
- Selling Security Holders
- Plan of Distribution
- Interests of Named Experts and Counsel
- Information with Respect to the Registrant (description of business, legal proceedings, market price and dividends on common equity, financial statements, Management Discussion and Analysis, changes in and disagreements with accountants, directors and executive officers, security ownership of certain beneficial owners and management and certain relationships and related transactions).

Part II of the registration contains information not required in the prospectus. This includes:

- Expenses of Issuance and Distribution
- Indemnification of Directors and Officers
- Recent Sales of Unregistered Securities, Undertakings Exhibits and Financial Statement
- Schedules

"Trading" registrations are filed to permit trading among investors on a securities exchange or in the Over-the-Counter market. These Registration Statements do not include a prospectus.

Prospectus

When the sale of securities as proposed in an "offering" registration statement is approved by the SEC, any changes required by the SEC are incorporated into the prospectus. This document must be made available to investors before the sale of the security is initiated. It also contains the actual offering price, which may have been changed after the registration statement was approved.

ACCOUNTING FOR PRODUCT HANDLING BUSINESS

Introduction

Previous course material has dealt with the accounting procedures applicable to a business engaged in service activity. We will now examine the accounting procedures appropriate for product handling entities. While the accounting procedures that apply to service entities also apply to product handling entities, there are some additional accounting procedures. It is important to realize that for purposes of this course, you will not be responsible for the calculations or journal entries presented herein. It is hoped that by observing the calculations and journal entries you will gain a better appreciation of the nature of the accounts being discussed. You should use the related self study questions as a guide in determining what information you need to know for this course.

Purchase of Inventory

The factor that distinguishes a product handling entity from a service activity entity is the existence of inventory. We will define inventory as follows:

Merchandise inventory consists of goods that are being held for sale in the ordinary course of business.

Realize that it is possible for the same type of item to be listed as inventory for one accounting entity but not for another. For example, an automobile would be considered merchandise inventory for a car dealer. For a firm manufacturing dining room furniture, however, an automobile would be shown as some type of equipment.

The purchase of merchandise inventory would be recorded as follows:

Purchases	xxx
Cash (or Accounts Payable)	xxx

The amount recorded would generally be the purchase price. Note that the account debited is Purchases, not Merchandise Inventory.

Complicating Factors

There are some factors that may alter the relative simplicity of the preceding and related subsequent entries. We will examine the following factors:

1. trade discounts
2. freight charges
3. returns and allowances
4. credit terms, including cash discounts

Trade Discounts

Vendors in many lines of industry publish catalogs in which their products are shown at suggested retail prices (also called list prices). Substantial reductions from these list prices are offered to dealers and other large-scale purchasers. Such reductions from the list price (often as much as 40% or more) are called trade discounts. A policy of quoting trade discounts is followed for several reasons, such as:

1. to reduce the cost of catalog publication. If separate discount lists are given the salesmen whenever prices change, catalogs may be used for a long period of time. Prices may be changed by simply changing the trade discounts without reprinting the entire catalog.
2. to be able to quote different prices to different types of customers, such as to retailers and wholesalers.

Trade discounts may be stated as a single percentage or as a chain of percentages.

Single Discount

Let us suppose that Item A has a list price of \$1,000 and that Company LMN has offered a 35% trade discount to Company XYZ, a wholesaler. The selling/purchase price would be calculated as follows:

List Price	\$ 1,000
Trade Discount (35%)	<u>- 350</u>
Selling/Purchase Price	\$ 650

Trade discounts are a means employed to determine the actual selling/purchase price of an item. Thus there is no justification to record list prices and their related trade discounts in the accounts; only the selling/purchase price would be recorded. Thus the entries on the books of Company LMN, the seller, and Company XYZ, the buyer, related to the above mentioned sale and purchase would be as follows:

Company LMN Seller		Company XYZ Buyer	
Cash (or Accts. Rec.)	650--	Purchases	650--
Sales	650--	Cash (or Accts. Pay.)	650--

Chain Discounts

Instead of a single discount, a particular entity might be entitled to multiple trade discounts. For example, Company ABC might offer a 10% discount to all buyers due to a recent overall reduction in prices, an additional 15% discount to retailers, and an additional 10% discount to wholesalers. Thus, if Company RST, a wholesaler, were to buy from Company ABC items with a list price of \$1,000, the selling/purchase price would be calculated as follows:

List Price	\$ 1,000.00
Trade Discount (10%)	<u>- 100.00</u>
Balance	\$ 900.00
Trade Discount (15%)	<u>- 135.00</u>
Balance	\$ 765.00
Trade Discount (10%)	<u>- 76.50</u>
Selling/Purchase Price	\$ 688.50

Observe that each trade discount is applied to the figure obtained by taking the prior percentage discount off the price to which it applies; i.e., each trade discount is not applied to the original list price but rather to the balance calculated after applying the prior discount.¹

A comparison of the above examples reveals that the result of applying a 35% single discount is not the same as the result of applying a chain of discounts (10%, 15%, 10%) which sum to 35%. Thus a chain of discounts should not be added and treated as a single discount.

The entries on the books of Company ABC, the seller, and Company RST, the buyer, related to the above mentioned sale and purchase would be as follows:

Company LMN Seller		Company XYZ Buyer	
Cash (or Accts. Rec.)	688.50	Purchases	688.50
Sales	688.50	Cash (or Accts. Pay.)	688.50

¹ An alternative way of calculating the selling/purchase price would be as follows:
 Selling/Purchase Price = \$1,000 (1.00 - 0.10)(1.00 - 0.15)(1.00 - 0.10)
 = \$1,000(.090)(.085)(.090)
 = \$688.50

Observation of the alternative way of calculating the selling/purchase price, given a chain of trade discounts would indicate that the answer is the same regardless of the order in which the multiplications are completed. Thus, given any chain of trade discounts, the discounts may be applied in any order (usually they are applied in the order that would result in the easiest calculations) and the same selling/purchase price will result.

Entries for Freight Charges

In each of the instances below, assume that the seller sold \$1,000 worth of merchandise inventory to the buyer. We will examine the entries for freight charges under four different circumstances.

(a) Terms: FOB Shipping Point; Buyer pays the carrier for freight charges, \$50

Seller's Books		Buyer's Books	
<u>Date of Sale</u>		<u>Date of Purchase</u>	
Accounts Receivable	1,000	Purchases	1,000
Sales	1,000	Accounts Payable	1,000
		Freight Expense ³	50
		Cash	50
<u>Date of Receipt of Payment</u>		<u>Date of Payment</u>	
Cash	1,000	Accounts Payable	1,000
Accounts Receivable	1,000	Cash	1,000

³ Alternative account titles are frequently used. Freight charges that apply to merchandise be purchased would be shown as Freight-in (should be shown as part of the cost of merchandise purchased, i.e., added to purchases). Freight charges that apply to merchandise sold would be shown as Freight-out (an expense account).

(b) Terms: FOB Shipping Point; Seller pays the carrier for freight charges, \$50

Seller's Books		Buyer's Books	
<u>Date of Sale</u>		<u>Date of Purchase</u>	
Accounts Receivable	1,000	Purchases	1,000
Sales	1,000	Accounts Payable	1,000
Accounts Receivable	50	Freight Expense ⁴	50
Cash	50	Accounts Payable	50
<u>Date of Receipt of Payment</u>		<u>Date of Payment</u>	
Cash	1,050	Accounts Payable	1,050
Accounts Receivable	1,050	Cash	1,050

(c) Terms: FOB Destination; Buyer pays the carrier for freight charges, \$50

Seller's Books		Buyer's Books	
<u>Date of Sale</u>		<u>Date of Purchase</u>	
Accounts Receivable	1,000	Purchases	1,000
Sales	1,000	Accounts Payable	1,000
Freight Expense ⁵	50	Accounts Payable	50
Accounts Receivable	50	Cash	50
<u>Date of Receipt of Payment</u>		<u>Date of Payment</u>	
Cash	950	Accounts Payable	950
Accounts Receivable	950	Cash	950

⁴ This entry, which recognizes the payment of freight charges by the seller, might be recorded by the buyer on a date subsequent to the date of purchase. The timing of the entry might depend upon the date the seller notifies the buyer that payment of freight charges were made by the seller. This notification could occur when the seller issues the sales invoice, which could occur on the date of sale or some time thereafter.

⁵ This entry, which recognizes the payment of freight charges by the buyer, might be recorded by the seller on the date of receipt of payment. The timing of the entry might depend upon the date the buyer notifies the seller that payment of freight charges were made by the buyer. Conceivably, this notification could occur when the buyer makes payment to the seller.

(d) Terms: FOB Destination; Seller pays the carrier for freight charges, \$50

Seller's Books		Buyer's Books	
<u>Date of Sale</u>		<u>Date of Purchase</u>	
Accounts Receivable	1,000	Purchases	1,000
Sales	1,000	Accounts Payable	1,000
Freight Expense	50		
Cash	50		
<u>Date of Receipt of Payment</u>		<u>Date of Payment</u>	
Cash	1,000	Accounts Payable	1,000
Accounts Receivable	1,000	Cash	1,000

In most merchandise transactions involving wholesalers and manufacturers, the buyer bears the transportation cost.

Returns and Allowances

Sometimes merchandise received from suppliers is not acceptable for any of a variety of reasons and merchandise must be returned or, if kept, is kept only because the supplier grants an allowance or reduction in its price. For the selling company such transactions result in either a cash disbursement -- a possibility if the customer has paid cash for the merchandise -- or a credit to Accounts Receivable. The companion debit could be made to the Sales account. However, most often a company would want information as to the volume of sales returns and allowances. Such information could indicate the need to seek a new supplier or to examine the production process to reduce defective products. For this reason it would be preferable to debit the account Sales Returns and Allowances. This account will subsequently be subtracted from the Sales account (which shows gross sales) in order to obtain net sales.

The notice sent by a seller to a customer informing him/her of the approval of a return or allowance may be in the form of a letter, or a credit memorandum may be issued to him/her.

From the point of view of the purchasing company, the return of unsatisfactory goods or the reduction in the price of the unsatisfactory goods would result in either the receipt of cash -- if it was a cash purchase -- or a reduction in Accounts Payable. The corresponding credit could be to the Purchases account. However, buying merchandise,

receiving and inspecting it, deciding that the merchandise is unsatisfactory, and returning it is a costly procedure that should be held to a minimum. The first step in holding it to a minimum is to know the amount of returns and allowances. Therefore, to make this information available to management, returns and allowances on purchases are commonly recorded in an account called Purchase Returns and Allowances. This account will subsequently be subtracted from the Purchases account (which shows gross purchases) in order to obtain net purchases.

The notice sent by a buyer to a seller informing him/her of the reduction of the seller's account on the buyer's books due to some appropriate cause, such as the receipt of damaged merchandise, may be in the form of a letter, or a debit memorandum may be issued to him/her.

Example

Seller's Books		Buyer's Books	
<u>Date of Sale</u>		<u>Date of Purchase</u>	
Accounts Receivable	1,000	Purchases	1,000
Sales	1,000	Accounts Payable	1,000
Freight Expense	50		
Cash	50		
<u>Date on Which Allowance is Granted</u> <u>Due to Delivery of Defective Merchandise</u>		<u>Date on Which Allowance is Received</u> <u>Due to Receipt of Defective Merchandise</u>	
Sales Returns & Allowances	300	Accounts Payable	300
Accounts Receivable	300	Purchase Ret. & Allow.	300
<u>Date of Receipt of Payment</u>		<u>Date of Payment</u>	
Cash	700	Accounts Payable	700
Accounts Receivable	700	Cash	700

Credit Terms

Manufacturers and wholesalers try to increase their sales by allowing customers a period of time within which to make payment for merchandise. By purchasing goods on credit, a retailer with limited capital can carry a larger inventory and increase his/her own sales. This buying/selling on credit may be advantageous to both parties to the transactions.

Credit terms are precisely stated on the sales invoice issued by the seller. Common abbreviations of terms offered are:

- n/30 read net thirty -- payment is due within 30 days from the date of the invoice. The word “net” in this expression means the list price of the merchandise less any trade discounts.

- n/EOM read net EOM -- payment is due by the end of the month in which the sale was made. The abbreviation “EOM” stands for the end of the month.

- n/10 EOM read net ten EOM -- payment is due by the tenth day of the month following the month of sale. This credit term is especially convenient for the small business in which the owner wishes to pay all the bills on a given day of the month or within a few days after the beginning of each month.

Cash Discounts

Realize that the quicker a seller can get his/her money back, the quicker he/she can obtain more inventory and thereby increase his/her sales. In order to encourage customers to pay invoices before expiration of the credit period, manufacturers and wholesalers (and sometimes retailers) will generally offer cash discounts. When discounts for early payment are granted, they are made part of the credit terms and appear on the invoice. Some common abbreviations for credit terms which include cash discounts are as follows:

- | | |
|------------------|--|
| 2/10, n/30 | read two ten, net thirty -- a two percent discount from the net amount (list price less any trade discounts) is allowed if payment is made within 10 days from the invoice date. No discount is allowed after 10 days, and the net amount, as previously described, is due within 30 days from the date of the invoice. |
| 2/10, 1/20, n/30 | read two ten, one twenty, net thirty -- a two percent discount from the net amount (list price less any trade discounts) is allowed if payment is made with 10 days from the invoice date; a one percent discount from the net amount is allowed if payment is made from the eleventh to the twentieth day from the invoice date; no discount is allowed after 20 days, and the net amount is due within 30 days from the date of the invoice. |
| 2/10 EOM, n/60 | read two ten EOM, net sixty -- a two percent discount from the net amount is allowed if payment is made by the tenth day of the month following the month of sale. No discount is allowed after the tenth day of the month following the month of sale, and the net amount is due within 60 days from the date of the invoice. |

Reasons for Cash Discounts

We have already mentioned that by offering cash discounts to induce prompt payment, the seller collects accounts receivable more quickly and is able to use the money collected to buy additional merchandise inventory. A greater volume of business can be handled with a given amount of invested capital if this capital is not tied up in accounts receivable for long periods. There is also less danger of accounts receivable becoming uncollectible if they are collected promptly.

One might feel that a “mere” one or two percent discount would not be sufficient to induce purchasers to pay their debts promptly. Realize that with terms of 2/10, n/30, payment must be made at least 20 days (credit period of 30 days less discount period of 10 days) before the end of the credit period in order to obtain the cash discount. If payment is made within the discount period there will be a two percent reduction. Thus, there is a 2% reduction in payment by paying 20 days early. A 2% return over 20 days is equivalent to approximately 36% over a 365 day year ($2\%/20 \text{ days} \approx 36\%/365 \text{ days}$). Failure to make payment within the discount period, therefore, results in an interest charge of approximately 36% (on an annual basis). Although interest rates vary widely, most businesses are able to borrow money from banks at an annual interest rate of less than 36%. Well-managed businesses, therefore, generally pay all invoices within the discount period even though this policy might necessitate borrowing from a bank in order to have the necessary cash available.

Recording Cash Discounts

The selling company regards a cash discount as a sales discount; the buyer calls the discount a purchase discount. The accounting for cash discounts will be demonstrated through the use of the following comprehensive problem:

Relevant Information: List price of inventory sold/purchased: \$1,000
 Trade discounts: 10% and 20%
 Terms: 2/10, n/30, FOB Shipping Point
 Seller paid freight charges of \$30

Seller's Books		Buyer's Books	
<u>Date of Sale</u>		<u>Date of Purchase</u>	
Accounts Receivable	720.00	Purchases	720.00
Sales	720.00	Accounts Payable	720.00
Accounts Receivable	30.00	Freight Expense	30.00
Cash	30.00	Accounts Payable	30.00

Calculations:

List Price	\$ 1,000.00
Trade Discount (10%)	<u>- 100.00</u>
Balance	\$ 900.00
Trade Discount (20%)	<u>- 180.00</u>
Selling/Purchase Price	\$ 720.00

Given terms FOB Shipping Point, the buyer would bear the freight expense. This is reflected in the prior entries by showing an increase in the Accounts Receivable and Accounts Payable accounts, such increases being necessary because the seller paid the freight charges while the buyer should bear the expense. A special note should be made on both the buyer's and seller's books because the cash discount, if subsequently taken, applies only to the net invoice price and not to the freight charges.

Seller's Books	Buyer's Books												
<u>Three Days After the Date of Sale</u>	<u>Three Days After the Date of Purchase</u>												
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Sales Returns & Allowances</td> <td style="text-align: right;">216.00</td> </tr> <tr> <td style="padding-left: 20px;">Accounts Receivable</td> <td style="text-align: right;">216.00</td> </tr> <tr> <td>Freight Expense</td> <td style="text-align: right;">10.00</td> </tr> <tr> <td style="padding-left: 20px;">Cash</td> <td style="text-align: right;">10.00</td> </tr> </table>	Sales Returns & Allowances	216.00	Accounts Receivable	216.00	Freight Expense	10.00	Cash	10.00	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Accounts Payable</td> <td style="text-align: right;">216.00</td> </tr> <tr> <td style="padding-left: 20px;">Purchase Ret. & Allow.</td> <td style="text-align: right;">216.00</td> </tr> </table>	Accounts Payable	216.00	Purchase Ret. & Allow.	216.00
Sales Returns & Allowances	216.00												
Accounts Receivable	216.00												
Freight Expense	10.00												
Cash	10.00												
Accounts Payable	216.00												
Purchase Ret. & Allow.	216.00												

Calculations:

List Price	\$ 300.00
Trade Discount (10%)	<u>- 30.00</u>
Balance	\$ 270.00
Trade Discount (20%)	<u>- 54.00</u>
Selling/Purchase Price of Returned Goods	\$ 216.00

Seller's Books	Buyer's Books												
<u>Date of Receipt of Payment</u>	<u>Date of Payment</u>												
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Cash</td> <td style="text-align: right;">523.92</td> </tr> <tr> <td style="padding-left: 20px;">Sales Discounts</td> <td style="text-align: right;">10.08</td> </tr> <tr> <td style="padding-left: 40px;">Accounts Receivable</td> <td style="text-align: right;">534.00</td> </tr> </table>	Cash	523.92	Sales Discounts	10.08	Accounts Receivable	534.00	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Accounts Payable</td> <td style="text-align: right;">534.00</td> </tr> <tr> <td style="padding-left: 20px;">Purchase Discounts</td> <td style="text-align: right;">10.08</td> </tr> <tr> <td style="padding-left: 40px;">Cash</td> <td style="text-align: right;">523.92</td> </tr> </table>	Accounts Payable	534.00	Purchase Discounts	10.08	Cash	523.92
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Sales Discounts	10.08												
Accounts Receivable	534.00												
Accounts Payable	534.00												
Purchase Discounts	10.08												
Cash	523.92												

Calculations:

Accounts Receivable/Accounts Payable: $750 - 216 = 534$

Cash Discount: $534 - 30 \text{ (freight)} = 504$

$504 \times 2\% = 10.08$