CHAPTER 1

An Introduction to Financial Statements

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Imagine that you're a banker, and you have to determine which companies to lend to, and on what terms. Or you're an investor who wants to know which companies are likely to outperform the market averages over the next year or two. In short, where should you invest your capital? To answer this question, investors turn to corporate financial statements.

Financial statements exist to provide useful information on businesses to people who have, or may have, an economic stake in those businesses. These statements should help:

- *investors*, to make more intelligent decisions on where to put their scarce capital;
- *bankers*, to determine whether or not a company will be able to service its debts;
- *suppliers*, to assess whether or not a potential customer is a good credit risk;
- *customers*, to determine whether or not the company is strong enough financially to deliver on long-term promises of service and warranty coverage;
- *tax authorities*, to determine whether or not a company is paying its fair share of taxes;
- *trade union representatives*, in forming their negotiating positions with management;
- *competitors*, to benchmark their performance;
- *courts of law*, to measure, for example, the damage caused by one firm to another as a result of alleged unfair trade practices;
- *antitrust regulators*, to measure market share and profits relative to competitors;
- *prospective employees*, to determine whether the company is worth pursuing as a long-term employer.

You may notice one important constituency missing from this list of financial statement users: corporate management. Financial statements are the responsibility of management, but are not designed to meet their own informational needs. Financial statements are a means for company managers to communicate the financial strength and profitability of their businesses to investors and other groups, but are not really intended for internal management use. To understand why, let's take a brief look at the financial statements (shown in Exhibits 1.1–1.3) of SAP Group, one of the world's largest software companies.

The three principal financial statements – the balance sheet, the income statement, and the statement of cash flows – are highly aggregated documents: masses of detail accumulated in a small number of line items. Without this aggregation, the statements would be unreadable; however, a lot of details are missing. While this lack of detail might be appropriate for potential investors, who have to compare financial data across many different companies, the information found in these financial statements is not sufficiently detailed to be of any practical use to managers in corporate decision-making.

This is not to say that managers shouldn't care about the financial statements. Managers must understand their financial statements because these are the most important sources of information used by the investing community to determine where to invest capital. Managers who don't understand the signals that their financial statements are sending to investors are not in a position to compete effectively in the global capital markets. However, internal decision-making and management control require data that are far more detailed (by product line, region, cost categories, etc.) than the data found in annual reports.

In addition, financial statements are mainly historical. The balance sheet reflects the financial position at a precise moment in the recent past. The income statement shows profits over a period of time in the recent past – for example, the year just completed. Similarly, the statement of cash flows reports on the sources and uses of cash over a period of time already past. But while appreciating the insights of these statements is critical to managers in understanding their business and its competitiveness in the capital markets, they need information systems that are forward-looking in nature. Managers plan, budget, and forecast – and they therefore need systems that help them to perform these critical functions.

Another problem with financial accounting from a management perspective is that accounting rules that are designed to measure costs or value assets can result in misleading figures, even when calculated in good faith by managers. For example, when a manufacturing company measures the cost of its inventory, it must include not only direct costs of production, such as labor and materials, but also manufacturing overhead (such as depreciation on equipment, power and electricity, and maintenance costs). In contrast with direct costs, overhead cannot be directly traced to individual units of production. Instead, they are assigned to individual products (and to inventory accounts) using an arbitrary allocation technique. The resulting inventory figures may be acceptable for the broad overview that an investor wants from the financial statements, but can be seriously misleading if management intends to use them to calculate product-line profitability, to set pricing policy, or to make product-mix decisions. In short, managers need cost-accounting systems that provide more accurate costing data.

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The three principal financial statements

The corporate financial reporting process focuses on the three principal financial statements – the balance sheet, the income statement, and the statement of cash flows.

The balance sheet[1]

Take a glance at SAP Group's balance sheet (Exhibit 1.1). One of the first things you should notice is that the balance sheet reports on the company's financial position at a moment in time, in this case the end of 2008 and 2009. In other words, it's a snapshot, taken at the end of each period, of the assets owned by the company and the financing for those assets. Assets are economic resources with the ability or potential to provide future benefits to a business, such as profits or cash flow.

Exhibit 1.1 SAP Group consolidated balance sheet (in € millions)

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	December 31	
	2009	**2008**
ASSETS		
Cash and cash equivalents	€1,884	€1,280
Other financial assets	486	588
Trade and other receivables	2,546	3,178
Other nonfinancial assets	147	126
Tax assets	192	399
Total current assets	5,255	5,571
Goodwill	4,994	4,975
Intangible assets	894	1,140
Property, plant, and equipment	1,371	1,405
Other financial assets	284	262
Trade and other receivables	52	41
Other nonfinancial assets	35	32
Tax assets	91	33
Deferred tax assets	398	441
Total noncurrent assets	8,119	8,329
TOTAL ASSETS	€13,374	€13,900
EQUITY AND LIABILITIES		
Trade and other payables	€638	€599
Tax liabilities	125	363
Financial liabilities	146	2,563
Other nonfinancial liabilities	1,577	1,428

(*Continued*)

Exhibit 1.1 Continued

	December 31	
	2009	**2008**
Provisions	332	248
Deferred income	598	623
Total current liabilities	3,416	5,824
Trade and other payables	€35	€42
Tax liabilities	239	278
Financial liabilities	729	40
Other nonfinancial liabilities	12	13
Provisions	198	232
Deferred tax liabilities	190	239
Deferred income	64	61
Total noncurrent liabilities	1,467	905
TOTAL LIABILITIES	€4,883	€6,729
Issued capital	€1,226	€1,226
Treasury shares	−1,320	−1,362
Share premium	317	320
Retained earnings	8,571	7,422
Other components of equity	−317	−437
Equity attributable to owners of parent	8,477	7,169
Noncontrolling interests	14	2
TOTAL EQUITY	€8,491	€7,171
EQUITY AND LIABILITIES	€13,374	€13,900

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

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The financing of assets occurs in two basic forms: liabilities and shareholders' equity. Liabilities are the company's debts or obligations. They are the claims on the assets held by a firm's creditors. Shareholders' equity shows the amount of financing provided by owners of the business, both in the form of direct investment (when shareholders contribute cash in exchange for shares) and indirect investment (when profits are reinvested in the firm).

The organization of the balance sheet can thus be summarized like this:

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$

The term "balance sheet" is derived from this equation. It simply reminds us that the right side and the left side must always equal, for all companies, in all industries, in all countries,

without exception. Simply put, the balance sheet must balance. The reason why this is can be seen if we look at the right side of the equation. Liabilities and shareholders' equity don't just represent financing, they also represent claims on the assets from the left side. In the event of liquidation (i.e., when a company goes out of business), first claim on resources belongs to creditors. The claims held by shareholders are residual in nature, which means that they are entitled to whatever is left over after the creditors have been paid off. Because shareholders' equity represents a residual claim on the assets, it will be whatever size it needs to be in order to ensure that the two sides of the balance sheet are equal.

SAP Group's balance sheet confirms this equality. Total assets at the end of 2009 of €13 374 million equal the sum of liabilities, €4883 million, and shareholders' equity, €8491 million.

The income statement

The income statement reports on a company's profits, or revenues less expenses, during the accounting period. Unlike the balance sheet, it's not a snapshot, but rather reflects what a firm has accomplished over a period of time. In the case of SAP Group, the income statement (Exhibit 1.2)

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Exhibit 1.2 SAP Group consolidated income statements (in € millions)

	Year Ended December 31		
	2009	**2008**	**2007**
Software and software-related service revenue	€8,198	€8,466	€7,441
Professional services and other service revenue	2,432	3,039	2,744
Other revenue	42	70	71
Total revenue	10,672	11,575	10,256
Cost of software and software-related services	−1,714	−1,743	−1,350
Cost of professional services and other services	−1,851	−2,285	−2,091
Research and development	−1,591	−1,627	−1,461
Sales and marketing	−2,199	−2,546	−2,173
General and administration	−564	−624	−499
Restructuring	−198	−60	−2
Other operating income/expense, net	33	11	18
Total operating expenses	−8,084	−8,874	−7,558
Operating profit	2,588	2,701	2,698
Other nonoperating income/expense, net	−73	−27	2
Financial income, net	−80	−50	124
Profit before tax	2,435	2,624	2,824
Income tax expense	−685	−776	−916
Profit after tax	€1,750	€1,848	€1,908

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

reports on the company's performance for the years 2007, 2008, and 2009. Notice that the accounting year (sometimes called the "fiscal year") is the same as the calendar year (1 January–31 December). This is not required, however. For example, most major retailers in the US have accounting years that end between late January and the end of March. This is done to avoid having to close the books and prepare financial statements at the busiest time of the year.

The top line of the income statement, *revenues* (also called "sales" or "sales revenues"), represents the monetary value of goods or services sold to customers. Expenses represent the cost of resources used by the company to earn revenues during the period.

Profit (also known as "earnings" or "income") is shown in several ways on an income statement. For example, gross profit, sometimes called "gross margin," measures revenues, net of manufacturing costs. For a nonmanufacturing company, such as a retailer or distributor, gross profit equals revenues net of the cost of merchandise sold during the year.

Operating income equals sales net of all operating expenses, excluding taxes. It measures how well the company has done in a given period from its normal, recurring, day-to-day activities of producing and selling its products. For SAP Group, gross profit and operating income in 2009 were €7107 million and €2588 million, respectively.

When taxes and the nonoperating sources of income and expense are added or subtracted from operating income, as appropriate, the result is net income, the "bottom line" of the income statement. For 2009, SAP Group reports net income of €1750 million.

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The statement of cash flows

The statement of cash flows summarizes the inflows and outflows of cash that arise from the three primary activities of a typical business: operations, investing, and financing. For SAP Group, operating activities refer mainly (but not exclusively) to the routine, recurring actions involved in developing and selling software, software-related services, and professional services. Investing activities involve the buying and selling of long-term assets such as machinery and equipment, companies or parts of companies, and financial securities such as government bonds. Financing activities refer mainly to actions involving the capital markets such as borrowing, paying off loans, issuing shares, share buybacks, and the payment of dividends.

The statement is structured in such a way that the net cash flows during the period for all three activities must equal the change in cash. In other words, the net cash flows from operating, investing, and financing activities must equal the net increase or decrease in the cash balance for the year. You can easily confirm this reconciliation in SAP Group's statement of cash flows.

What makes this statement so interesting is not just that it summarizes cash flows, and in so doing reconciles beginning and ending cash, but that it also reveals the sort of activities that gave rise to those cash flows. In short, the statement reveals where a company's cash came from during the year, and what the company did with it.

For example, SAP Group's statement of cash flows (Exhibit 1.3) shows operating cash flow of nearly €3015 million. Most of this cash (€2303 million) was returned in the form of repayments of borrowings. We know this is true because negative financing cash flows (i.e., as shown in brackets or with a "minus" sign) mean that the company returned more cash to investors (bankers and shareholders combined) than it acquired. Some of the remaining cash in 2009, nearly 600 million, was distributed by SAP Group in the form of dividends.

Exhibit 1.3 SAP Group consolidated statements of cash flows (in € millions)

	Year Ended December 31		
	2009	**2008**	**2007**
Cash flows from operating activities			
Profit after tax	€1,750	€1,848	€1,908
Depreciation and amortization	499	539	262
Gains/losses on disposals of noncurrent assets	−11	11	1
Gains/losses on disposals of financial assets	−2	−16	−1
Impairment loss on financial assets recognized in profit	10	15	8
Decrease/increase in sales and bad debt allowances on trade receivables	64	76	0
Other adjustments for noncash items	14	52	45
Deferred income taxes	−39	−91	8
Decrease/increase in trade receivables	593	−48	−521
Decrease/increase in other assets	205	−12	−277
Decrease/increase in trade payables, provisions and other liabilities	−116	−277	375
Decrease/increase in deferred income	48	61	124
Net cash flows from operating activities	3,015	2,158	1,932
Cash flows from investing activities			
Purchase of noncontrolling interests	€0	€0	€−48
Business combinations, net of cash and cash equivalents acquired	−73	−3,773	−672
Repayment of acquirees' debt in business combinations	0	−450	0
Purchase of intangible assets and PP&E	−225	−339	−400
Proceeds from sales of intangible assets or PP&E	45	44	27
Cash transferred to restricted cash	0	−448	−550
Use of restricted cash	0	1,001	0
Purchase of equity or debt instruments of other entities	−1,073	−396	−788
Proceeds from sales of equity or debt instruments of other entities	1,027	595	1,040
Net cash flows from investing activities	−299	−3,766	−1,391
Cash flows from financing activities			
Dividends paid	€−594	€−594	€−556
Purchase of treasury shares	0	−487	−1,005
Proceeds from reissuance of treasury shares	24	85	156
Proceeds from issuing shares (share-based compensation)	6	20	44
Proceeds from borrowings	697	3,859	47
Repayments of borrowings	−2,303	−1,571	−48
Purchase of equity-based derivative instruments	0	−55	0
Proceeds from the exercise of equity-based derivative financial instruments	4	24	75
Net cash flows from financing activities	−2,166	1,281	−1,287

(*Continued*)

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Exhibit 1.3 Continued

	Year Ended December 31		
	2009	**2008**	**2007**
Effect of foreign exchange rates on cash and cash equivalents	54	−1	−45
Net increase (decrease) in cash and cash equivalents	604	−328	−791
Cash and cash equivalents at the beginning of the period	1,280	1,608	2,399
Cash and cash equivalents at the end of the period	€1,884	€1,280	€1,608

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

How the financial statements relate to each other

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Although each statement is a separate, discrete entity, it is also linked with the other two. For example, the net income from the income statement (e.g., €1750 million in 2009 for SAP Group) is reflected in both retained earnings (from the shareholders' equity section of the balance sheet) and in the operations section of the statement of cash flows. Also, the net cash flows from the statement of cash flows (see final line) plus beginning cash (on the balance sheet) must equal ending cash. These relationships should come as no surprise because, logically, we would expect a company's performance, as reflected in its income statement, to influence its cash flows, and for both profit and cash flows to influence its financial position (i.e., the balance sheet).

To illustrate these relationships, let's take another look at SAP Group's financial statements. Net income in 2009 was €1750 million. As revealed in the statement of cash flows, the company paid €594 million in dividends that year. Retained earnings (on the balance sheet in the shareholders' equity section) represent all of the net income a company has ever earned in its history that has not yet been paid to shareholders as a dividend. In other words, it measures all of the profits retained by the business for reinvestment. We would expect retained earnings to change each year by an amount equal to the year's net income, less any dividends paid in that year. In the case of SAP Group, we should see an increase of €1750 million minus €594 million, or €1156 million. And that is very close to the amount by which the company's retained earnings increased from the end of 2008 to the end of 2009 (€8571 million − €742 million, i.e., €1149 million).

Note also that cash flows from operating, investing and financing activities (plus effect of foreign exchange rates on cash and cash equivalent in 2009, i.e., €54 million) result in a net increase in cash of €604 million, which is exactly equal to the difference between the cash balance at the end of 2009 (€1884 million) and at the end of 2008 (€1280 million).

Other items in the annual report

As mentioned earlier, the balance sheet, income statement, and statement of cash flows are highly condensed. For this reason, firms are required to provide supplemental information in

the form of supporting schedules and notes. An opinion on the truthfulness of the financial statements from a firm of independent public accountants must also be furnished. Depending on its country of origin, a company may also include a discussion and analysis of recent performance and future prospects.

The statement of changes in shareholders' equity

There is, in fact, a fourth financial statement presented in many annual reports, although it functions more like a supporting schedule, and thus is not usually accorded the same status as the other three. This schedule, called the statement of changes in shareholders' equity (although it sometimes goes under different names), explains changes to all accounts in the shareholders' equity section of the balance sheet.

The notes

In addition to the principal financial statements, companies must also provide extensive supplemental disclosures known as "notes" or "footnotes." You will see these at the back of any annual report. The importance of these notes can be seen from the statement at the bottom of each of SAP Group's financial statements: "The accompanying Notes are an integral part of these Consolidated Financial Statements." This reminds us that the financial statements cannot be fully understood without reading the notes. In fact, the term "footnotes" is somewhat misleading, though widely used, because it may lead you to think that they serve the same function as footnotes in a book. This is not true because footnotes in the annual report are an indispensable part of the story. The story doesn't really hold together without them.

Most notes fall into either of two categories:

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- The first type describes the accounting policies used by the company to prepare its financial statements. For example, the first note in most annual reports is a summary of key accounting principles and policies.
- The second type of note presents additional, clarifying detail about one or more financial statement line items. Examples of this type include notes that elaborate on debt balances, investments, pensions, and taxes. Companies are also expected to provide financial details on major business segments. SAP Group discloses data on revenues, profits, assets, and capital expenditures for each of the segments – Product (marketing and licensing the software products, performing custom software development services for customers, and providing support services for the software products), Consulting (various professional services, mainly implementation of the software products), and Training (educational services on the use of the software products).

The auditor's opinion

Annual reports must include an opinion from an independent public accounting firm, attesting to whether or not the financial statements were correctly prepared and can therefore

Exhibit 1.4 Independent auditor's report

We have audited the consolidated financial statements prepared by SAP AG, Walldorf, comprising the statement of financial position, the income statement, the statement of comprehensive income, the statement of changes in equity, the statement of cash flows and the notes to the consolidated financial statements, together with the review of group operations for the business year from January 1 to December 31, 2009. The preparation of the consolidated financial statements in accordance with IFRSs, as adopted by the EU, and the additional requirements of German commercial law pursuant to § 315a Abs. 1 HGB [Handelsgesetzbuch "German Commercial Code"] as well as the preparation of the review of group operations in accordance with § 315 HGB are the responsibility of the parent company's management. Our responsibility is to express an opinion on the consolidated financial statements and on the review of group operations based on our audit.

We conducted our audit of the consolidated financial statements in accordance with § 317 HGB and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer [Institute of Public Auditors in Germany] (IDW), and in supplementary compliance with International Standards on Auditing (ISA) and the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the consolidated financial statements in accordance with the applicable financial reporting framework and in the review of group operations are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Group and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the consolidated financial statements and the review of group operations are examined primarily on a test basis within the framework of the audit. The audit includes assessing the annual financial statements of those entities included in consolidation, the determination of entities to be included in consolidation, the accounting and consolidation principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements and the review of group operations. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

In our opinion, based on the findings of our audit, the consolidated financial statements comply with IFRSs, as adopted by the EU, the additional requirements of German commercial law pursuant to § 315a Abs. 1 HGB and give a true and fair view of the net assets, financial position and results of operations of the Group in accordance with these requirements. The review of group operations is consistent with the consolidated financial statements and as a whole provides a suitable view of the Group's position and suitably presents the opportunities and risks of future development.

Mannheim, March 11, 2010 KPMG AG Wirtschaftsprüfungsgesellschaft

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be relied on by investors and other parties in making decisions regarding the business. The opinion shown in Exhibit 1.4 follows a standard format, with occasional variations.

The first paragraph indicates the scope of the opinion and also states that the responsibility for the financial statements rests with management. This responsibility has been reinforced by recent legislation in the US (known as Sarbanes–Oxley) that requires chief executive officers and chief financial officers to certify, under oath, the truthfulness of their companies' financial statements. This means that while auditors attest to the reliability of the accounts,

the ultimate responsibility rests with senior managers.[2] SAP produces a similar declaration, signed by each member of the Executive Board:

> To the best of our knowledge, and in accordance with the applicable reporting principles, the consolidated financial statements give a true and fair view of the assets, liabilities, financial position and profit or loss of the Group, and the management report of the Group includes a fair review of the development and performance of the business and the position of the Group, together with a description of the principal opportunities and risks associated with the expected development of the Group.

The second paragraph affirms that the auditor followed generally accepted auditing principles. In other words, the audit was conducted according to the standards of the auditing profession. The auditor then expresses the opinion in the final paragraph. It is here that the auditor states that the financial statements provide a "true and fair" view of the company's financial position, and results of operations for each of the years presented in the annual report.

Most opinions are unqualified, or "clean," which means that there are no exceptions, reservations, or qualifications. In effect, the auditor is telling you, the reader, that the financial statements can be trusted in making investment and other decisions related to this business. But while the overwhelming majority of audit opinions are clean, there are some exceptions.

A qualified opinion may arise because of serious uncertainties regarding the realization or valuation of assets (which can sometimes occur when companies are financially distressed), outstanding litigation, or tax liabilities that might compromise the firm's financial health. Inconsistencies between periods caused by changes in accounting rules or policy can also result in a qualified opinion.

An auditor may also disclaim an opinion (i.e., issue no opinion at all) or even issue an adverse opinion. Disclaimers may arise, for example, because of pending bankruptcy. The uncertainties regarding the truthfulness of financial statement numbers are so profound, the auditor is reluctant to issue any opinion on the financial statements. This happened to Parmalat, the Italian dairy company, after it was embroiled in a massive financial scandal. Adverse opinions are rare, because an auditor is likely to resign or be fired by a client before an adverse opinion would ever appear in a published annual report.

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Management discussion and analysis

Some annual reports, especially for companies that trade on stock exchanges in the US, include a management discussion and analysis section, also called the MD&A.[3] SAP calls their version the "review of operations." This section is an extended letter from the firm's management that summarizes the significant factors affecting the firm's operating results, financial strength, and cash flows for the past three years. It also contains an extensive discussion of business risks and forward-looking statements regarding the company's expectations for future operations, earnings, and prospects.

The review of operations from SAP's 2009 Annual Report runs to 87 pages. Most of the discussion consists of detailed explanations for the company's performance and financial condition, with emphasis on changes from the previous year. Important events from 2009 are also discussed, including acquisitions and product development. Management contrasts

financial figures from 2009 with 2008, explaining why these numbers improved or worsened. Considerable attention is also given to liquidity, which is defined here as the ability of the company to obtain the cash resources it needs for growth and debt repayment.

Generally Accepted Accounting Principles: the rules of the game

When auditors declare that financial statements "present fairly" a company's financial condition, profitability, and cash flows, what they really mean is that the statements were prepared in accordance with Generally Accepted Accounting Principles (hereafter, GAAP). GAAP comprises the rules and principles that guide managers in the preparation of their companies' accounts. These rules provide the filter through which potentially millions of data points pass to produce the highly summarized financial statements we see in corporate annual reports.

GAAP sets the "rules of the game" under which financial statements are prepared. When these rules are implemented in good faith, the chances are high, though far from assured, that the resulting financial statements can be relied on by users to make important economic decisions regarding the business.

Here, we focus on two GAAP regimes: the one that prevails in the US, otherwise known as US GAAP, and International Financial Reporting Standards (IFRS). Although many other accounting regimes exist around the world, capital markets have come to be dominated by these two approaches. Important differences exist between the two, but their primary objectives are the same. Moreover, there is a serious ongoing effort at convergence that should ultimately lead to a single set of global financial accounting standards.

US GAAP comes from a variety of sources, but the dominant player is the Financial Accounting Standards Board (FASB), based in Norwalk, Connecticut. The FASB is a private-sector body that is tasked with determining the appropriate financial reporting responses to an ever-changing business climate. Its official pronouncements are called "Financial Accounting Standards." In some cases, these standards are supplemented by "Interpretations" that augment or clarify key aspects of the standards.

IFRS is the product of the International Accounting Standards Boards (IASB), based in London. Since 2005, compliance with IFRS has been required for all publicly traded companies based in the European Union. It is also widely used in Asia. Today, over 100 countries either require or allow the use of IFRS.

The barriers to understanding financial statements

Businesses can be complex, and if annual reports are to capture economic reality, they too must be complex. Analyzing and interpreting financial statements can be highly rewarding for readers who take the time to understand this complexity and the nature of the problems they

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are likely to encounter. The following discussion introduces the major barriers you can expect to face in trying to make sense of corporate financial reports.

The volume of data

The most obvious problem encountered by the reader of financial statements is the sheer volume of information available, especially for businesses traded on a major stock exchange. In addition to the principal financial statements, footnotes, management discussion and analysis, and auditors' reports, there are also financial filings with stock exchange and regulatory authorities (such as the SEC in the US). The result can be a veritable mountain of information. Although capital markets run on information, the risk is that a reader can be easily overwhelmed.

A variety of analytical tools, such as financial statement ratios, exist to help readers overcome this problem. These tools are discussed in detail in later chapters.

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Accounting choice

Although GAAP and IFRS prescribe a set of rules and guidelines for preparing financial statements, they also afford corporate executives a broad range of choice. From the viewpoint of the financial statement reader, accounting choice adds greatly to the complexity of the task at hand. To some extent this choice is a logical outcome of the diversity we observe in the business world. What might be an appropriate accounting treatment for a steel company might not be appropriate for a biotechnology firm or an internet service provider. GAAP/IFRS must be flexible enough to accommodate all sorts of businesses and all types of business models. But even within the same industry, significant differences across companies in their accounting policies are often observed. For example, Coca-Cola's approach to translating the financial statements of its foreign subsidiaries into US dollars is different from that of PepsiCo, its major industry competitor.

To get a flavor for the nature of accounting choice, consider the following example. A machine with an expected life of five years is purchased for \$500 000. For long-term assets like this, we must decide on a depreciation method. Depreciation is the process by which the cost of an asset is allocated to the future periods that will benefit from its use. The most common method is called "straight-line." Under this approach, each of the next five years (the periods expected to benefit from the use of the asset), will be assigned \$100 000 of depreciation (\$500 000÷5). This means that in the first year, the income statement will include \$100 000 of depreciation expense. The balance sheet will show machinery with a net book value of \$400 000 at the end of the year, the acquisition cost net of the depreciation charge.

But suppose we elect to use another depreciation method, as GAAP and IFRS allow us to do. For example, we may choose the "double-declining balance" method, in which depreciation is charged to the income statement in an accelerated fashion. Under this approach, we take the straight-line rate of 20% (the annual rate of depreciation on the asset) and multiply it by 2. The resulting figure, 40%, is then multiplied by the net book value of the asset at the beginning of each year to determine that year's depreciation expense. This means that depreciation in the

first year is $200 000, instead of the $100 000 recognized under the straight-line method. Therefore, as a result of choosing double declining balance, depreciation expense in the first year would be $100 000 higher, and operating income $100 000 lower. In addition, the net book value of the asset at the end of the first year would be $300 000, instead of $400 000.

What this example shows is that the simple choice of one depreciation method over another can have a profound impact on both the balance sheet and the income statement. Which set of numbers is better? It's hard to say. Under some conditions, the straight-line approach may be better, but under other conditions it might not be. What's important to recognize is that both methods are allowed. Indeed, other methods are allowed too. Now imagine having to decide how all of the company's long-term assets are to be depreciated. And imagine the range of choices offered to corporate executives in how they measure other balance sheet items – or how they measure any transaction that arises in the normal course of their business.

Quite simply, differences in accounting choice can yield huge differences in financial statement numbers. One of the ways that a reader copes with this challenge is by carefully scrutinizing the notes to the financial statements.

In most annual reports, the first note summarizes the significant principles and policies chosen by the company's managers, helping the reader to understand the context under which the financial statements were prepared and key transactions measured. These disclosures allow analysts and other interested parties to compare a company's accounting policies with industry competitors and to make judgments on the quality of the numbers produced in the annual report.

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Earnings management

Accounting choice doesn't just make financial statements more complicated. It also provides a powerful weapon for managers who wish to mislead the capital markets, for whatever motive. Accounting policy requires judgment, and whenever there is scope for judgment, there is also scope for manipulation.

"Earnings management" is the term commonly used to describe efforts by corporate managers to distort or bias their companies' reported results. "Creative accounting" is also used. Both terms imply a conscious effort by managers to mislead readers of financial statements.

Although the opportunities for earnings management are practically limitless, the most serious efforts fall into either of two categories: faulty revenue recognition, and the improper recognition of losses and expenses. The Enron fiasco brought to light another area prone to mischief: off-balance-sheet financing. This accounting game also featured prominently in the global financial meltdown of 2008.

Incompleteness

SAP Group is the world's largest enterprise software company. The company's best known products are its SAP Enterprise Resource Planning (SAP ERP) and SAP BusinessObjects software. But while these brands obviously carry great value for SAP Group, you won't see them in the company's balance sheet. The same holds true for the company's other well-known

brands. This fact may seem odd given that these brands are almost certainly the most valuable resources the company has.

The above example shows that important attributes of a business, attributes with potentially profound effects on financial performance, may not always find their way into corporate balance sheets, at least not directly.

Reliability is a key characteristic of financial statements. To be reliable, financial statements should be verifiable: auditors must be able to check the numbers to ensure an acceptable degree of accuracy. This is not to say that all numbers have to be perfectly accurate; such a standard is not feasible, especially in large businesses such as SAP Group. But it does require at least some degree of objectivity, otherwise there is little for the auditors to observe and verify. For an intangible asset, such as the SAP BusinessObjects software, the common accounting practice is to include it in the balance sheet only if the asset has been bought. In other words, intangibles acquired from other companies are included, but internally generated intangibles are not. This means that when SAP Group acquires another company, any brands acquired from that purchase can be valued and subsequently included in the consolidated balance sheet. But the SAP BusinessObjects software, which was developed internally over many years, is not.

A similar practice can be seen in companies such as General Electric or Novartis. When they develop a valuable patent internally (i.e., from their own research and development activities), the patent is not included in the balance sheet. The only patents included are those acquired from other businesses.

Sophisticated readers of financial statements are fully aware of this inconsistency, and of the need to cast a wide net when gathering information about a company. In short, they understand that not everything you need to know about a company in order to value its shares or to assess its creditworthiness is revealed in the accounts.

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Key lessons from the chapter

- There are many users of financial statements including: investors, bankers, suppliers, customers, tax authorities, trade unions, competitors, courts of law, government regulators, and prospective employees. Capital providers (i.e., shareholders, bankers, bondholders, and prospective investors) are arguably the most important constituencies.
- Although financial accounting is not targeted to the needs of corporate managers per se, financial statements are the outside world's "window" on the company. Therefore, managers need to know what signals are being sent to investors about their companies and how those signals are interpreted. Otherwise, their companies will be at a competitive disadvantage in the global capital markets.
- The notes at the back of the annual report complement the three principal financial statements – the balance sheet, the income statement, and the statement of cash

flows – and provide extensive supplemental disclosures. The notes describe the accounting policies used by the company and present additional clarifying detail about financial statement line items.

- Annual reports must include an opinion from an independent public accounting firm, attesting to whether or not the financial statements were correctly prepared.
- US companies prepare their financial statements in accordance with Generally Accepted Accounting Principles (GAAP). GAAP sets the "rules of the game" under which financial statements are prepared. Most non-US companies prepare their financial statements in accordance with International Financial Reporting Standards (IFRS).
- A serious effort is under way to achieve convergence between US GAAP and IFRS.

Key terms and concepts from the chapter

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Stakeholders
Investors
Creditors
Balance sheet
Income statement
Statement of cash flows
Statement of shareholders' equity
Notes to the financial statements
Audit opinion
Clean opinion
Management discussion and analysis
Generally Accepted Accounting Principles (GAAP)
International Financial Reporting Standards (IFRS)
Earnings management

Questions

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 principal 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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Problems

1.1 Balance sheet terminology

Below is the statement of financial position (balance sheet) for the global brewing company, AB InBev. Identify the major differences in format and terminology between this balance sheet and the one introduced in this chapter for SAP.

Consolidated statement of financial position

As at 31 December Million US dollar	2011	2010
ASSETS		
Noncurrent assets		
Property, plant and equipment	16,022	15,893
Goodwill	51,302	52,493
Intangible assets	23,818	23,359
Investments in associates	6,696	7,295
Investment securities	244	243
Deferred tax assets	673	744
Employee benefits	10	13
Trade and other receivables	1,339	1,700
	100,04	101,745
Current assets		
Investment securities	103	641
Inventories	2,466	2,409
Income tax receivable	312	366
Trade and other receivables	4,121	4,638
Cash and cash equivalents	5,320	4,511
Assets held for sale	1	32
	12,323	12,597
Total assets	112,427	114,342
EQUITY AND LIABILITIES		
Equity	1,734	1,733
Issued capital	17,557	17,535
Share premium	381	2,335
Reserves	17,820	13,656
Retained earnings	37,492	35,259
Equity attributable to equity holders of AB InBev	3,552	3,540
Noncontrolling interest	41,044	38,799
Noncurrent liabilities	34,598	41,961
Interest-bearing loans and borrowings	3,440	2,746
Employee benefits	11,279	11,909
Deferred tax liabilities	1,548	2,295
Trade and other payables	874	912
Provisions	51,739	59,823
Current liabilities	8	14
Bank overdrafts	5,559	2,919

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As at 31 December Million US dollar	2011	2010
Interest-bearing loans and borrowings	449	478
Income tax payable	13,337	12,071
Trade and other payables	241	238
Provisions	19,644	15,720
Total equity and liabilities	112,427	114,342

1.2 Understanding balance sheet relationships

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Stora Enso is a large pulp and paper company headquartered in Finland. The company uses IFRS and reports its results in millions of euros (€). Compute the missing balance sheet amounts for each of the three years.

	2011	2010	2009
Current assets	€4,610	€4,494	?[b]
Noncurrent assets	?	8,543	?
Total liabilities	?	?	?
Total assets	?	?	€11,593
Current liabilities	2,786	2,569	2,619
Noncurrent liabilities	4,253	?	?
Total shareholders' equity	?	?	5,183
Share capital	?	3,150	?
Retained earnings	3,301	?[a]	1,200
Total liabilities and shareholders' equity	12,999	?	?

[a]Net income for 2010 is €766 and dividends are €158.

[b]Current assets – Current liabilities = €1144.

1.3 Interpreting an auditor's opinion

Excerpts are provided below from the auditor's opinion in the 2011 Annual Report of Creative Technology, Ltd., a Singapore-based consumer electronics company.

Required

(a) Describe the audit opinion rendered by PwC. Is this opinion "unqualified" or "qualified"?

(b) What is meant by the term "true and fair"?
(c) What is the economic significance of this opinion for investors and other interested parties?
(d) In what ways does management's responsibility for the financial statements differ from that of the auditor's?

We have audited the accompanying financial statements of Creative Technology Ltd (the "Company") and its subsidiaries (the "Group") . . . which comprise the consolidated balance sheet of the Group and the balance sheet of the Company as at 30 June 2011, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated statement of cash flows of the Group for the financial year then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the financial statements

Management is responsible for the preparation of financial statements that give a true and fair view in accordance with the provisions of the Singapore Companies Act (the "Act") and Singapore Financial Reporting Standards, and for devising and maintaining a system of internal accounting controls sufficient to provide a reasonable assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are properly authorized and that they are recorded as necessary to permit the preparation of true and fair profit and loss accounts and balance sheets and to maintain accountability of assets.

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Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Singapore Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal controls relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal controls. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements of the Group and the balance sheet of the Company are properly drawn up in accordance with the provisions of the Act and Singapore Financial Reporting Standards so as to give a true and fair view of the state of affairs of the Group and of the Company as at 30 June 2011, and the results, changes in equity and cash flows of the Group for the financial year ended on that date.

PricewaterhouseCoopers LLP
Public Accountants and Certified Public Accountants
Singapore

Case studies

1.1 Apple: an introduction to financial statement analysis*

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Apple is a global leader in the computing industry, with an emphasis on personal computing, mobile communication devices, and portable digital music players. It designs, manufactures, and markets both hardware and software. At the time of this writing (autumn 2012), Apple is the largest company in history in terms of market capitalization (i.e., the market value of the company's equity).

As recently as the late 1990s, however, Apple was perceived as mainly a niche player in the personal computer business, where the emphasis was on commoditized, low-margin products. The return of Steve Jobs, ousted in the 1980s from the company he cofounded, is now legendary in corporate history. He is credited for refocusing the company on the customer experience with products that emphasize not only performance and technology, but also aesthetics.

The excerpts from the company's financial statements included in this case will give you a summary view of recent financial performance. As you review these disclosures, think about what information is *excluded*, and how the absence of this information affects the reports' ability to communicate the true value of Apple.

Required

Balance sheet

(a) What was the magnitude and direction of the change to total assets for 2010?
(b) What was the magnitude and direction of the change to total liabilities for 2010?

*This case was prepared by Daniel Bens, Associate Professor of Accounting and Control, INSEAD.

(c) What was the magnitude and direction of the change to total shareholders' equity for 2010?
(d) Verify that the sum of your answers to (b) and (c) equals your answer to (a).
(e) What specific accounts explain most of the change to total assets?
(f) Based on your own experience, think about what makes Apple a valuable company. Does this "asset" that you've imagined appear on Apple's balance sheet? Are you satisfied that the balance sheet accurately reflects this value? Why or why not?

Income statement ("consolidated statement of operations")

(a) What was the magnitude and direction of the change to net sales?
(b) What was the magnitude and direction of the change to net income?
(c) Do the changes above seem consistent with the changes in total assets you calculated previously?
(d) Based on your own experience, think about the various product lines that generate these revenues (i.e., "sales") for Apple. Do you see the revenue from the individual product lines on the statement? Are you satisfied that the income statement accurately reflects these revenues? Why or why not?

Statement of cash flows

(a) What are the names of the three subsections that present the different sources of cash flow for the year?
(b) Note that net income is the first figure used in calculating cash generated by operating activities. How does net income compare to cash generated by operating activities?
(c) What does Apple appear to be doing with the cash that it generates from its day-to-day operations? (Hint: review investing activities.)
(d) Does Apple appear to have significant financing activities to report?

The auditor's opinion

(a) Describe Ernst & Young's role as Apple's external auditor?
(b) How useful is this opinion in helping an investor to value Apple's shares?

Apple's financial statements: Consolidated statements of operations (in millions, except share amounts which are reflected in thousands and per share amounts), three years ended September 25, 2010

	2010	2009	2008
Net sales	$65,225	$42,905	$37,491
Cost of sales	39,541	25,683	24,294
Gross margin	25,684	17,222	13,197

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	2010	2009	2008
Operating expenses			
Research and development	1,782	1,333	1,109
Selling, general and administrative	5,517	4,149	3,761
Total operating expenses	7,299	5,482	4,870
Operating income	18,385	11,740	8,327
Other income and expense	155	326	620
Income before provision for income taxes	18,540	12,066	8,947
Provision for income taxes	4,527	3,831	2,828
Net income	$14,013	$8,235	$6,119
Earnings per common share			
Basic	$15.41	$9.22	$6.94
Diluted	$15.15	$9.08	$6.78
Shares used in computing earnings per share			
Basic	909,461	893,016	881,592
Diluted	924,712	907,005	902,139

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Consolidated balance sheets (in millions, except share amounts)

	September 25, 2010	September 26, 2009
ASSETS		
Current assets		
Cash and cash equivalents	$11,261	$5,263
Short-term marketable securities	14,359	18,201
Accounts receivable, less allowances of $55 and $52, respectively	5,510	3,361
Inventories	1,051	455
Deferred tax assets	1,636	1,135
Vendor nontrade receivables	4,414	1,696
Other current assets	3,447	1,444
Total current assets	41,678	31,555
Long-term marketable securities	25,391	10,528
Property, plant and equipment, net	4,768	2,954
Goodwill	741	206
Acquired intangible assets, net	342	247
Other assets	2,263	2,011
Total assets	$75,183	$47,501

(*Continued*)

	September 25, 2010	September 26, 2009
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$12,015	$5,601
Accrued expenses	5,723	3,852
Deferred revenue	2,984	2,053
Total current liabilities	20,722	11,506
Deferred revenue – noncurrent	1,139	853
Other noncurrent liabilities	5,531	3,502
Total liabilities	27,392	15,861
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value; 1 800 000 000 shares authorized; 915 970 050 and 899 805 500 shares issued and outstanding, respectively	10,668	8,210
Retained earnings	37,169	23,353
Accumulated other comprehensive (loss)/income	(46)	77
Total shareholders' equity	47,791	31,640
Total liabilities and shareholders' equity	$75,183	$47,501

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Consolidated statements of cash flows (in millions), three years ended September 25, 2010

	2010	2009	2008
Cash and cash equivalents, beginning of the year	$5,263	$11,875	$9,352
Operating activities:			
Net income	14,013	8,235	6,119
Adjustments to reconcile net income to cash generated by operating activities:			
Depreciation, amortization, and accretion	1,027	734	496
Stock-based compensation expense	879	710	516
Deferred income tax expense	1,440	1,040	398
Loss on disposition of property, plant and equipment	24	26	22
Changes in operating assets and liabilities:			
Accounts receivable, net	(2,142)	(939)	(785)

	2010	2009	2008
Inventories	(596)	54	(163)
Vendor non-trade receivables	(2,718)	586	110
Other current assets	(1,514)	163	(384)
Other assets	(120)	(902)	289
Accounts payable	6,307	92	596
Deferred revenue	1,217	521	718
Other liabilities	778	(161)	1,664
Cash generated by operating activities	18,595	10,159	9,596
Investing activities:			
Purchases of marketable securities	(57,793)	(46,724)	(22,965)
Proceeds from maturities of marketable securities	24,930	19,790	11,804
Proceeds from sales of marketable securities	21,788	10,888	4,439
Purchases of other long-term investments	(18)	(101)	(38)
Payments made in connection with business acquisitions, net of cash acquired	(638)	0	(220)
Payments for acquisition of property, plant, and equipment	(2,005)	(1,144)	(1,091)
Payments for acquisition of intangible assets	(116)	(69)	(108)
Other	(2)	(74)	(10)
Cash used in investing activities	(13,854)	(17,434)	(8,189)
Financing activities:			
Proceeds from issuance of common stock	912	475	483
Excess tax benefits from stock-based compensation	751	270	757
Taxes paid related to net share settlement of equity awards	(406)	(82)	(124)
Cash generated by financing activities	1,257	663	1,116
Increase/(decrease) in cash and cash equivalents	5,998	(6,612)	2,523
Cash and cash equivalents, end of the year	$11,261	$5,263	$11,875
Supplemental cash flow disclosure:			
Cash paid for income taxes, net	$2,697	$2,997	$1,267

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Report of Ernst & Young LLP, Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of Apple Inc.

We have audited the accompanying consolidated balance sheets of Apple Inc. as of September 25, 2010 and September 26, 2009, and the related consolidated statements of operations, shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of

the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Apple Inc. at September 25, 2010 and September 26, 2009, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with US generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Apple Inc.'s internal control over financial reporting as of September 25, 2010, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated October 27, 2010 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

San Jose, California
October 27, 2010

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1.2 PepsiCo: communicating financial performance*

The Chairman's letter to the shareholders from PepsiCo's 2007 Annual Report is presented below.

Delivering Performance with Purpose in 2007

Dear Shareholders:

We have titled this year's annual report "Performance with Purpose: The Journey Continues." That's because in 2007 PepsiCo made great progress toward the long-term corporate objectives we set for ourselves last year: To achieve business and financial success while leaving a positive imprint on society.

*Source: 2007 PepsiCo Annual Report

Once more, our extraordinary associates around the world delivered terrific performance, and I am delighted to share with you the following 2007 financial results:

- Net revenue grew 12%, roughly three times the rate of global GDP growth.
- Division operating profit grew 10%.
- Earnings per share grew 13%.
- Total return to shareholders was 26%.
- Return on invested capital was 29%.
- Cash flow from operations was $6.9 billion.

In 2007 PepsiCo took important steps to support future growth.
What makes me particularly proud is that our 2007 performance was strong – not just measured by these short-term metrics – but also with the long-term equally in mind:

- We increased capital expenditures in plant and equipment worldwide to enable growth of core brands and expand into new platforms such as baked and crisp-bread snacks and non-carbonated beverages.
- We added several tuck-in acquisitions in key markets and segments, and we further expanded our successful coffee and tea joint ventures.
- We created the Chief Scientific Officer position to ensure our technical capabilities keep pace with increasingly sophisticated consumer demand; and we funded incremental investment to explore breakthrough R&D opportunities.
- We maintained focus on building next-generation IT capabilities with Project One Up, to support our long-term growth prospects worldwide.

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Our brands once again demonstrated competitive strength.
On the ground, in cities and towns around the world, good brand strategies were implemented with operational excellence. I'd like to share a few notable examples of the big marketplace wins we enjoyed in 2007:

- Our carbonated soft drink and savory snack brands gained market share in the United States and in many of our top international markets.
- In the United Kingdom, Baked Walkers crisps was named "New Product of the Year" by *Marketing Week* magazine.
- SunChips snacks delivered double-digit growth in the United States as a result of great, innovative marketing and in-store execution.
- 7UP H2Oh! was our fastest-growing brand in value and volume share in Brazil in its launch year.
- Pepsi Max came of age as a global brand, with outstanding performance in the United States as Diet Pepsi Max, after successes in Northern Europe and Australia and 2007 launches across Asia.

- PepsiCo beverage brands crossed the $1 billion mark in Russia retail sales.
- We posted double-digit volume growth in China beverages and high-single-digit beverage volume growth in India.

And we did all of this while battling increased commodity inflation and more macro-economic volatility than in previous years.

Required

In her review of PepsiCo's performance in 2007, Indra Nooyi, PepsiCo's Chairman and CEO, claims that, "Net revenue grew by 12%, roughly three times the rate of global GDP growth." What message is she trying to convey in this statement? After reviewing the disclosure "Results of Operation – Division Review," which is found in the notes to the financial statements, do you agree with Mrs. Nooyi's assertions about PepsiCo's growth?

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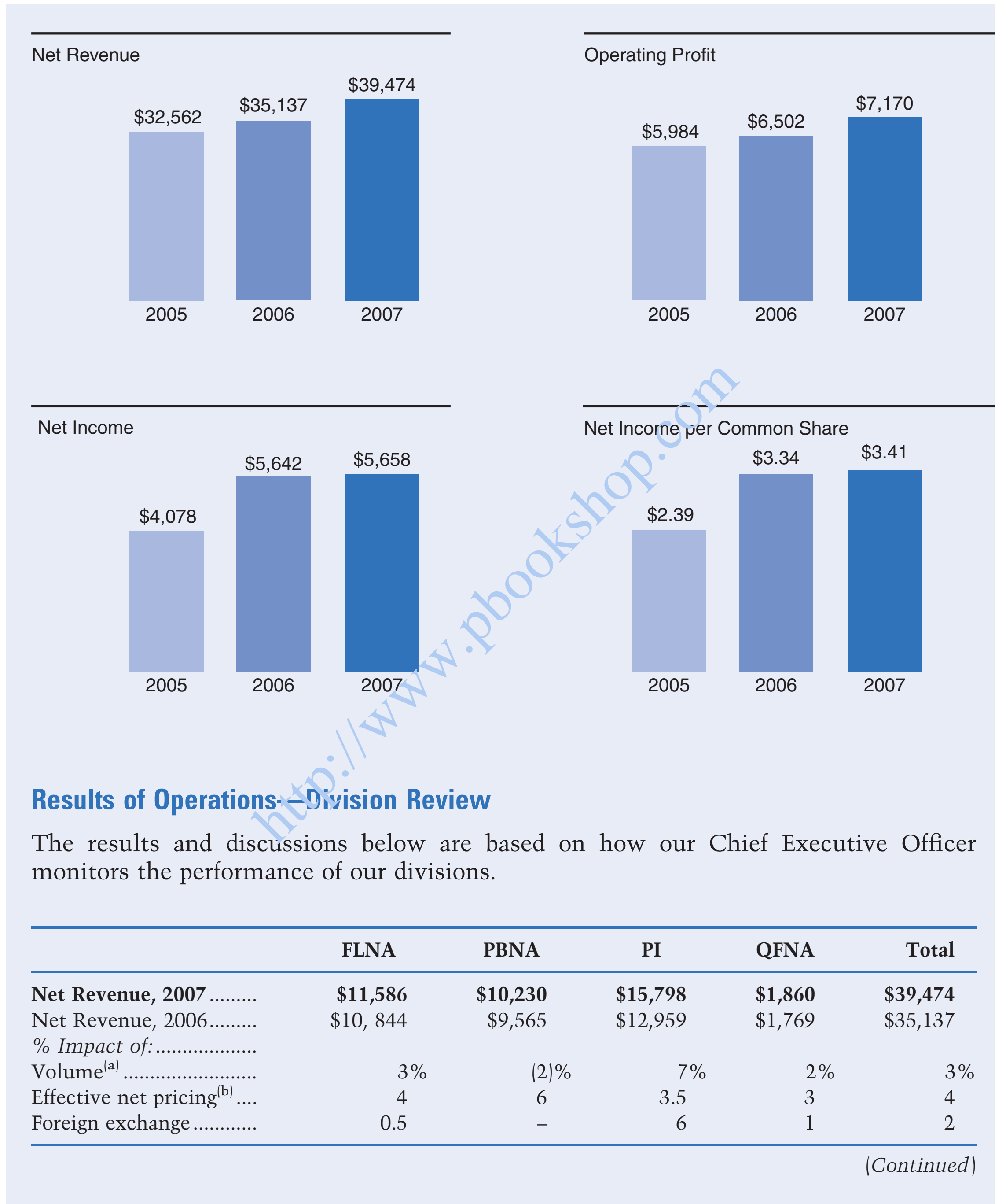
Consolidated Statement of Income

PepsiCo, Inc. and Subsidiaries: Fiscal years ended December 29, 2007, December 30, 2006, and December 31, 2005

(in millions except per share amounts)	**2007**	2006	2005
Net Revenue	**$39,474**	$35,137	$32,562
Cost of sales	**18,038**	15,762	14,176
Selling, general and administrative expenses	**14,208**	12,711	12,252
Amortization of intangible assests	**58**	162	150
Operating Profit	**7,170**	6,502	5,984
Bottling equity income	**560**	553	495
Interest expense	**(224)**	(239)	(256)
Interest income	**125**	173	159
Income before Income Taxes	**7,631**	6,989	6,382
Provision for Income Taxes	**1,973**	1,347	2,304
Net Income	**$5,658**	$5,642	$4,078
Net Income per Common Share			
Basic	**$3.48**	$3.42	$2.43
Diluted	**$3.41**	$3.34	$2.39



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Results of Operations—Division Review

The results and discussions below are based on how our Chief Executive Officer monitors the performance of our divisions.

	FLNA	PBNA	PI	QFNA	Total
Net Revenue, 2007	**$11,586**	**$10,230**	**$15,798**	**$1,860**	**$39,474**
Net Revenue, 2006	$10, 844	$9,565	$12,959	$1,769	$35,137
% Impact of:					
Volume[a]	3%	(2)%	7%	2%	3%
Effective net pricing[b]	4	6	3.5	3	4
Foreign exchange	0.5	–	6	1	2

(*Continued*)

	FLNA	PBNA	PI	QFNA	Total
Acquisitions/divestitures	–	2	6	–	3
% Change[c]	*7%*	*7%*	*22%*	*5%*	*12%*
Net Revenue, 2006.........	$10,844	$9,565	$12,959	$1,769	$35,137
Net Revenue, 2005.........	$10,322	$9,146	$11,376	$1,718	$32,562
% Impact of:					
Volume[a]	1%	3%	6%	1%	3%
Effective net pricing[b]	3	1	4	2	3
Foreign exchange...........	0.5	–	1	1	1
Acquisitions/divestitures	0.5	–	3	–	1
% Change[c]	5%	5%	14%	3%	8%

(a) Excludes the impact of acquisitions and divestitures. For PBNA and PI, volume growth varies from the amounts disclosed in the following divisional discussions due primarily to non-consolidated joint venture volume and temporary timing differences between BCS and CSE. Our net revenue for PBNA and PI excludes non-consolidated joint venture volume and is based on CSE.

(b) Include the year-over-year impact of discrete pricing actions, sales incentive activities and mix resulting from selling varying products in different package sizes and in different countries.

(c) Amounts may not sum due to rounding.

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Notes

1. The balance sheet is also known as the statement of financial position. Although the latter is the official term, business people everywhere continue to use the term "balance sheet." We will do likewise in this book.
2. In some countries, such as the UK, principal responsibility for the financial statements rests with the board of directors.
3. A growing number of countries now require similar disclosures.