CHAPTER OBJECTIVES

After careful study of this chapter, you will be able to:

1. Describe an auditor's report.
2. Understand the meaning of an operating segment.
3. Describe the disclosures in a segment report.
4. Explain interim reporting.
5. Prepare an interim report.
SYNOPSIS

Market Efficiency

1. General purpose financial statements designed to meet the needs of external users are published in a company's annual report, which also includes accompanying notes, an auditor's report, the management report, and management's discussion and analysis. In addition, companies prepare interim reports for accounting periods of less than one year.

2. The efficient markets hypothesis presumes that the prices of securities traded in the capital markets fully reflect all publicly available information, and that these prices adjust to new information almost immediately in an unbiased manner. Full disclosure of financial information helps to prevent the use of insider information and aids in the efficient operation of capital markets.

Auditor's Report (Opinion)

3. Most published financial statements are audited by an independent certified public accountant. In an audit, the accountant conducts an examination and expresses an opinion concerning the company's internal control and the fairness of the financial statements. The audit is conducted in accordance with generally accepted auditing standards. An unqualified opinion states that the financial statements present the information fairly in accordance with generally accepted accounting principles (GAAP), in all material respects. A qualified opinion states that, except for the effects of the qualified item, the financial statements present the information fairly, in conformity with GAAP. An adverse opinion states that the financial statements do not present the information fairly, in conformity with GAAP. A disclaimer states that the auditor does not express an opinion.

4. An audit report consists of five paragraphs. The introductory paragraph lists the financial statements audited, indicates that management's assessment of internal controls were audited, declares that management is responsible for the statements and related internal controls, and asserts that the auditor is responsible for expressing three related opinions. The second paragraph, known as the scope paragraph, describes the auditor's activity, stating that the auditor has examined the financial statements in accordance with generally accepted auditing standards and has performed appropriate tests to evaluate the reasonableness of the information. The third paragraph, also known as the definition paragraph, defines the internal control over financial reporting. The fourth paragraph, known as the inherent limitations paragraph, discusses the limitations that internal control may not prevent or detect potential misstatements. Finally, the fifth paragraph, or opinion paragraph, tells the auditor's opinion on the financial statements. This paragraph concludes with an opinion about whether the company maintained effective internal control over its financial reporting.

Audit Committee, and Management's Report

5. All publicly held companies are required by the SEC to have an audit committee. Audit committees have oversight over the financial reporting process. Such a committee is usually composed of "outside directors" rather than company management, to help maintain auditor independence.

6. The preparation and presentation of a company's financial statements are the responsibility of its management. Many companies include a management report in their annual reports, acknowledging management's responsibility and discussing internal control and the roles of the audit committee and the independent auditor.
Segment Reporting

7. Financial statements prepared by a company on a "consolidated" basis aggregate the accounting results of various legal segments. Disaggregation of segment financial information improves the predictive value and feedback value of financial statement information. FASB Statement No. 131 requires that the financial statements of a company include certain disaggregated information about its operating segments.

8. An operating segment is a company component (a) that engages in business activities to earn revenue and incur expenses, (b) whose operating results are regularly reviewed by the company's chief operating officer, and (c) for which financial information is available. Financial information must be provided about each reportable segment—each operating segment that satisfies at least one of the following tests:

(a) Revenue Test. Its reported revenues (including sales to external customers and intersegment sales) are 10% or more of the combined revenues of all of the company's reported operating segments.

(b) Profit Test. The absolute amount of its profit or loss is 10% or more of the combined reported profits of all industry segments that did not report a loss.

(c) Asset Test. Its segment assets are 10% or more of the combined assets of all operating segments.

9. Enough reportable segments must be disclosed so that their combined revenues are at least 75% of total company revenues (excluding intersegment sales).

10. A company must disclose general information about how it is organized and about the types of products and services from which each reportable segment earns its revenues. In addition, for each reportable segment the company must disclose:

(a) General information: A company must identify how it is organized, what factors were used to identify its operating segments, and describe the types of products and services from which each reportable segment earns its revenues.

(b) Information about profit (or loss): The company must report a measure of the profit (loss) for each reportable segment, and must also disclose the segment's revenues, interest revenue and interest expense, and depreciation, depletion, and amortization expense.

(c) Information about assets: The company must report a measure of the total assets of each reportable segment, as well as the total related capital expenditures.

(d) Reconciliations: The company must reconcile the segments' revenues, profits, and assets to its respective total revenues, pretax income from continuing operations, and total assets.

(e) Company-wide disclosures: A company must disclose its revenue from external customers for each product and service and information about geographical areas including revenues from U.S. external customers and in individual foreign countries and total long-lived assets located in the U.S. and in all foreign countries.

11. The intent of disaggregated disclosures is to help users better understand a company's performance, better assess its likely future cash flows, and make more informed judgments. There are some comparability issues, however, related to differences between companies as to their operations, transfer pricing policies, and expense allocation procedures.
Interim Financial Reports

12. Interim financial statements, intended to improve the timeliness of accounting information, are reports for periods of less than one year. Interim reports are issued by all publicly held companies. APB Opinion No. 28 sets out guidelines for the presentation of interim information. According to the Opinion, each interim period is considered primarily an integral part of an annual period.

13. The generally accepted accounting principles used in preparation of a company's annual report are used, with some modifications, for interim periods. Revenues are recognized during an interim period in the same manner as during an annual period. Seasonal variations in revenue are disclosed. Expenses that can be associated directly with or allocated to interim product or service revenues are matched against those revenues. In general, the same inventory pricing method (e.g., FIFO, LIFO) is used for interim as for annual reports. Expenses that are not directly associated with product sales or services are matched against revenues using a variety of bases. Gains and losses that occur during an interim period and that would not be deferred at year-end are recognized in the interim period of occurrence.

14. Income taxes for each interim period are computed using an estimate of the effective tax rate on annual income from continuing operations. The amount of income taxes applied to each interim period is the income tax computed on year-to-date income from continuing operations minus the related income taxes reported in previous interim periods of the year. Where an established pattern of seasonal losses offset by income in later periods exists, the resulting income tax credit is recognized in the loss period.

15. Material extraordinary items and results of discontinued operations are reported, net of taxes, in the interim period during which they occur. Materiality is determined in relation to estimated income for the entire year, not the interim period.

16. Earnings per share are computed for each interim period presented. Care is needed in reporting comparative interim earnings per share, because differences arising from the short time periods may make prediction of annual earnings per share difficult.

17. According to APB guidelines, publicly held companies presenting interim reports must at a minimum disclose (a) sales or gross revenues, income taxes, extraordinary items (net of tax), and net income; (b) earnings per share; (c) seasonal revenues, costs, and expenses; (d) significant changes in estimates of income taxes; (e) results of discontinued operations and material unusual or infrequent items; (f) contingent items; (g) changes in accounting principles or estimates; and (h) significant changes in financial position (i.e., cash flows). When a company reports this information on a quarterly basis, it must also provide current year-to-date information and comparable data from the previous year. When an interim condensed balance sheet and cash flow data are not presented, significant changes in liquid assets, working capital, long-term liabilities, and stockholders' equity are disclosed.

SEC Reports

18. The Securities and Exchange Commission (SEC) has the legal authority to prescribe accounting principles and reporting practices for companies issuing publicly traded securities. The Office of the Chief Accountant provides the SEC with advice on accounting and auditing. The Chief Accountant is responsible for Regulation S-X, which governs the form and content of financial statements filed with the SEC. The Chief Accountant also has authority over the Financial Reporting Releases that prescribe accounting principles for regulated companies. The Division of Corporation Finance assists in the establishment of reporting standards (except those applying to financial statements) and is responsible for reviewing financial reports submitted to the SEC by regulated companies.
19. Two of the required SEC reports, Form 10-K and Form 10-Q, are important to accountants. Form 10-K is the most common SEC annual report form. It requires two types of information: (1) information that must also be reported in annual reports to stockholders and that may be included in Form 10-K simply by reference to the company’s published annual report, such as the financial statements, notes, and MD&A; and (2) information that is required only in SEC reports. This second type of information is considered to be of interest primarily to a limited and sophisticated group of users (e.g., security analysts) and includes items such as directors and officers, executive compensation, and legal proceedings.

20. Form 10-Q contains disclosures similar to those in Form 10-K, but on a quarterly and year-to-date basis. The financial statement disclosures included are similar to those in a company’s published quarterly report. However, Form 10-Q disclosures may be more extensive because the SEC requires presentation of comparative interim income statements. Companies must file both Form 10-K and Form 10-Q electronically.

Appendix: Financial Analysis Comparisons

21. In intracompany comparison, a company’s current financial performance and condition are compared with the company’s past results. Evidence of trends is an important factor in such comparisons. Consistency over time of information prepared for use in such comparisons is critical.

22. In intercompany comparison, a company’s performance is compared with that of competitors, with the industry as a whole, or with the results in related industries. Comparability of the information used across companies, as well as consistency over time, is of concern in such comparisons.
SELF-EVALUATION EXERCISES

True-False Questions

Determine whether each of the following statements is true or false.

1. A qualified opinion by an auditor states that the financial statements as a whole do not present the information fairly, in conformity with GAAP.
   Answer: False
   A qualified opinion states that except for the effects of the qualified item, the rest of the financial statements do present the information fairly, in conformity with GAAP.

2. A company must provide certain disaggregated information about an operating segment only if it satisfies all three of the following tests: the revenue test, the profit test, and the asset test.
   Answer: False
   A company must report segment information if it satisfies any one of the three tests (revenue, profit, or asset).

3. Expenses identified with the operating activities of more than one interim period are allocated among those periods.
   Answer: True
   These expenses are allocated among the interim periods based on several methods such as time expired or benefit received.

4. Materiality for an interim period is determined in relation to income for the entire year.
   Answer: True
   Materiality is based on the entire year, not just the financial information for the quarter.

5. Publicly traded companies are required to disclose cash flow from operations (CFO) per share, as well as earnings per share, on the face of the income statement.
   Answer: False
   While a company is required to report earnings per share on the face of the income statement, CFO per share is prohibited by GAAP.

6. For the purpose of determining whether an operating segment is reportable, intersegment sales are included in the segment's revenues.
   Answer: True
   The revenue test for determination of segmental reporting uses all sales, including sales to external customers and intersegment sales.

7. On a company-wide basis, a company must disclose information about its geographic areas and about revenues from major customers.
   Answer: True
   Information regarding geographic operations as well as revenue from external customers in both the United States and foreign countries are required to be disclosed.

8. A company's financial statements are the responsibility of its management.
   Answer: True
   Management is responsible for the information in and the presentation of financial statements in accordance with GAAP.

9. Publicly traded companies presenting interim financial statements should treat the interim period primarily as a separate reporting period, rather than as an integral part of an annual period.
   Answer: False
   Each interim period is viewed primarily as an integral part of an annual period.
10. The efficient markets hypothesis presumes that the market price of a company's securities will eventually adjust to all events affecting the company.

Answer: False
Research in efficient markets has shown that the price of securities traded in the market are adjusted almost immediately based on new information. However, there is some research that shows that the market is not always efficient.

11. The audit committee of a company is usually composed of “outside directors” rather than management.

Answer: True
Most members of the audit committee are outside directors. Because the auditor reports to the audit committee, the use of outside directors helps assure the independence of the auditor from undue influence by management.

12. Financial statements are prepared on a consolidated basis in order to include disaggregation of segment financial information.

Answer: False
Consolidated financial statements do not disaggregate information; instead they aggregate or combine the financial information of separate segments of a company.

13. When a company is required to report disaggregated information about its operating segments, enough reportable segments must be disclosed so that their combined revenues make up at least 75% of total company revenues.

Answer: True
In addition to the revenue, profit, and assets, there is an overall materiality test. This test requires that the reportable segments must be a substantial portion of the company’s total operations. This test is met by reporting enough segments to reach 75% of the entire company’s revenue.

Multiple Choice Questions
Select the one best answer for each of the following questions.

1. Minimum interim disclosures by a publicly held company include:
(a) sales or gross revenues.
(b) earnings per share.
(c) significant changes in estimates of income taxes.
(d) contingent items.
(e) all of the above.

Answer: (e) all of the above.
When public companies report interim financial information, the following data must be reported at a minimum: (1) sales or gross revenues, income taxes, extraordinary items (net of tax), and net income; (2) earnings per share for each period presented; (3) seasonal revenues, costs, and expenses; (4) significant changes in income taxes; (5) results of discontinued operations and material unusual or infrequent items; (6) contingent items; (7) changes in accounting principles or estimates; and (8) significant changes in financial position (i.e., cash flows). (Note: the answer choices in the question are underlined above.)
2. Which of the following facts would not make an operating segment reportable?
(a) The segment's revenues, including intersegment sales, are 20% of the total company's revenues.
(b) The segment's profit is $50,000, while the company's profit is $430,000.
(c) 75% of the segment's revenues are earned from one unaffiliated customer.
(d) The segment's identifiable assets are 11% of the company's assets.

Answer: (c) 75% of the segment's revenues are earned from one unaffiliated customer.

The fact that 75% of a segment's revenue comes from one unaffiliated customer is not a requirement for separate reporting for a segment.

Choice (a) is incorrect because it would require reporting by an operating segment because the segment's revenues exceed 10% of the company's total revenues. This 10% requirement can include intersegment as well as external sales. Choice (b) is incorrect because it would require reporting by an operating segment because the segment's profit of $50,000 represents 11.6% of the company's total profit, which exceeds the 10% requirement. Choice (d) is incorrect because it would require reporting by an operating segment because the segment's identifiable assets are greater than the required 10%.

3. Information about which of the following is required in a company's financial statements under FASB Statement No. 131?
(a) types of products and services from which each reportable segment earns its revenue
(b) revenue from external customers for each product and service
(c) information about geographic areas
(d) all of the above

Answer: (d) all of the above

FASB Statement 131 disclosure requirements are quite detailed. In general, it requires that a company provide general information about its organization including a description of the types of products and services from which each reportable segment earns its revenues (choice (a)). Each segment is required to report the segment's revenues split into sales from external customers and intersegment sales (choice (b)). In addition, a company is required to report information about geographic areas (choice (c)) including information about revenues and assets in foreign countries.

4. Interim financial statements:
(a) are issued by all publicly held companies.
(b) need not disclose seasonal variations in revenue.
(c) are always audited like annual financial statements.
(d) do not report extraordinary items and discontinued operations.

Answer: (a) are issued by all publicly held companies.

Interim financial statements are reports that cover periods less than a year. All publicly held companies are required to prepare interim financial reports in order to provide external users with more timely financial information.

Choice (b) is incorrect because disclosure of seasonal variations in revenue is required to be reported in interim financial statements. Choice (c) is incorrect because typically interim financial statements are not audited, except for SEC reports, due to the time and cost constraints. Choice (d) is incorrect because interim financial statements report extraordinary items and discontinued operations in the same manner as annual financial statements.
5. The SEC:
   (a) reviews the audited information of all corporations.
   (b) requires the presentation of comparative interim income statements on Form 10-Q.
   (c) requires that publicly traded companies file interim financial information on Form 10-K.
   (d) requires that a company include a management's discussion and analysis in any published financial statements.

   **Answer: (b)** requires the presentation of comparative interim income statements on Form 10-Q.

   Interim financial statements are filed with the SEC on Form 10-Q within 35 days of the end of the company's three non-year ending quarters.

   Choice (a) is incorrect because the SEC only reviews the information on publicly held corporations, not all corporations. Privately held corporations are not required to submit SEC reports. Choice (c) is incorrect because the 10-K is the form that the SEC requires publicly held companies to submit annual reports, not interim financial reports. Choice (d) is incorrect because management discussion and analysis is only required by the SEC form annual reports (Form 10-K), not all published financial statements.

6. An unqualified audit opinion:
   (a) is usually expressed by a company's audit committee.
   (b) means that the auditor states that the financial statements are presented fairly in accordance with generally accepted accounting principles.
   (c) accepts the auditor's responsibility for the financial statements presented.
   (d) is identical to a qualified opinion except that it does not include an opinion paragraph.

   **Answer: (b)** means that the auditor states that the financial statements are presented fairly in accordance with generally accepted accounting principles.

   An unqualified audit opinion means that the auditor has found the financial statements to be presented fairly in accordance with generally accepted accounting principles.

   Choice (a) is incorrect because the auditor, not the audit committee, issues opinions. The audit committee has oversight of the financial reporting process of a company. Choice (c) is incorrect because management, not the auditor, is responsible for the presentation of the financial statements. The auditor is only responsible for the opinion expressed with regard to the presentation of the financial statements. Choice (d) is incorrect because both a qualified and unqualified audit opinion have an opinion paragraph.
7. In interim financial reporting, what tax rate does a company use to report income tax expenses for the third quarter?
   (a) The company's effective tax rate last year.
   (b) The tax rate applicable to the third quarter only.
   (c) The effective tax rate that the company expects to be applicable to the full current year based on estimates at the end of the third quarter.
   (d) The effective tax rate for taxable income measured at the end of the third quarter.

**Answer: (c)** The effective tax rate that the company expects to be applicable to the full current year based on estimates at the end of the third quarter.

In interim financial reporting, a company is required to estimate at the end of each quarter what their effective tax rate will be at the end of the year and use that rate to estimate the income tax expenses for the year to date.

Choice (a) is incorrect because last year's tax rate has no bearing on what the current year's tax rate will be. Choice (b) is incorrect because the use of only the third quarter does not take into consideration the effects the other quarters' income will have on the effective tax rate of the entire company at the end of the year. Choice (d) is incorrect because it ignores the effects of the fourth quarter on the effective tax rate.

8. The figure that is set at 100% and used as the base for vertical analysis of a company's balance sheet is:
   (a) total stockholders' equity.
   (b) total liabilities.
   (c) total assets.
   (d) either (a), (b), or (c).

**Answer: (c)** total assets.

Total assets is the figure that is expressed as 100% and all other figures are expressed accordingly.

Because total liabilities and total stockholders' equity together equal total assets, the use of either of these items would result in a total assets value of greater than 100%. Choice (c) is incorrect because it uses both total liabilities and total stockholders' equity.

**Problem-Solving Strategies**

**Segment Reporting**

<table>
<thead>
<tr>
<th>Strategy:</th>
<th>The most common type of problem with regard to segment reporting concerns which segment or segments are required to be reported on separately. The easiest way to approach these problems is to learn the three operating tests (revenue, profit, and assets) and then apply these tests in a systematic method.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategy:</td>
<td>Remember, an operating segment is significant and therefore reportable if it meets any of the three tests.</td>
</tr>
</tbody>
</table>

Revenue Test: If a segment has reported revenues (including both external and internal sales) that are 10% or more of the combined revenues of all the company's reported operating segments.

Profit Test: If a segment's absolute amount of its profit or loss is 10% or more of the combined reported profits of all operating segments that did not report a loss.

Asset Test: If a segment's assets are 10% or more of the combined assets of all operating segments.
In addition to these three tests, there is an overall test of materiality that requires that enough reportable segments must be disclosed to account for 75% of the entire company’s revenues.

Assume that the Western Oaks Company has four operating divisions with the following information:

<table>
<thead>
<tr>
<th>Segment</th>
<th>Revenue</th>
<th>Profit</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>5,000,000</td>
<td>1,000,000</td>
<td>15,000,000</td>
</tr>
<tr>
<td>B</td>
<td>32,000,000</td>
<td>5,000,000</td>
<td>35,000,000</td>
</tr>
<tr>
<td>C</td>
<td>2,000,000</td>
<td>250,000</td>
<td>4,000,000</td>
</tr>
<tr>
<td>D</td>
<td>25,000,000</td>
<td>6,000,000</td>
<td>65,000,000</td>
</tr>
<tr>
<td>Totals</td>
<td>64,000,000</td>
<td>12,250,000</td>
<td>119,000,000</td>
</tr>
</tbody>
</table>

Which of the four operating segments would require separate disclosure?

The best way to approach this problem is to apply each test and list which segments meet the test requirements.

1. **Revenue Test**: Since 10% of the total revenue is $6,400,000, only segments B and D meet this test.

2. **Profit Test**: Ten percent of total profits is $1,225,000. Based on this test, again, only segments B and D meet the test.

3. **Asset Test**: Ten percent of the total assets is $11,900,000. In this instance, segments A, B, and D meet the test.

It is obvious that segments B and D will require separate disclosure because they exceeded all three test thresholds. We must also separately disclose segment A because it exceeded the asset test threshold. Remember, any segment that passes one of the three tests must be separately disclosed. Because segment D did not pass any of the three tests, it does not require separate disclosure.
Test Your Knowledge

1. Financial information about the Multi-Products Company is presented below:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Segment A</th>
<th>Segment B</th>
<th>Segment C</th>
<th>Segment D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$ 500,000</td>
<td>$ 344,000</td>
<td>$100,000</td>
<td>$36,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Assets</td>
<td>1,000,000</td>
<td>420,000</td>
<td>400,000</td>
<td>90,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Profit (loss)</td>
<td>50,000</td>
<td>(10,000)</td>
<td>48,000</td>
<td>5,500</td>
<td>6,500</td>
</tr>
<tr>
<td>Intersegment sales</td>
<td>60,000</td>
<td>-0-</td>
<td>55,000</td>
<td>2,000</td>
<td>3,000</td>
</tr>
</tbody>
</table>

Determine which segments are reportable and indicate why.

2. Which of the following statements regarding segment reporting are correct?
   (a) Determination of whether an operating segment is reportable is made on the basis of materiality.
   (b) A company's financial statements are disaggregated using the "management approach" rather than classified by products, geography, legal entity, or type of customer.
   (c) All separate departments of a company are considered to be operating segments.
   (d) A company must report enough segments to include information about a substantial portion of its total operations.
   (e) Disaggregation of financial reports is intended to improve the reliability, but not the predictive value or the feedback value, of a company's financial reports.

3. Which of the following statements related to the SEC is correct?
   (a) The SEC requires a management's discussion and analysis in a company's Form 10-K annual report.
   (b) The management's discussion and analysis is a narrative analysis and discussion that provides information, for example, on the company's liquidity, capital resources, and results of operations.
   (c) The SEC requires that each regulated company file a financial reporting release summarizing its financial statements.
   (d) Form 10-K, which contains only information included in a company's published financial statements, may be completed by reference to those statements.
   (e) Comparative interim income statements are included in Form 10-Q.
   (f) The Division of Corporation Finance establishes reporting standards for financial statements.
   (g) The Chief Accountant, who is responsible for Regulation S-X, has authority over the Financial Reporting Releases.
   (h) Form 10-Q disclosures may be more extensive than those in a company's published quarterly report.
   (i) The SEC has the legal authority to prescribe accounting principles and reporting practices.
   (j) The SEC requires companies to file Form 10-K and Form 10-Q electronically.
1. Segments A, B, and D are reportable.
   Segments A and B meet the revenue test.*
   Segments A, B and D meet the profit test.^
   Segments A and B meet the asset test.

   * Intersegment sales are included in sales for the revenue test.
   ^ Segment A meets the profit test even though it is a loss since absolute values are used. Total of all segments making a profit = $60,000 x 10% = $6,000. Segment A meets this at $10,000.

2. Correct statements:  a, b, d

3. Correct statements:  a, b, e, g, h, i, j