

two general categories: operating leases and capital leases. On the one hand, operating leases are often viewed as temporary rentals, with rent expense being reported in the income statement of the company needing the asset. This company renting is referred to as the *lessee*. Operating leases can be short-term relative to the total life of the asset being rented. In addition, the rentals over the lease period do not provide a significant recovery of the asset's value over the term of the lease for the company providing the asset. Regardless of this fact, minimum lease payments under operating lease agreements often represent a substantial fixed charge awaiting the lessee.

A capital lease, on the other hand, is generally long-term. It requires rentals that are significant and approximate the value (excluding future interest) of the asset being rented. When this type of agreement is executed, the lessee must view the leased asset as if it had been purchased using a long-term financing arrangement. The company that owns the asset is willing to receive installment payments over the lease term, and in this case provides the financing. Keep in mind that there is no transfer of title to the lessee. The transaction is simply accounted for as if it were a capital asset acquisition.

The rationale for this accounting treatment is to prevent companies from not reporting the liability that parallels a lease agreement of this nature. Since the lease agreement emulates a purchase with long-term financing, companies are required to account for them in a manner similar to a purchase. Therefore, leases of this nature require balance sheet recognition of a capitalized leased asset and the associated long-term liability.

According to its balance sheet, The Home Depot has capitalized leases that total \$261 million. Since the leases are reported as assets, they will be associated with a related liability as well. Capital lease obligations are reported in both the current and long-term liability sections of the balance sheet.

As the leased assets are used in The Home Depot Company's operations, they will decline in usefulness similar to a purchased asset. Therefore, capitalized leased assets are depreciated as well. In most instances, assets of this nature are written off over the lease term. Upon the termination of the lease agreement, the leased asset should be fully depreciated and the lease obligation fulfilled by the lessee. At this point, the asset simply transfers back to the lessor, or is sold to the lessee at a bargain purchase price.

Long-Term Investments

Long-term investments, discussed along with their short-term counterpart, are recorded when a company invests in another company's debt or equity.

If management intends to hold these investments beyond one year, these investments must be categorized under the heading *long-term investments*. Occasionally management reclassifies long-term investments as market conditions change from one period to the next.

Long-term *stock investments* can be accounted for under the (1) cost, (2) fair value, (3) equity, or (4) consolidation approach. A careful review of the investments footnote (following the financial statements) may identify the types of investments and their related valuation. On occasion, if the reported investment is minimal, the note will provide little assistance.

According to the footnote, The Home Depot classifies its debt investments as AFS and accounts for them at their current market price. AFS investments are classified as short- or long-term investments, depending on management's intent. In either case, changes in market value are recognized in stockholders' equity as *unrealized gain or loss on AFS securities*. Upon careful review we find no mention of gain or loss under other comprehensive income. This suggests that no material change in the market value of the AFS securities has taken place.

NOTES RECEIVABLE A note receivable is a written promise to pay a specific amount or amounts at some point forward. Most notes receivable are loans but can result from a conventional sales arrangement that allows for extended terms. Occasionally, accounts receivable can be converted to a note receivable to extend the original terms of the agreement, generate a rate of return for the holder of the note, and strengthen legally the agreement between the parties. The Home Depot reports \$77 million in notes receivable at the close of fiscal year 2000.

Intangible Assets, Including Costs in Excess of Fair Value of Net Assets Acquired

Previous classifications included assets that were generally tangible in nature. Intangible assets, however, generally lack physical substance and possess a greater degree of uncertainty in regard to future benefits than do tangible assets. They represent rights, privileges, and competitive advantages, backed by a legal agreement. Nonetheless, intangible assets, when properly created or acquired, can enhance the profitability of the enterprise for years to come. Once recorded, these assets operate no differently than tangible assets such as property, buildings, equipment, or fixtures. Their costs are capitalized and generally allocated to future periods through a

method known as *amortization*. Amortization of intangible assets and depreciation of fixed assets both represent cost allocation processes that satisfy the matching principle. Examples of intangible assets include patents, copyrights, trademarks, organizational costs, and goodwill:

- *Patents* grant to the organization the exclusive right to manufacture, sell, or control a product or process for a specific period of time.
- *Copyrights* give the owner the right to reproduce and sell a published work or artistic creation.
- *Trademarks* are rights that relate to brand or trade names.
- *Organizational costs* include all costs incurred in the formation of the enterprise and would include attorney and accounting fees, federal and state filing costs, underwriting costs, and so on. They are regarded as expenditures that will benefit the organization over its life. These costs are capitalized and generally written off over a period of 5 to 10 years (5-year write-off period for taxable entities).
- *Goodwill* is recognized when one company acquires another company and pays more than the value of its net identifiable assets (assets less liabilities). It is often said that goodwill is the most intangible of the intangible assets group.

The Home Depot reports goodwill (cost in excess of the fair value of net assets acquired) at \$314 million at the close of fiscal year 2000. Goodwill can only result from the purchase of another company and represents the expected value of better-than-normal future operating performance. It is measured as the difference between the purchase price of an acquired firm and the fair value of its identifiable net assets.

Goodwill has traditionally been written off over a period not to exceed 40 years. This write-off can place a significant drag on earnings for an extended period of time.² A recent change in accounting for goodwill by the Financial Accounting Standards Board (FASB) requires companies to no longer write off newly acquired goodwill. The FASB believes that companies should write down goodwill only when its value appears to be permanently impaired. The Board's rationale is that the synergistic benefits derived through business combinations often have indefinite lives. To arbitrarily write down goodwill does not follow the matching principle. In a sense, the FASB is suggesting that goodwill is similar to land in that it need not be written off unless its value becomes impaired.

Current Liabilities

Liabilities and stockholders' equity support a company's investment in assets. Liabilities must be recognized on the date they were incurred. Liabilities, much like assets, can be classified according to when they will be satisfied. Current or short-term liabilities are obligations that will be satisfied in the upcoming year; noncurrent liabilities will be settled at some point beyond the current period. The Home Depot balance sheet reports a number of current liabilities:

- Accounts payable
- Accrued salaries payable and related expenses
- Sales taxes payable
- Other accrued expenses
- Income taxes payable
- Current installments of long-term debt

A pie chart can be used to quickly identify large liabilities. Figure 3.6 clearly shows that accounts payable is 45 percent and other accrued expenses are 32 percent of total current liabilities. Graphing this information over time, as demonstrated with inventory, will point to respective growth, stability, or decline in these areas.

ACCOUNTS PAYABLE Accounts payable, also known as trade accounts payable, represent amounts owed to other companies as a result of goods, services, materials, supplies, and so on acquired throughout the year. Almost 50 percent of The Home Depot's current liabilities, or \$1.976 bil-

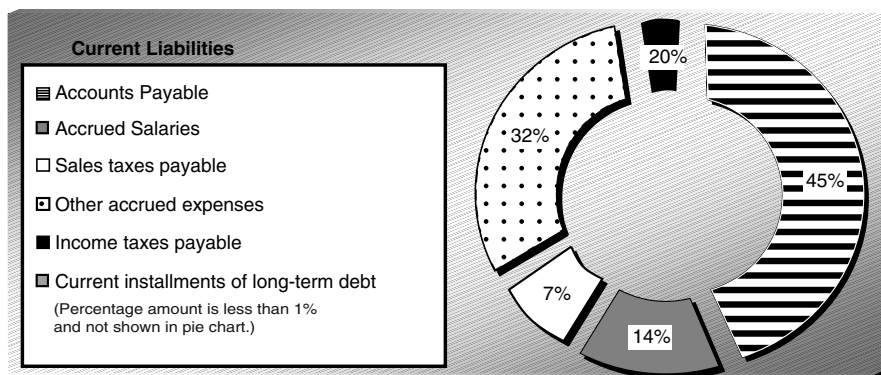


Figure 3.6 Analysis of current liabilities.

lion, is tied to accounts payable. Obviously, to support the operation of more than 1,100 stores, The Home Depot must continually purchase significant quantities of goods from product supply houses. Conventional payment terms might require satisfaction of these obligations within 30 to 60 days of the invoice date, depending on The Home Depot's relationship with the vendor.

ACCRUED SALARIES PAYABLE AND RELATED EXPENSES The recognition of accrued salaries and related expenses results from the application of accrual basis accounting. Accrual accounting requires revenues to be recognized when earned and expenses when incurred. The actual receipt of or payment with cash is not essential to the recognition of revenues and expenses in the accounting records. The key issue is whether product sales have occurred and what costs or expenses relate to the sale. Salaries are accrued because they are an expense that relates to the generation of revenue in the current period.

When an accrual takes place, it is often related to a transaction that does not coincide with the close of the fiscal year or the exact amount is not yet known (in the case of a contingent liability). For example, The Home Depot may distribute compensation to a certain group of employees on a weekly basis and others twice a month, on the 10th and 25th. Because the distribution of wage does not cover services provided by employees through the close of the fiscal year, an accrued liability for wages earned between the last payment date and the end of the year must be reported in the balance sheet. The accrued liability for salaries and other related expenses reported by The Home Depot amounts to \$627 million. This amount would also include payroll taxes that the company is responsible for and would include FICA, FUTA, and SUTA payroll taxes. This amount was computed at the close of the business year and recorded via a year-end adjusting entry.

SALES TAXES PAYABLE State and federal mandates require corporations to collect sales tax when sales of tangible personal property are executed. Upon receipt from its customers, corporations have a legal obligation to remit these taxes to an appropriate government agency. Sales taxes are remitted periodically; therefore, any amounts collected represent a liability for the company collecting them.

The Home Depot reports \$298 million of sales taxes payable at the close of the fiscal year. This is classified as a current liability because satisfaction of this obligation will take place in the following quarter.

OTHER ACCRUED EXPENSES Other accrued expenses can include a variety of obligations. For example, this may include interest accrued on The Home Depot notes payable. The company presently has 6 percent senior notes outstanding that require interest payments each March 15 and September 15. Because the interest payment date does not fall at the end of The Home Depot's fiscal year, there must be an accrual of interest from the last interest payment date through the end of the fiscal year. The company has additional obligations in the form of leases and installment notes that would require similar accounting accruals.

Accrued expenses can also include estimated liabilities that will be settled in the upcoming year. This could include property tax expense that has been assessed for the current year but will be paid in the upcoming year, a litigation loss that has been accrued for but not yet settled, or bonuses that have been earned by key executives but will be paid in the upcoming quarter. Revenues received in advance (unearned revenue), such as deposits for goods ordered by The Home Depot customers, would also be recognized as a current liability.

INCOME TAXES PAYABLE Income taxes payable represents an estimated liability that is generally satisfied with periodic payments by the corporation to several taxing authorities. Income tax payments are based on an estimate of corporate pretax income. As estimates change with the passage of time, so will the periodic installments paid by the firm. Any estimated liability should be reported at the close of the fiscal year.

To understand what constitutes pretax income, one must first understand the difference between *before tax financial reported income* (income statement) and *pretax income* (tax return). Revenues and expenses for tax purposes are determined in accordance with the rules set forth by the Internal Revenue Code and other IRS regulations. Revenues and expenses for financial reporting purposes are based on generally accepted accounting principles (GAAP). The result can be a significantly different income measure depending on which set of rules is applied. Because of this, companies generally report future tax liabilities and/or assets. Any income tax obligation (benefit) due in the following year is reported as a current liability (asset).

The Home Depot reports a current liability of \$78 million to various tax authorities at the close of the 2001 fiscal year. However, as will be seen later, The Home Depot has a noncurrent or deferred obligation to the income tax authorities of \$195 million as a result of operations. The issue of deferred income taxes will be more thoroughly discussed in the "Long-Term Debt (Excluding Current Installments)" section in this chapter.

CURRENT INSTALLMENTS OF LONG-TERM DEBT The final item shown under current liabilities involves components of long-term debt that are due in the upcoming period. This is typically referred to as the current maturities of long-term debt and may include obligations such as installment notes, mortgages, leases, and bond issues.

Upon review of The Home Depot notes to the financial statements, we notice it has issued high-grade, commercial paper that bears an average interest cost of 6.1 percent. Commercial paper generally represents short-term debt. The Home Depot is also a party to a number of capital leases that require period payments of principal and interest. The portion of principal that will be settled in the coming year is reported as a current portion of that long-term debt. Mortgage notes or other installment notes operate in much the same way. The Home Depot has \$4 million of long-term obligations that will be settled in the coming year.

Long-Term Debt (Excluding Current Installments)

Long-term liabilities generally represent the most significant obligation for the corporation. Although this obligation does not impact a firm's current liquidity, ultimately it becomes payable. Thus, there is significant concern with regard to the payment of ongoing interest and the ability to retire the obligation, either over time or when it becomes due as a single amount.

Long-term liabilities are obligations arising from past events that are not payable in the coming year. Generally, there is a much greater degree of formality when an organization incurs long-term debt. Long-term capital leases, mortgage obligations, pensions, and other retirement benefit obligations are examples of long-term liabilities. Most of these examples, as was illustrated, require the recognition of both a short- and a long-term obligation.

According to note 2, The Home Depot's long-term debt comprises \$754 million of commercial paper (usually short-term notes with original maturities of 30 to 270 days issued by highly rated corporations but classified by The Home Depot as long-term because of their rollover status), \$500 million of senior notes due in 2004, \$230 million of capital lease obligations payable in varying installments through 2027, and another \$75 million in notes payable in varying installments through 2018. All of these obligations must be managed properly to prevent a decline in the company's credit rating.

Other Long-Term Liabilities

Other long-term liabilities outside of those discussed in note 2 are not clearly identifiable from the notes to the financial statements. Companies that raise capital through the issuance of bonds would recognize a long-term obligation: bonds payable. Additionally, many companies provide to employees pension and health-care benefits upon retirement. Generally, these employee benefits are not earned until the employee has been with the company for a number of years, known as a *vesting period*.

From an accounting perspective, companies that provide employee retirement benefits must accrue for them with the passage of time. If companies fund less than 100 percent of the accrued pension or other post-employment expense, a liability for the future obligation must be recognized. Obligations relating to pension plans and other post-employment benefit (OPEB) programs are reported under long-term liabilities as accrued pension cost obligation or accrued other post-employment benefit obligation. Table 3.2 illustrates the magnitude of pension and other post-employment benefit obligations for Abbott Laboratories at the close of its 1998 fiscal year. Four components are of special interest:

1. *Projected benefit obligation* is the actuarial present value of employee benefits earned using projected salary levels and present years of service.
2. *Pension or OPEB plan assets* are placed in trust by the company, invested, and then distributed to employees upon retirement. Their value fluctuates with the stock market and the economy.
3. *Prepaid (accrued) benefit cost* is the pension or OPEB asset or liability being reported in the balance sheet.
4. *Net cost* is the pension or OPEB expense for the current reporting year.

Although it is beyond the scope of this book to discuss the calculations that led to the following numbers, it is necessary to highlight two important points. First, Abbott Laboratories reported 1998 pension and OPEB expense (or cost) in the amount of \$62.1 million and \$69.5 million. The expense comprises four items:

1. *Service cost* increases pension expense because of an additional year of service benefits (pension and OPEB) earned by Abbott Laboratories employees.

Table 3.2 Note 5: Post-Employment Benefits, Abbott Laboratories

<i>(in thousands)</i>	<i>Defined Benefit Plans</i>	<i>Medical and Dental Plans</i>
	1998	1998
Projected benefit obligations, January 1	\$2,000,329	\$646,448
Service cost — benefits earned during the year	108,754	30,664
Interest cost on projected benefit obligations	140,287	43,770
Actuarial loss (gain), primarily changes in discount rate and lower than estimated health care costs	182,829	18,057
Benefits paid	(85,722)	(23,993)
Other, primarily translation	<u>2,143</u>	<u>---</u>
Projected benefit obligations, December 31	<u>\$2,348,620</u>	<u>\$714,946</u>
Plans' assets at fair value, January 1, principally listed securities	\$2,192,486	\$86,600
Actual return on plans' assets	426,023	18,656
Company contributions	18,945	1,265
Benefits paid	(85,722)	(23,993)
Other, primarily translation	<u>(761)</u>	<u>---</u>
Plans' assets at fair value, December 31, principally listed securities	<u>\$2,550,971</u>	<u>\$82,528</u>
Projected benefit obligations less than (greater than) plans' assets, December 31	\$202,351	(\$632,418)
Unrecognized actuarial (gains) losses, net	(143,876)	137,701
Unrecognized prior service cost	6,134	<u>---</u>
Unrecognized transition obligation	<u>(21,015)</u>	<u>---</u>
Prepaid (accrued) benefit cost	<u>\$43,594</u>	<u>(\$494,717)</u>

Table 3.2 Note 5: Post-Employment Benefits, Abbott Laboratories (Continued)

Service cost—benefits earned during the year	\$108,754	\$30,664
Interest cost on projected benefit obligations	140,287	43,770
Expected return on plans' assets	(179,194)	(7,211)
Net amortization	<u>(7,728)</u>	<u>2,290</u>
Net pension or OPEB cost	<u>\$62,119</u>	<u>\$69,513</u>

2. *Interest cost* is the cost of the projected benefit obligation, measured on a present value basis. The mere passage of time increases the projected benefit obligation and pension expense.
3. *Expected return on plan assets* is used in the calculation of pension and OPEB expense to reduce its potential volatility. The reduction of pension and OPEB expense by an expected return on plan assets yields *net* pension or OPEB expense (or cost).
4. *Net amortization* relates to the actuarial adjustments (changes in discount rates, mortality rates, etc.) that are made periodically, thereby increasing or decreasing the projected benefit obligation. Rather than adjust pension or OPEB expense dollar for dollar, the resulting gains and losses (known as *liability gains/losses*) are often amortized over time.

A second adjustment often involves *asset gains/losses*. Asset gains/losses result from the difference between the expected return on pension or OPEB plan assets and the actual return on plan assets. Because of the potential for large swings in the stock market, the use of an average expected return over time reduces volatile reporting.

Next, Abbott Laboratories reports an asset prepaid benefit cost of \$43.5 million for its defined benefit pension plan and an accrued liability of \$494.7 million for OPEB. This means that there are sufficient (actually an excess of) pension plan assets to cover Abbott Laboratories' projected benefit obligation. However, the OPEB obligation is currently under-funded, thus the recognition of the \$494.7 million obligation. Accrued pension and OPEB obligations emerge when the company's pension or OPEB expense is not covered by an equal cash contribution to the respective plans. This recognition simply follows the accrual basis of accounting.

Deferred Income Taxes

Deferred income tax liabilities and assets represent future income tax obligations or future income tax benefits as a result of past events. They arise

when GAAP and the Code conflict with regard to the timing of revenues, expenses, gains, and losses. The resulting timing differences are temporary (in most cases), but nonetheless create a reporting difference between taxable income and financial income. Timing differences result when revenues, gains, expenses, or losses affect financial reported income in one period but taxable income in another period.

As an example, let's assume The Home Depot depreciates a \$50,000 asset over 5 years for financial reporting purposes but uses a 3-year accelerated cost recovery schedule for tax purposes. Table 3.3 illustrates depreciation expense timing differences.

As noted, depreciation expense in year 1 is \$25,000 for tax purposes and \$10,000 for financial reporting purposes. The \$15,000 difference is called an *originating temporary difference*. When we move to year 2, another \$5,000 originating temporary difference results. The combination of the two differentials then becomes a future reversing difference. While no reversals occur in year 3, years 4 and 5 show a combined total of \$20,000 reversing differences. What this means is that The Home Depot would report a deferred income tax liability in anticipation of greater taxable income down the road when compared to financial reported income. Keep in mind that while depreciation expense differences exist *within* periods, they are equal in amount over the life of the asset. In either reporting, \$50,000 of depreciation expense is recognized. This is why these originating differences are noted as temporary differences.

If we take this example one step further and assume that this company has \$80,000 of income before depreciation, Table 3.4 illustrates what would be reported as taxable and financial reported income (ignoring taxes).

Therefore, in years 1 and 2, taxable income will be lower than financial reported income and reduce that year's income tax obligation. In year 3 there will be no difference in reported income and in years 4 and 5 taxable income exceeds financial reported income. Nonetheless, because greater tax benefits

Table 3.3 Example of Timing Differences

Year	Tax Depreciation	Book Depreciation	Difference
1	\$25,000	\$10,000	\$15,000
2	15,000	10,000	5,000
3	10,000	10,000	---
4	---	10,000	(10,000)
5	---	<u>10,000</u>	(10,000)
	<u>\$50,000</u>	<u>\$50,000</u>	

Table 3.4 Year 1 Income before Depreciation

	<u>Tax</u>	<u>Book</u>
Income before depreciation	\$80,000	\$80,000
Less: Depreciation expense	<u>25,000</u>	<u>10,000</u>
Income after depreciation	<u>\$55,000</u>	<u>\$70,000</u>

were achieved in year 1, a *deferred* tax liability is reported in the balance sheet based on the difference in year 1. Ultimately, deferred tax liabilities become current tax liabilities.

Depreciation timing differences are often the largest contributor to the magnitude of deferred tax liabilities. Because most companies take advantage of the accelerated depreciation schedules, deferred tax liabilities appear in the long-term liabilities section of corporate balance sheets. However, another expense related to health care benefits upon retirement give rise to a deferred income tax benefit (an asset). Companies that provide for employee healthcare coverage upon retirement must recognize an expense and a related liability (if not funded) with the passage of time. The IRS does not allow the recognition of this expense until the distribution of benefits takes place. When companies accrue for this expense, they create future deductible amounts for tax purposes. Ultimately these expenses will lower taxable income and reduce future income tax obligation. Future deductible amounts are reported as deferred tax assets.

Common examples of temporary (timing) differences include:

- *Depreciation.* Generally results in a deferred tax liability
- *Bad debt expense.* Generally results in a deferred tax asset
- *Prepaid or deferred expenses.* Generally results in a deferred tax liability
- *Unearned revenues.* Generally results in a deferred tax asset
- *Accrued warranty liabilities.* Generally results in a deferred tax asset
- *Other post-retirement benefit expenses.* Generally results in a deferred tax asset

Minority Interest

Because The Home Depot reports a minority interest of \$11 million between the liability and stockholders' equity sections of the balance sheet, this indicates that it has an ownership interest of more than 50 percent but less than 100 percent in another company. When this situation occurs, 100 percent of the assets of the subsidiary company are included in the asset section of The

Home Depot's balance sheet. The amount reported as minority interest is the amount of the assets The Home Depot does not own. The \$11 million amount is reported neither as a liability nor equity but simply represents another investor's (company's) interest in the consolidated net assets of a Home Depot subsidiary.

Stockholders' Equity

Assets are financed both by debt and equity. Equity represents the net assets of a corporation. This concept can be compared to owning a house (asset) with an outstanding mortgage note (liability). If the house is valued at \$200,000 and the payoff on the mortgage note is \$140,000, then the equity in the house is \$60,000. A company's balance sheet is viewed in much the same way. It is composed of many assets, a variety of liabilities, and a residual interest (equity) in those assets. The relationship between the three defines the balance sheet equation.

Furthermore, there continues to exist an inverse relationship between a company's debt and its equity. If equity increases relative to total assets, then debt decreases proportionally. The greater the equity component in a balance sheet, the less pressure on the organization to cover related interest costs and generate a profit. Stockholders' equity is generally divided into two categories: contributed capital and earned capital.

CONTRIBUTED CAPITAL Contributed capital is recognized when a company acquires assets through the sale or exchange of common stock. When this occurs, companies recognize additional contributed capital in the balance sheet as well as an asset or reduction in an existing liability. Most often the asset received is cash, but occasionally a building and/or equipment can be received as well. Companies also have the flexibility to settle existing debt obligations with the issuance of common shares. In all of these cases, the net assets of the companies change because of management's decision.

The Home Depot balance sheet shows that contributed capital consists of common stock and additional paid-in capital. Alongside these elements is The Home Depot's disclosure of authorized common shares, issued common shares, and outstanding common shares. Authorization establishes the ceiling on the total number of shares that may be issued by the company. The Articles of Incorporation identify this number, which can be exceeded only if the corporate charter is amended. The issued number of shares is the shares sold over time, while the number of shares outstanding can be less than or equal to the number of shares issued. If the number of shares outstanding is less than the number of shares issued, the company has reacquired some of its own common stock. Companies do this to enhance future

earnings per share, reduce total future dividends paid, support executive compensation programs, or help fend off hostile takeovers. Reacquired shares are called treasury shares.

At the close of 2000, The Home Depot reported approximately 2.323 million shares of common stock at a par value of \$.05 per share. Understand that par value and fair market value are unrelated measures. Multiplying the number of shares outstanding by a par value of \$.05, a value of \$116 million is recorded in The Home Depot balance sheet. The \$116 million also constitutes the legal capital of the firm. Legal capital is used as a protective means to prevent companies from distributing dividends in excess of earnings and additional paid-in capital. It provides some measure of value to creditors in case of liquidation.

The paid-in capital account represents the excess of selling price per common share over par value per share. Because company stock is sold periodically, the selling price will often vary depending on market conditions. Thus, paid-in capital can accumulate in different amounts with each public offering of the firm. To date, The Home Depot has been paid \$4.81 billion in excess of par value by its shareholders.

EARNED CAPITAL The other component of shareholders' equity is called *earned capital* or *retained earnings*. Earned capital represents the accumulated earnings of that company since its inception, less any dividends paid to the company's shareholders. Many newly established companies pay limited dividends and instead concentrate on growth. Rather than acquire capital externally at an additional cost, they can use these internally generated funds in a more efficient way. Established companies, on the other hand, attract a different type of investor who looks to dividends as a source of periodic revenue.

When a company first begins operations, accumulated or retained earnings are zero. With the passage of time however, earnings are reported and dividends are distributed. As a result, retained earnings may be positive or negative. A positive measure indicates that the company has attained some level of profitability (net income) and has distributed less than those earnings to shareholders. Negative retained earnings suggest that the company has sustained net losses over time or paid out dividends in excess of profits achieved. There is no relationship between retained earnings and a company's cash position. Remember that retained earnings are a subset of equity, and equity supports all assets.

ACCUMULATED OTHER COMPREHENSIVE INCOME An additional component of stockholders' equity is *accumulated other comprehensive income*. Accumulated other comprehensive income includes gains and losses related

to certain events that have historically bypassed the income statement for income smoothing reasons. Therefore, for many years, the only reported measure of a company's performance was net income. A recent change in financial reporting now requires companies to report a more complete measure of income called *comprehensive income*. In essence, comprehensive income includes not just net income but other comprehensive income. As increases and decreases in other comprehensive income occur *during the reporting period*, these are reported in the statement of change in stockholders' equity or in a separate statement of comprehensive income. But any *accumulated balance* of these unrealized gains and losses is reported under stockholders' equity in the balance sheet. These items normally include unrealized gains and losses on available for sale securities, translation gains and losses on foreign currency, and excess of additional pension liability over unrecognized prior service cost.

According to The Home Depot's balance sheet, the only item of accumulated other comprehensive income is foreign currency translation adjustments. These arise when assets and liabilities denominated in a foreign currency are translated into U.S. dollars. Careful review of The Home Depot annual report discloses that the company operates 67 stores in Canada, 5 stores in Chile, 2 stores in Argentina, and 2 stores in Puerto Rico. When consolidation takes place, the assets and liabilities denominated in foreign currencies must be combined with the assets and liabilities denominated in U.S. dollars. Note 1 to the financial statements provides additional disclosure of this action, as well as what rates are used in the translation process.

SHARES PURCHASED FOR COMPENSATION PLANS The last element that appears on the balance sheet is the *cost of shares reacquired for compensation plans*, also known as a company's *treasury stock*. Treasury stock represents stock that has been repurchased by the issuer for some intended purpose. For example, companies that buy back their shares do the following:

- *Take advantage of current market conditions and lower stock prices.* Reacquisition of shares at low prices eliminates future dividend payments to existing shareholders, therefore enhancing future cash flow.
- *Support ongoing executive compensation programs.* If key executives exercise stock options, the company must have existing shares to issue to these individuals. A stock option gives the holder the right to buy company stock at a predetermined price, often at a great discount. Essentially, stock options represent a form of deferred compensation.

- *Enhance future earnings per share.* If shares of stock are no longer outstanding, they are removed from the computation of earnings per share. Fewer outstanding shares increases earnings per share in subsequent accounting periods. Companies often seek opportunities to enhance this measure.

According to The Home Depot's balance sheet, the cost of their reacquired treasury shares is \$6 million. Most companies use the cost method to account for the acquisition of treasury stock. This means that they measure treasury stock based on the current market price at the time of acquisition. For example, if The Home Depot reacquires 100,000 shares to be held in treasury and pays \$30 per share, treasury stock is reported at \$3 million. On the balance sheet, treasury stock is a contra-equity account and is therefore deducted from stockholders' equity. Some users of financial information believe treasury stock should be considered an asset but fail to recognize that a company cannot own itself.

CONCLUSION

The balance sheet provides important information regarding a company's liquidity and solvency. Shortcomings, however, involve a myriad of valuation approaches and management estimates. This chapter was designed to help the reader understand the structure of the balance sheet and its related elements. Financial statements from The Home Depot 2000 annual report were used for illustrative purposes. As we proceed to Chapter 4 and Chapter 5 and discuss the *statement of earnings* and the *statement of cash flow*, you should begin to better understand the interrelationships that exist between the mandatory financial statements.

NOTES

1. Accounting Trends and Techniques, 1993 (New York: AICPA, 1993), Table 2–28.
2. As an example, AOL purchased Time Warner in January 2001 for \$147 billion. The purchase took place when Time Warner net assets amounted to \$51 billion; therefore the remaining \$96 billion was classified as goodwill. The subsequent amortization of goodwill (an expense) for AOL amounts to \$1.5 billion per quarter.

4

INCOME STATEMENT

Steve Ray cannot believe the wealth of information tucked into the company annual report. The previous chapters of this book have given him much greater understanding of a company's financial status, and now he is looking forward to studying the income statement. Upon studying this chapter, he will be able to tell whether Baker is generating profits from day-to-day operations. Operating income (loss) is a separate line item on an income statement and is much different from net income (loss). Net income (loss) includes profits or losses from day-to-day operations plus several other transactions, such as taxes, interest, gains/losses on equipment sales, and more. It is becoming clear to Steve how a business can report losing money from day-to-day operations and still show a robust net income.

The income statement, also labeled the statement of operations, measures a company's performance over a specified period of time. For this reason, the statement is titled for a period of time—for example, year ending January 28, 2001. The statement is different from the balance sheet because it is a cumulative record of activity for a month, quarter, multiple quarters, or for one year. Creditors, investors, and many others use the income statement as a measuring stick of how a company has performed, where it appears to be heading, and what its future cash flows will be.

In Chapter 7 we explore the numbers and evaluate The Home Depot's income statement. To complete a thorough analysis of The Home Depot, it is necessary to have a solid understanding of the income.

IMPORTANCE OF THE INCOME STATEMENT

Creditors, employees, suppliers, investors, and more use the income statement. The report serves as a measuring stick of how a company has performed, where it appears to be heading, and what future cash flows are likely to be. For example, Figure 4.1 compares the performance of The Home

Depot and Kmart. The Home Depot amount and trend in net income points to future success. Success appears to have eluded Kmart for the most recent periods and is questionable in the future. Kmart is losing money, and its performance is inconsistent. This information certainly sends a signal to question management's strategic focus in an effort to position Kmart for long-term success. The 5-year financial summary in the annual report serves as the source of this information.

Figure 4.1 also provides clues regarding future cash flows. Operating cash flows are generated from day-to-day operations. This type of cash flow is essential for success. Although further analysis is required, The Home Depot trend points to the ability to generate future cash flows. This does not seem to be the case for Kmart. In the final analysis, only a company's operating activities provide continuous cash flow. Cash received from selling assets, loans (debt), and stock (equity) may be significant on an occasional basis, but cannot be relied on as a year-to-year source of funds.

LIMITATIONS OF THE INCOME STATEMENT

The income statement provides a measure of performance that can be challenged on certain grounds. First, some believe that the organization's performance should be measured as its increase/decrease in net assets (equity). This economic theory of income measurement is premised on an organization's

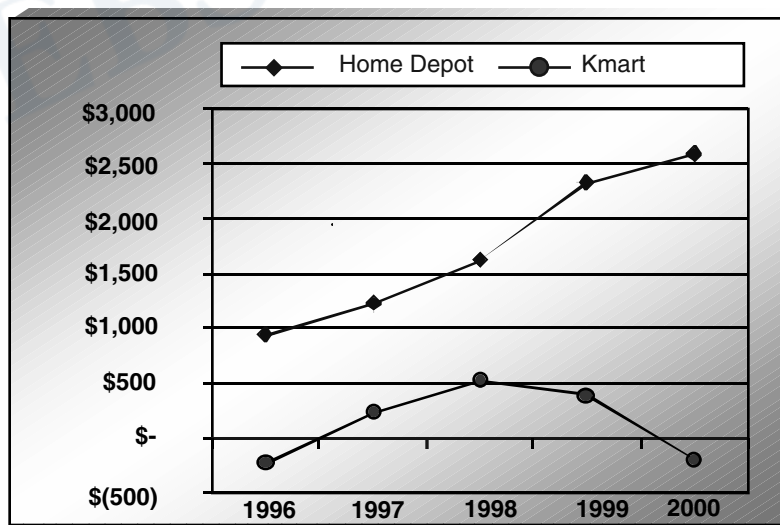


Figure 4.1 Net income (loss) analysis.

change in wealth and is referred to as a *capital-maintenance approach*. The weakness of this measure is that it fails to identify the specific elements of income and thus removes a company's flexibility to include or exclude certain events from income. Accountants generally use a *transactional approach* to measure performance (excess of revenues and gains over expenses and losses) from one year to the next. This model has been expanded recently to include items of other comprehensive income previously discussed in Chapter 3. The popularity of the transactional approach will likely continue.

A second income statement limitation is closely tied to a manager's accounting choice. For example, one manager might depreciate an asset using a straight-line approach, while another selects an accelerated approach. The end result is different reported expenses and different reported earnings. Because various methods of cost allocation exist, companies are required to disclose their choice(s) in the notes to the financial statements. This allows informed users to better compare companies.

Third, in some cases accounting rules are more specific, yet management intent drives the accounting. To illustrate, assume that two companies invest \$3 million in the stock of a third, unrelated company. Current accounting rules require managers to disclose whether they intend to hold the investment for the short term or for an extended period. A manager's decision in this case changes the accounting for the investment. For one assumption, a change in market value is recognized in the income statement, the investment held for trading. Here the unrealized gains and losses are reported as part of net income. Under the second assumption, unrealized gains and losses are reported outside income, as a component of other comprehensive income, the investment held as available for sale (AFS). Financial statement users must realize that earnings outcomes often influence management's accounting decisions. The subject of managed earnings and earnings quality will be more formally discussed in Chapter 8.

The fourth weakness of the income statement is its basis of preparation. Accrual accounting, while it provides a better measure of performance, includes noncash expenses in the calculation of income. For example, depreciation expense is an allocation of cost that has no associated cash outflow, yet it decreases net income.

Fifth, net income ignores when future cash receipts tied to current revenues will be received and when future cash payments tied to current expenses will be paid. This occurs because accounting rules require the recognition of earned revenue prior to the cash receipt. Accounting rules also require the recognition of an expense prior to its cash payment. An example of this would be a company that recognizes pension and other post-employment expenses. Some companies may contribute to this expense

immediately while others may not. Therefore, cash flow from operations in the early years for a non-contributing company will be much higher than reported income because of these accruals. This is an important point from an employee retirement perspective. A company can expense the cost of funding a retirement, yet not set aside all the cash necessary to pay the benefits to the recipients. For the interested reader, Appendix B carefully explains the accounting rules regarding the recording of transactions before the cash flows have occurred.

FORMAT OF THE INCOME STATEMENT

The income statement is generally divided into two sections: operating and nonoperating. The *operating* section of the income statement includes revenues and expenses that correspond to the principal operations of the company (i.e., day-to-day operations). The combination of operating revenues and operating expenses leads to a reported measure of operating income or operating loss.

The *nonoperating* section of the income statement, however, includes income/expense items and gain/loss items that are routine to most any type of business entity but are viewed as peripheral to day-to-day business operations. Examples include interest earned on investments, interest incurred on borrowings, and gains and/or losses associated with the disposal of assets and/or elimination of liabilities. An example of a peripheral activity would be the sale of a piece of equipment. If the equipment has a book value of \$20,000 and it is sold for \$15,000, there is a realized loss of \$5,000. While the loss is reported on the income statement, it is recognized in the nonoperating section under *other expenses and losses*. This loss is excluded from operating income because it is related to a support activity rather than an operating activity.

The sum of operating income (loss) and nonoperating income (loss) is simply *income (loss) before income tax expense*. Once income tax expense or benefit is considered, net income (loss) is the residual. The level of detail disclosed between operating income and net income varies among companies. We will show in Chapter 7 that when evaluating a company, a study of operating income from one year to the next is much more meaningful than a study of net income from one year to the next.

Often, the nonoperating income or loss and tax expense components provide subtle signals of a company's financial complexity that deserve careful study. Figure 4.2 shows a difference between operating income and net income for The Home Depot ranging between \$1,000 to \$1,500 million. A careful review of the income statement shows that much of the difference is due to income taxes. This is not the case for Enron. Figure 4.2 shows a difference

between operating income and net income ranging between \$1,000 and \$1,500 million, as well. A careful review of the income statement shows that this difference is attributable to a host of complex economic events and taxes. This level of detail is a signal that the financial backbone of the company is complex and deserves careful study. In addition, how can the difference between operating income and net income be so different in 1998 and 2000, yet have very similar values in 1999? The user should read these as signals that professional guidance is necessary to untangle the intricacy and understand the implications surrounding the many different financial transactions underway at Enron.

Irregular Items

Three items of special importance are also included in the conventional income statement but are reported beyond the operating and non-operating sections: discontinued operations, extraordinary events, and changes in accounting principles. Accounting professionals view these events as irregular items and generally prefer that their effects be removed from the main body of the income statement. Lucent Technologies' comparative income statement (Table 4.1) illustrates the effects of a discontinued operation and an accounting principle change on net income. Net income decreased in 2000 and increased due to restructuring in 1999 and 1998.

Discontinued Operations

One of the most-often-occurring irregular items is the gain/loss associated with the disposal of a business segment. Just as many companies have recently expanded operations through business acquisitions, many of these same companies have disposed of other operating segments along the way. For a disposal

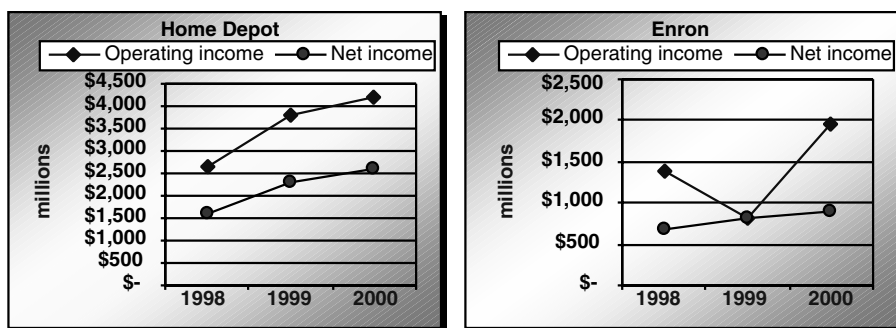


Figure 4.2 Operating and net income analysis.

to qualify as a discontinued operation, the assets, results of operations, and activities of a business segment must be clearly distinguishable, physically and operationally, from the balance of the enterprise. Table 4.1 shows that Lucent lost \$462 million from discontinued operations in 2000.

An example of a discontinued operation would be the elimination of an automobile line by General Motors. The economic substance of this event (revenues and expenses related to the Oldsmobile line, for example) would be removed from the upper portion of the statement of operations and reported separately beyond continuing operations. This method of segregated reporting highlights the significance of the event and illustrates the business unit's profitability or lack thereof. Furthermore, assets that are being sold by a company generally receive fewer economic commitments from the organization and have a tendency to underperform. A separate reporting of the discontinued operation prevents its measure of performance from contaminating the record of performance of the ongoing enterprise when the organization is under review by outside analysts.

Extraordinary Items

A second irregular item that gets special accounting consideration is an *extraordinary event*. An extraordinary item is a transaction or event that is

Table 4.1 Lucent Technologies Three-Year Comparative Income (Loss) Information

<i>Results of Operations (in Millions)</i>	<i>2000</i>	<i>1999</i>	<i>1998</i>
Revenues	\$33,813	\$30,617	\$24,367
Gross margin	14,274	15,012	11,429
Depreciation and amortization expense	2,318	1,580	1,228
Operating income	<u>2,985</u>	<u>4,694</u>	<u>1,953</u>
Income from continuing operations	1,681	3,026	769
Income (loss) from discontinued operations	(462)	455	296
Income before cumulative effect of accounting change	1,219	3,481	1,065
Cumulative effect of accounting change	<u>—</u>	<u>1,308</u>	<u>—</u>
Net income	<u><u>\$1,219</u></u>	<u><u>\$4,789</u></u>	<u><u>\$1,065</u></u>

both unusual *and* infrequent in occurrence, taking into account the environment in which the company operates. According to APB Opinion 30, paragraphs 30–32:

- Unusual nature means the underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.
- Infrequency of occurrence means the underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

The APB was clear in suggesting that specific characteristics of the entity, such as type and scope of operations, lines of business, and operating policies should be considered in determining ordinary and typical activities of an entity. The environment in which an entity operates is a primary consideration in determining whether an underlying event or transaction is abnormal and significantly different from the ordinary and typical activities of the entity. The environment of an entity includes such factors as the characteristics of the industry or industries in which it operates, the geographical location of its operations, and the nature and extent of governmental regulation.

For example, assume two companies sustain significant flood loss damage. One company might classify the loss as extraordinary, yet the other might not. Flood loss sustained by an enterprise located in a flood plain would not constitute an unusual occurrence and would not warrant extraordinary classification. Nor would an earthquake loss for a company located in California.

One extraordinary item addressed by the FASB is the economic affect of the September 11, 2001, terrorist attack on the World Trade Center and the Pentagon. Certain businesses, as a consequence of the attack, have sustained significant personnel losses and severe economic damage. Many of these companies, as well as associated businesses, were forced to report extraordinary losses in their 2001 current year financials.

Another item, known as a *corporate restructuring charge*, may appear to be unusual or infrequent but is still reported as a component of continuing operations. The FASB considers organizational restructuring a part of today's normal business environment. However, restructuring charges, if

material, can be shown as a separate line item. For example, Sara Lee Corporation experienced a \$2,040 million restructure in fiscal year 1998. As a result, Sara Lee reported a loss before income taxes of \$443 million. Had the restructuring charge not been taken, it would have earned a profit before income tax of \$1.597 million. Many companies use proforma-reporting techniques as a means of softening the effects of reported restructuring changes. They essentially highlight what earnings would have been had they not experienced a corporate restructure. Many believe that this type of reporting is misleading and helps to disguise management shortfalls.

Change of Accounting Principle

A third irregular event that requires special accounting treatment is an *accounting principle change*. A change in accounting principle results when a company switches from one generally accepted accounting principle to another or when the FASB issues a new accounting pronouncement. A change in an accounting principle often requires an adjustment to specific asset or liability accounts, as well as an adjustment to net income or retained earnings (prior year changes where necessary). When income is affected, the firm is said to be applying the “current approach.” When retained earnings are affected, the firm is said to be applying the “retroactive approach.” Firms may not select one method over the other. Each new accounting standard specifies which approach to use in a given situation. Most changes in accounting principles are accounted for under the current approach, with a cumulative effect of the change reported in current year income.

Cumulative prior-year differentials often occur when companies switch depreciation methods or change inventory cost-flow assumptions. Essentially, the cumulative effect is the total income difference between what was reported using the current depreciation method versus what would have been reported under the newly adopted depreciation method. Most often these changes target assets acquired over, let’s say, the past five years, rather than those assets acquired in the current year. This allows management to report an outcome that might have a favorable impact on earnings. This is referred to as a discretionary change by a company and is not the result of a new accounting rule.

Retroactive adjustments generally pertain to changes in a company’s revenue recognition practices or changes in inventory cost-flow assumptions that involve last-in, first-out (LIFO). Rather than take the cumulative differentials to reported earnings of the current year as with the current approach, the effect is recognized as an adjustment to retained earnings. This allows

the effect to bypass current year income but requires restatement of related prior year information. Most users of financial information dislike this approach because of the changes to previously reported values.

The economic consequence of a mandatory change in accounting principle can also have a dramatic effect on reported earnings.¹ General Motors, for example, recorded a \$20.8 billion accounting charge in 1992 as a result of a new accounting rule issued by the Financial Accounting Standards Board. The rule, FAS 106 “Employers Accounting for Postretirement Benefits Other than Pensions” required companies to change their accounting for postretirement benefits from a pay-as-you (cash) basis to an accrual basis. According to the Board:

“a defined postretirement benefit plan set forth the terms of an exchange between the employer and employee. In exchange for the current services provided by the employee, the employer promised to provide, in addition to current wages and other benefits, health and other welfare benefits after the employee retires. It follows from that view that postretirement benefits are not gratuities but are part of an employee’s compensation for services rendered. Since payment is deferred, the benefits are a type of deferred compensation. The employer’s obligation for that compensation is incurred as employees render the services necessary to earn their postretirement benefits.”

The Board’s objectives in issuing this FAS was to improve employers’ financial reporting for postretirement benefits in the following manner:

- a) To enhance the relevance and representational faithfulness of the employer’s reported results of operations by recognizing net periodic postretirement benefit cost as employees render the services necessary to earn their postretirement benefits.
- b) To enhance the relevance and representational faithfulness of the employer’s statement of financial position by including a measure of the obligation to provide postretirement benefits based on a mutual understanding between the employer and its employees of the terms in the underlying plan.
- c) To enhance the ability of users of the employer’s financial statements to understand the extent and the effects of the employer’s undertaking to provide postretirement benefits to its employees by disclosing relevant information about the obligation and cost of the postretirement benefit plan and how those amounts are measured.
- d) To improve the understandability and comparability of amounts reported by requiring employers with similar plans to use the same method to measure their accumulated postretirement benefit obligations and the related costs of the postretirement benefits.²

As a result of General Motor's \$20.8 billion accounting charge, it lost close to \$23 billion in 1992. The balance of this chapter is devoted to a discussion of the elements of The Home Depot consolidated statement of earnings.

ELEMENTS OF THE HOME DEPOT'S STATEMENT OF EARNINGS

The Home Depot's statement of earnings can be divided into two sections: operating and nonoperating. The operating section includes sales revenues, cost of goods sold, and other operating expenses.

Operating Section

NET SALES The operating section begins with The Home Depot's *net sales* of goods and services, reported at \$45,738 million. The figure includes revenues generated from the sale of merchandise, tool and equipment rental, and product installation service revenue. Net sales result when the Home Depot Company deducts from gross sales:

- Cost of goods returned by customers
- Cash discounts earned by contractors when they pay within the discount period
- Allowances granted to customers when goods are defective

These items generally are not disclosed in the annual report but are tracked for internal reporting purposes. Information about returned merchandise, allowances granted to customers, and discounts taken by contractors are important for managing suppliers, customers, and cash flow.

Net sales in whole dollars and percentage growth are often included in the financial highlights and 5- to 10-year summary. These measures are designed to provide the user a perspective of company size and growth. Figure 4.3 shows that The Home Depot is substantially larger than Lowe's in terms of sales, yet both are growing at the same approximate rate of 20 percent. This growth rate appears reasonable given management's historical track records. Most interesting will be to see what happens next year with the growth rates of each company. For Enron, the signals are different. Note, we had to graph sales dollars and growth rates separately for Enron because of the magnitude of the values. Any and all users should question a business that goes from \$40,000 million to \$100,000 million in one year, at a growth rate in excess of 150 percent. The message is simple: If it looks too good to be true, it probably is!

COST OF MERCHANDISE SOLD The next line item, cost of merchandise sold, is generally the most significant expense reported in the income statement.

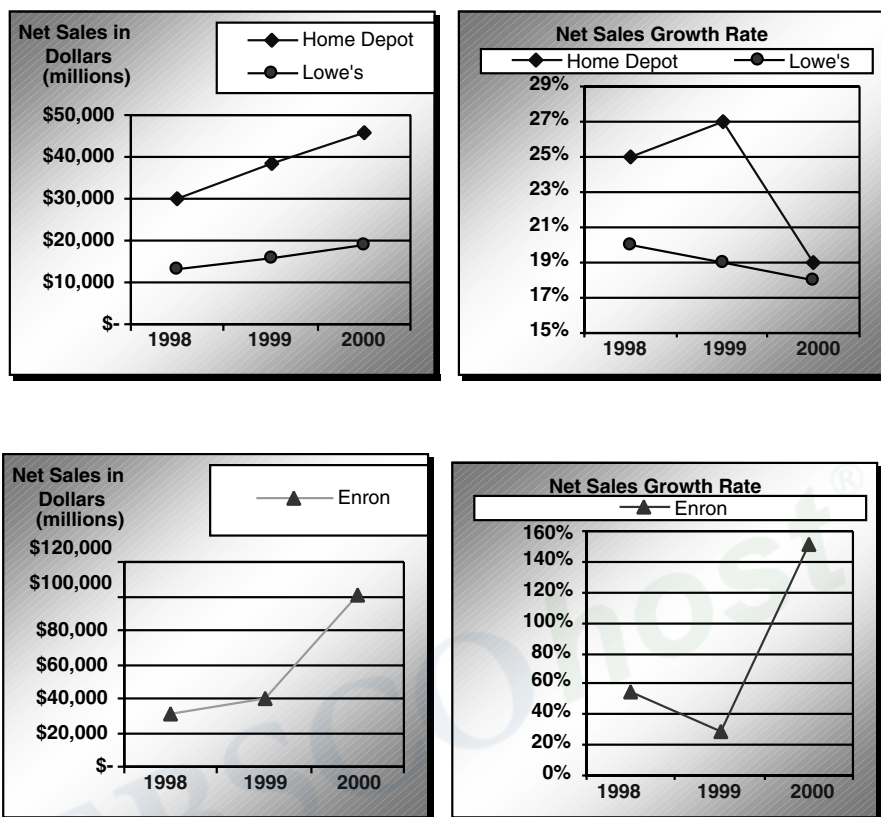


Figure 4.3 Net sales in dollars and growth percent.

Cost of goods sold is only recognized when a sale of merchandise has taken place, \$32,057 million for The Home Depot.

Cost of goods sold as a percentage of net sales is an important measure of a firm's performance. The percentage can be compared from year to year as well as across firms within the same industry. Figure 4.4 shows that the percentage of cost of goods sold is very similar for The Home Depot and Lowe's, with both resting near 70 percent. However, a small percentage difference can have a larger impact on the bottom line when sales are in the billions of dollars. For example, reducing The Home Depot cost of goods sold by 1 percent would contribute approximately \$400 million to operating profits. Remember that cost of goods sold is directly related to the cost-flow assumption that is chosen by the company to value its inventory (i.e., first-in, first-out (FIFO), LIFO, weighted average). Inventory valuation was previously discussed in Chapter 3's "Current Assets."

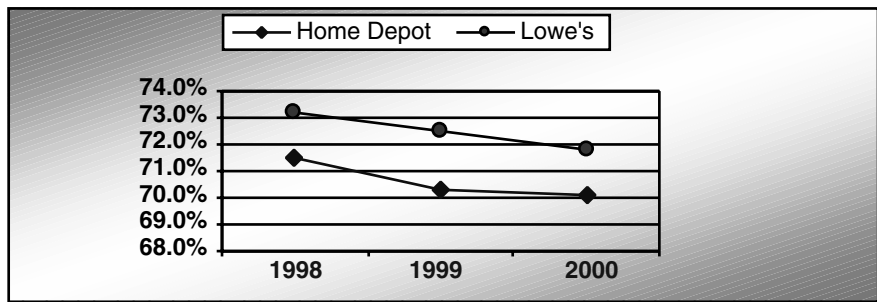


Figure 4.4 Comparative analysis of cost of goods sold, percent of net sales.

GROSS PROFIT The difference between net sales and cost of goods sold is a company's *gross profit* or *gross margin*. A reported gross profit is essential to cover operating expenses that a company incurs during the operating year. Management's effective control over inventory acquisition cost can lead to an improved or at least stable gross profit measure from one year to the next.

Companies that report lower operating profits often have been quoted as saying, "Product price increases could not be passed along to the consumer in a timely manner." Circumstances like these create a squeeze on gross margins that ultimately filters down to a company's bottom line. Many times price increases cannot be passed along because of existing market conditions such as an economic downturn. To increase prices would simply create less product demand.

According to The Home Depot's 2000 income statement, gross profit is \$13,681 million and has increased by more than 60 percent over the past 3 years. Likewise, gross profit as a percentage of net sales has steadily improved and is currently 30 percent (\$13,681 million/\$45,738 million). The decline in cost of goods sold as a percent of net sales shown in Figure 4.4 translates to an increase in gross profits. For The Home Depot, 30 cents (\$1.00 - .70) of every sales dollar is used to meet current-period operating expenses. The improvement of gross profit as a percentage of sales (29.9 percent in 2000 versus 29.7 percent in 1999), according to management, is the direct result of three company-wide initiatives:

- A lower cost of merchandise as a result of product line reviews
- Benefits from global sourcing programs
- An increase in revenue from tool rental centers

Additional insight is available to a user who has a solid understanding of the relationship between costs of goods sold and sales revenues. When costs of goods sold are compared to revenue, a company's product mark-up percentage becomes more visible. During 2000, The Home Depot had an average mark-up on product costs and services of approximately 43 percent ($\$45,738/\$32,057$ minus 1). A sufficient mark-up is essential for a company to maintain a consistent bottom line.

SELLING AND STORE OPERATING EXPENSES *Selling expenses* are expenses that directly relate to the selling of goods and/or services. For example, The Home Depot employs thousands of sales personnel whose job is to assist customers throughout the store and monitor inventory levels. These employee salaries represent a significant selling expense for a company of The Home Depot's size. As a result, these costs will increase as the company opens new locations or as employees become "more seasoned." A careful review of The Home Depot's management discussion and analysis (MD&A) section of the annual report illustrates this point. According to management, a higher payroll expense was realized in 2000 as a result of market wage pressures and an increase in employee longevity. In addition, medical costs increased due to higher family enrollment in the Company's medical plans, rising health care costs, and higher prescription drug costs.

Television and radio advertising production costs, as well as media placement costs, are other examples of selling expenses for The Home Depot. Most of these costs are initially capitalized but become an expense as the advertising occurs throughout the year. Selling expenses for The Home Depot as well as other companies might include sales commissions, sales office salaries, travel and entertainment, and depreciation expense on a sales office or sales training facility.

Store operating expenses or occupancy expenses are another significant cost for The Home Depot. Once again, as desirable growth rates are achieved, total occupancy expenses should increase proportionately to the number of stores that are opened. On average, however, expenses should remain the same. For example, average depreciation expense per store should remain relatively constant from one year to the next (assuming a straight-line depreciation method). But should new construction prices increase, the average expense per period accelerates. This is the result of a greater capitalized cost being allocated to a consistent useful life (say, 45 years). This causes the average depreciation expense per store and in total to increase.

In certain instances, operating expenses will rise regardless of expansion. Consider, for example, a company's utility costs and property taxes. Typically, these expenses increase because of utility industry conditions and government budgetary pressures. As local taxing authorities and utility service providers increase rates, a company's income statement is adversely affected. The Home Depot management addresses these issues in the MD&A section of the annual report and states that "store occupancy costs such as property taxes, property rent, depreciation and utilities, increased in year 2000 as a result of new store growth and energy rate increases."

PRE-OPENING EXPENSES Consistent with management's initiative to aggressively expand its operations, The Home Depot opened 204 new stores and relocated 8 others during fiscal year 2000. In advance of these store openings, new personnel were hired, trained, and required to assist in the organization of the new facility. Expenses associated with these activities are called *pre-opening expenses*. These expenses can be incurred over a few weeks or a much longer period, depending on the complexity of the operation. Accounting rules do not allow for these costs to be capitalized; therefore they are expensed as they are incurred, generally in the year in which the store opens for business. Within the MD&A section, management explains that pre-opening costs were higher during fiscal year 2000 due to the opening of more EXPO Design Centers and the expansion of The Home Depot stores into new markets, including international locations, which involve higher training, relocation, and travel costs. This expense amounted to \$142 million in 2000, as opposed to only \$88 million in fiscal year 1998.

GENERAL AND ADMINISTRATIVE EXPENSES A company's general and administrative expenses often include a variety of costs that relate to other than its sales operations. For example, the depreciation of a company's corporate headquarters constitutes a general and administrative expense. Depreciation of a sales training center, conversely, would constitute a selling expense. Management salaries, utility costs, and property taxes are further examples of general and administrative expenses.

An explicit comparison of the above operating expenses deserves careful study on an individual company basis. The expense titled: Store selling and operating expense as a percent of sales can be drawn from The Home Depot 10-year summary. The summary shows this expense category has recently increased to 18.6 percent of sales from 17.8 percent the previous year. This is a signal to management that store selling and operating expenses must be carefully controlled. Comparability of general, selling, and operating expenses across different companies is difficult because each will likely have a different

definition and classification system. To overcome this comparability obstacles, the user can simply graph total operating expenses as a percent of sales.

OPERATING INCOME Operating income (or loss) is the difference between operating revenues and operating expenses. Operating income is essentially the most useful measure of a company's performance from one year to the next. The reason for this is that it excludes nonoperating gains and losses that often can distort measures of performance.

The Home Depot Company generated \$4,191 million of operating income in 2000, an increase of \$383 million over its 1999 reporting year. Even with the increase, however, operating income as a percentage of sales had fallen from the preceding year, as shown in Figure 4.5. The percentage decrease can be attributed to an increase (27 percent) in operating expenses during 2000, which management discusses in the MD&A section.

Figures 4.3 to 4.5 point to a comprehensive view of financial operating performance. At this point in our study of The Home Depot and Lowe's income statements, we see solid growth in sales and a stable operating income percent of sales. Good management teams will stabilize and work to decrease operating costs in an effort to maintain and grow the operating revenue and income in total and percent of sales. The Home Depot and Lowe's leadership teams have successful track records, so sound management is expected in the future.

The Enron story is quite different. Figure 4.3 shows substantial sales growth, yet Figure 4.5 shows a poor operating income of just 2 percent and no increase in the current year when sales grow from \$40,000 to \$100,000 million. This is a signal that any student in a beginning financial analysis class should question. The immediate reaction is that the upbeat and positive qualitative discussion spread throughout the Enron annual report is not worth the paper it is written upon. Figures 4.3 and 4.5 point to a situation

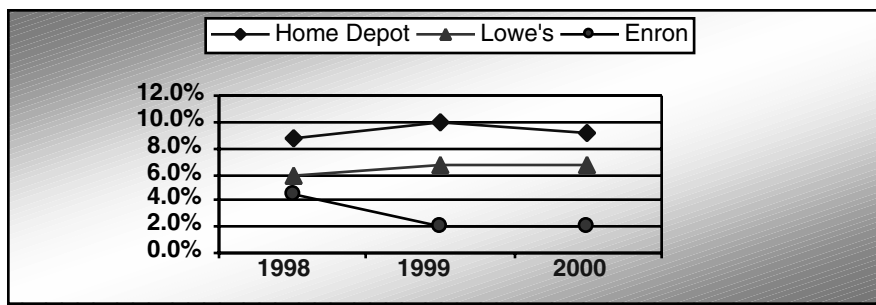


Figure 4.5 Operating income as a percent of sales.