

UW-Madison Financial Forum

University Financial Reporting: Why and How

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University Financial Reporting: Why and How Agenda

- Level set - Why do companies/organizations prepare financial reports?
 - Information Asymmetry -> Demand for Information
 - Accounting Information Framework
- Alternative Roles for Accounting and Financial Reporting
 - Managerial Decision-Making (Budgets, etc.)
 - External Reporting
 - University (Governmental) Setting -> Accountability
- Reporting Practices
 - Financial Statements
 - Reporting Infrastructure – Internal Controls / 3rd party Audits



Demand for Accounting Reports

Case Study in Information Demand

You are in the market for a used car. You have visited several used car lots and identified a fairly recent model that you like. However, the price seems a bit high. The salesperson assures you the car is a “creampuff” with low “easy” mileage. This is first time you have ever bought a used car – so you are unsure about how to proceed.

Discuss at your table possible responses to this dilemma from the perspective of the:

- *Buyer*
- *Seller*

Be prepared to report out in 10 minutes.



Demand for Accounting Reports

Response to Used car Delimma...

Buyer...

Seller...



Demand for Accounting Reports

- The Market for Lemons...
 - Buyer... get more information
 - test drive
 - get your mechanic to look at it.
 - discount price willing to pay for the car.
 - Seller
 - offer a warranty
 - provide more information about the car
- Demand for information
 - Salesperson knows more about the true value of the car than you do.
 - Classic case of information asymmetry, which can increase the cost of transactions in the market... costly actions by both parties.

Extend to capital markets...



Extend to Financial Reporting

- Analogy to the market for capital.
 - When companies sell stock or borrow money, they also are asking investors and creditors to “buy” something (the prospective cash flows of the company), about which the company has more information than the outsiders.
- e.g., one group of stakeholders can benefit at the expense of others, using better information:
 - managers/insiders versus creditors/prospective shareholders.



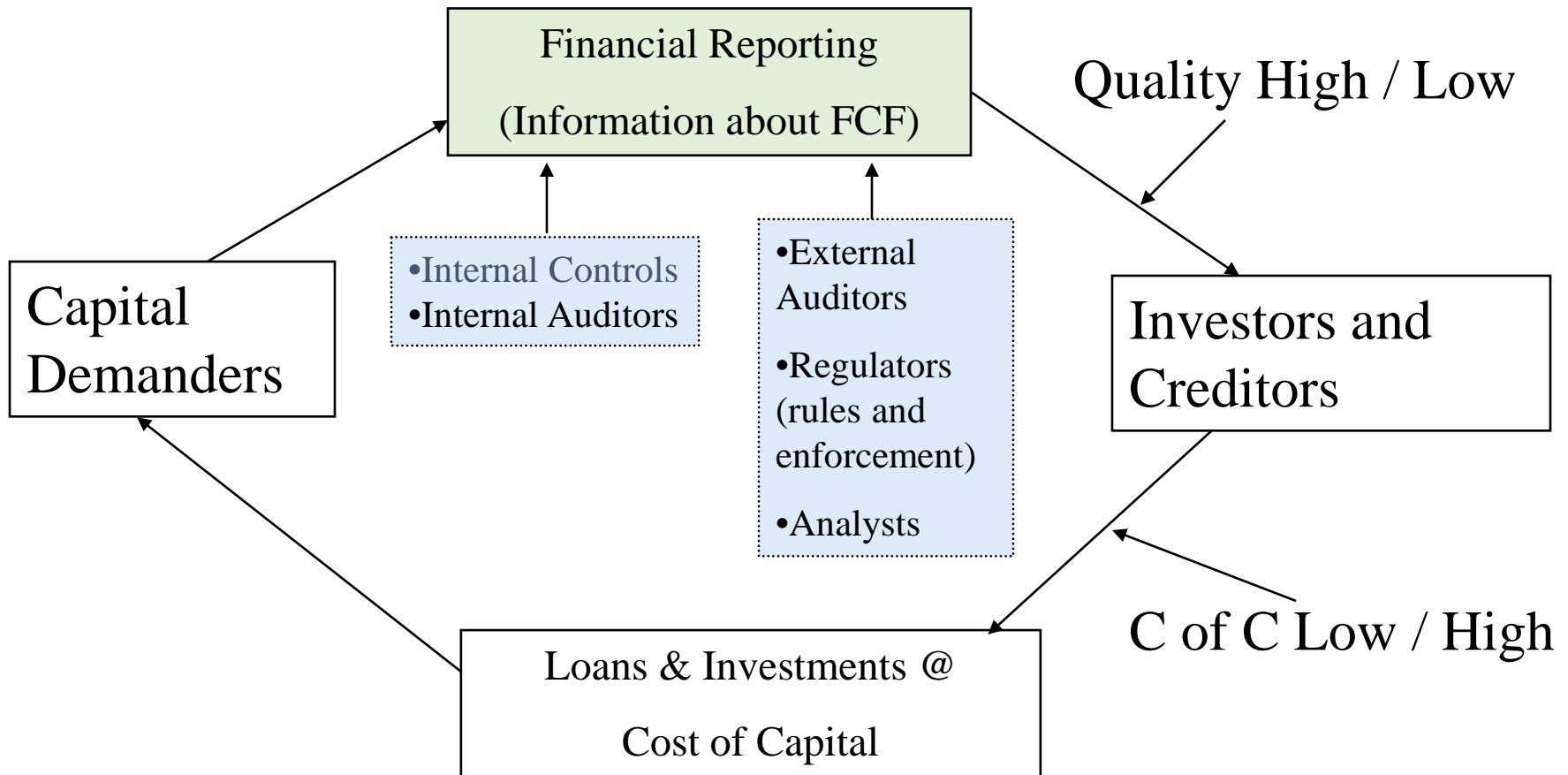
Extend to Financial Reporting

- Expected response to this information asymmetry... similar to the used car market for lemons:
 - Investors / Creditors demand an “information premium” to provide capital.
 - Company has incentive to reduce this information asymmetry and avoid the cost of the “information premium”.
- This is the role that accounting reports and other financial reporting play in our economy.



Financial Reporting Framework

Corporate Setting



Insights

Definition: Accounting is how we **measure** and **describe** economic activities.

The purpose of accounting is to provide decision makers with useful information about economic activities.

That is, the Financial Reporting Box (Financial Statements) is how we provide decision-useful information.

- Reflect / Measure Real things (Assets, Liabilities, Revenues, and Expenses)
- Help predict the future cash flows from an investment or loan.
- What research tells us about this framework.
 - Extensive research supports these relationships - ***including the role of the “reporting infrastructure” boxes in the middle*** that serve to make the reports more credible.



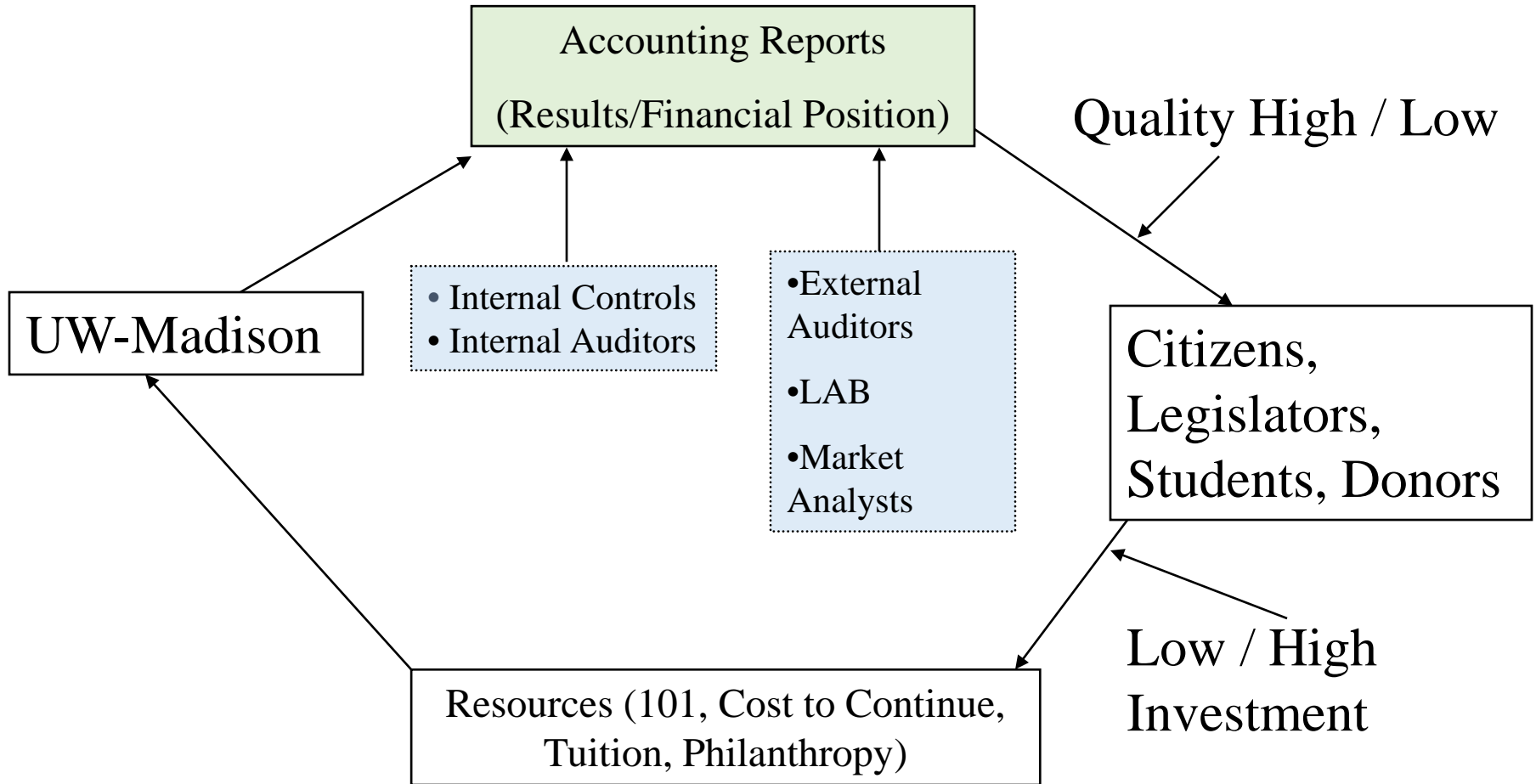
Alternative Roles for Accounting

- Accounting reports serve the needs of a variety of users and decisions they have to make. In our example, users of financial information – investors & creditors – need information to allocate resources and determine prices for various investments – external reporting or **Financial Accounting**.
- Other important users – **Management Decisions**
 - Investment decisions (new Chemistry building)
 - Hiring / HR – Pay Plans, Benefits, Travel and Entertainment, other Expense management
 - Setting prices (Tuition)
- Key point – The University also has external decision-makers (taxpayers, legislators, students, donors). Accounting reports provide accountability to these important stakeholders. That is, these concepts apply to a governmental (university) context...



Financial Reporting Framework

University Context



Insights on University Accounting

- Similar to the corporate setting:
 - Decision-makers (internal and external) demand financial information and accounting reports serve that role.
 - The higher quality is the accounting information, the higher the amount of resources that is likely to come to the university.
 - Important information “enhancers,” such as good internal controls and 3rd party independent audits increase the credibility of the reports contributing to higher quality information - referred to as transparency (think reserve fund controversy).
 - If public capital markets are accessed (issue bonds), investors may be in play as well.

Thus... the framework generalizes to the university setting – but there are some differences.



Reporting Practices – How?

- The Accounting System
- Final Product – Financial Statements
 - Balance Sheet (Statement of Net Position)
 - Income Statement (Statement of Revenues, Expenses, and Changes in Net Assets)
 - Statement of Cash Flows
- Independent Audit
- Internal Controls as a Fundamental Antecedent



How – the Accounting Process

- ***Accounting System***: a means through by which financial data are collected, recorded in the accounts, summarized, and tabled to provide information useful in decision making.
 - Accounting period is the period of time over which economic information is reported e.g., monthly, quarterly, annually).
 - Accounts are used to capture the economic events that affect the organization' financial position.
 - Five types of accounts: assets, liabilities, net position, revenue and expense.

Are reported in the financial statements... ***See UW example in your packet***



Statement of Net Position (aka Balance Sheet)

- Reports **assets**.
- Claims of creditors, **liabilities**.
- **Net Position**: Assets less Liabilities.
- Specific date – *one point in time!*

“What we own (control), what we owe (present obligations).”



Assets

- Resources – items that will provide future benefits -- owned or controlled by the business
 - Cash
 - Accounts receivable
 - Inventories
 - Furniture and fixtures
 - Equipment
 - Supplies



Liabilities

- Obligations or debts of the business – claims on those assets
 - Accounts payable
 - Notes payable
 - Interest payable
 - Salaries payable
 - Unearned revenue
- Short term / Long-term (Current / Non-Current)
 - Lease obligations



Net Investment

- Net position of ownership claims less liabilities
 - Net investment
 - **Restricted**
 - **Unrestricted**



Statement of Revenues, Expenses, and Changes in Net Assets

- AKA “Income Statement” - Reports operating results (good or bad) for a period as measured by net income or loss.
 - Reflects changes in assets & liabilities
 - Summarizes revenues and expenses for period: *month, quarter, year.*
- A note on measurement -- revenues and expenses are generally recorded on an accrual basis – i.e., based on changes in economic position, not necessarily cash received or paid.
- This accrual measure of income has been shown to provide more decision useful information.
- However, measurement based on a cash basis is also useful ... leads to 3rd primary statement...

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Statement of Cash Flows

- Provides information about cash receipts and cash payments
- Summarizes for period: *month, quarter, year*.
- Cash effects of operating, investing, and financing activities.

That is, the cash flow statement recasts the accrual-based statement of revenues & expenses on a cash basis with a focus on types of activities.



Statement of Cash Flows

- Where did the cash come from?
- How was cash used during the period?
- What was the change in the cash balance during the period?



Supplements to the Financial Statements

- Management Discussion and Analysis (MD&A)
- Notes to Financial Statements
- Auditor's report



Notes to Financial Statements

- Explanatory notes and supplementary schedules
 - Clarifies information in financial statements
 - Expands with additional detail
 - Describes accounting policies
 - Explains uncertainties and contingencies

Depreciation and Amortization

The Company's Buildings, Furniture, Fixtures and Equipment are recorded at cost and depreciated using the straight-line method over the estimated useful lives of the assets. Leasehold Improvements are amortized using the straight-line method over the original term of the lease or the useful life of the improvement, whichever is shorter. The Company's Property and Equipment is depreciated using the following estimated useful lives:

	<u>Life</u>
Buildings	5 – 45 years
Furniture, Fixtures and Equipment	2 – 20 years
Leasehold Improvements	5 – 45 years



Auditor's Report

- Certified Public Accountant – CPA
 - Auditor (CPA) conducts *independent* examination of financial statements
 - Unqualified opinion indicating that the financial reports are a “Fair representation” of the results and financial position.
 - In accordance with generally accepted accounting governmental accounting standards (GASB)?
- Audited financial statements are viewed as higher quality... more credible... can be relied on to make decisions.



Internal Controls

Internal control consists of range of procedures adopted within an organization to:

- Safeguard assets.
 - *Enhance accuracy and reliability of accounting records.*
 - Increase efficiency of operations.
 - Ensure compliance with laws and regulations.
- All four elements are addressed in the COSO framework; our focus is on accuracy and reliability of accounting records. Why?
 - ... *Required to be able get an unqualified audit opinion.*



Internal Controls

An internal control systems have five primary components as listed below.

- Control environment.
- Risk assessment.
- Control activities.
- Information and communication.
- Monitoring.

Internal Control Activities

- Establish responsibility
- Segregation of duties
- Documentation procedures
- Physical controls
- Independent Internal Verification
- Human Resource Controls



Summary

- Accounting reports meet a crucial demand for information to help decision-makers (investors, creditors, other stakeholders) to allocate resources to corporations or government entities / universities.
- Higher quality accounting reports facilitate exchanges at better prices and/or in larger amounts.
- A good internal control system supports higher quality accounting reports and allows an independent 3rd party audit, which further enhances the credibility (quality of the accounting reports).

Bottom Line: Every person in this room (and others who interact with the UW-Madison accounting system) has a role in supporting high quality accounting reports. Such high quality reporting is our “product” and helps the UW-Madison provide good accountability to support requests for resources that will help us achieve our mission.

