

Review of Financial Reporting

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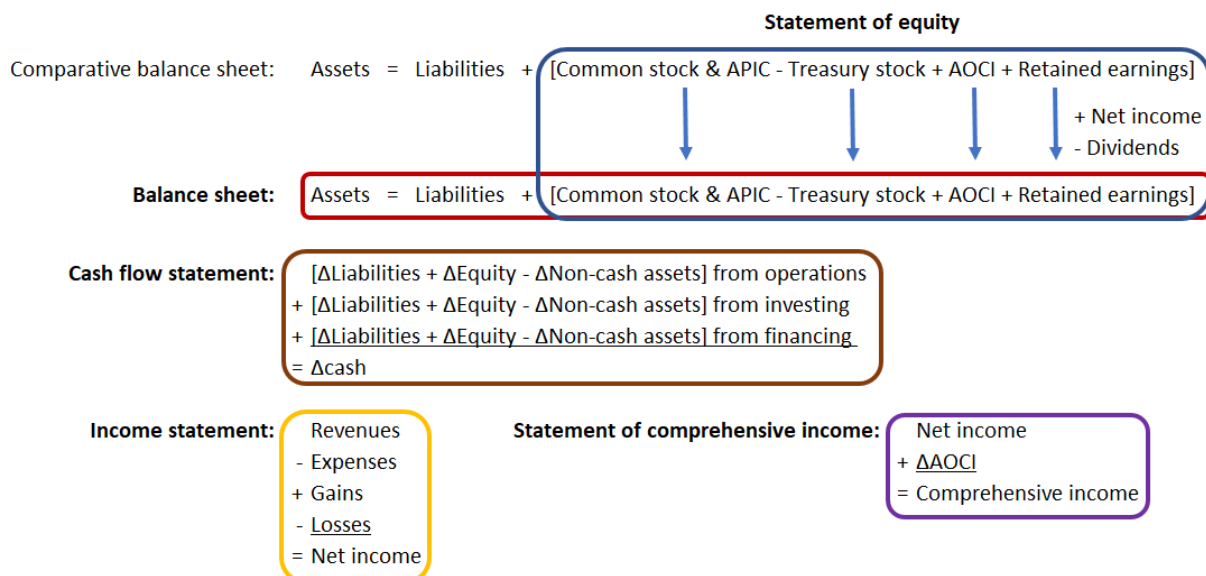
January 1, 2021

This chapter provides a “big-picture” review of the financial statements, the key products of financial accounting.

Financial reports include three primary financial statements: the balance sheet, the income statement, and the cash flow statement. The balance sheet reports the resources that the entity owns or controls (assets) and the claims against those resources (liabilities and equity) as of the balance sheet date. In other words, it provides information about the financial position of the company, and it is accordingly often referred to as the statement of financial position. The income statement presents accrual-based measures of performance for the period that ended on the balance sheet date, including revenue, expenses, gains, and losses; it ends with net income. The cash flow statement explains the difference between net income and net cash flow from operating activities, and it also provides information on investing and financing cash flows. In doing so, the cash flow statement helps explain changes in the financial position during the period.

Published financial reports also include a statement of comprehensive income and a statement of equity. The statement of comprehensive income lists gains and losses that are reflected on the balance sheet (i.e., assets or liabilities were adjusted to reflect the gains or losses), but which have not yet been reported in the income statement. These gains and losses are added to reported net income to yield comprehensive income. The statement of equity describes changes in each of the equity accounts during the period that ended on the balance sheet date.

As explained below, the five financial statements are related to each other. The following figure summarizes the relationships among them.



The five sections of this chapter (1.1 through 1.5) describe each of the financial statements. The discussion includes a review of basic accounting principles as well as explanations about the relationships among the financial statements and their key limitations.

1.1 Balance Sheet

The balance sheet presents information about the financial position of the firm, which in turn reflects the cumulative effect of all operating, investing and financing activities since the formation of the company through the balance sheet date. Exhibit 1.1 presents Microsoft's balance sheet for the fiscal year that ended on June 30, 2020.

The balance sheet presents the following equation:

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

In fact, as shown in the figure above and explained below, all five financial statements are related to this equation.

Assets

Assets are economic resources, but not all resources are recognized on the balance sheet. To be recognized, an economic resource must represent *probable* future economic benefits (criterion 1) that are *measurable* with reasonable precision (criterion 2) and be owned or controlled by the entity as a *result of past transactions* (criterion 3).

The third criterion means that the entity is entitled to receive the benefits from the asset because it already performed (i.e., paid cash to acquire the asset or provided other goods or services) or it incurred a liability.

Economic resources that do not satisfy the above criteria are not recognized on the balance sheet. In particular, economic benefits resulting from *executory contracts*—that is, contracts where both parties are yet to perform (e.g., employment contracts, sale contracts)—and most *internally developed intangibles* (e.g., research and development, brands, human capital, information technology, intellectual property) remain off balance sheet.

Resources resulting from executory contracts are not recognized because the firm has not performed yet, so the “past transaction” criterion is not satisfied.

Investments in internally developed intangibles such as research and development (R&D) are generally not recognized on the balance sheet because the related benefits involve high uncertainty and are not considered sufficiently “probable” or “measurable” (criteria 1 and 2, respectively).

Microsoft's financial statements provide a nice example of the economic significance of unrecognized intangibles. On June 30, 2020, the market value of outstanding shares was \$1,541

billion (7,571 million shares, \$203.51 price per share), while the related book value (i.e., the amount reported on the balance sheet) was \$118 billion. The gap between the market and book values of equity is due primarily to the omission of Microsoft's R&D capital and brand—its most important economic resources—from the balance sheet. These resources, which have been developed over many years of R&D efforts, advertising and other activities, are omitted from the balance sheet because R&D, advertising, and other organic investments in intangible assets are expensed as incurred rather than being capitalized and reported as an asset on the balance sheet.

Exhibit 1.1 Microsoft's Balance Sheet

(In millions)		
June 30,	2020	2019
Assets		
Current assets:		
Cash and cash equivalents	\$ 13,576	\$ 11,356
Short-term investments	122,951	122,463
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Total cash, cash equivalents, and short-term investments	136,527	133,819
Accounts receivable, net of allowance for doubtful accounts of \$788 and \$411	32,011	29,524
Inventories	1,895	2,063
Other current assets	11,482	10,146
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Total current assets	181,915	175,552
Property and equipment, net of accumulated depreciation of \$43,197 and \$35,330	44,151	36,477
Operating lease right-of-use assets	8,753	7,379
Equity investments	2,965	2,649
Goodwill	43,351	42,026
Intangible assets, net	7,038	7,750
Other long-term assets	13,138	14,723
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Total assets	\$ 301,311	\$ 286,556
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 12,530	\$ 9,382
Current portion of long-term debt	3,749	5,516
Accrued compensation	7,874	6,830
Short-term income taxes	2,130	5,665
Short-term unearned revenue	36,000	32,676
Other current liabilities	10,027	9,351
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Total current liabilities	72,310	69,420
Long-term debt	59,578	66,662
Long-term income taxes	29,432	29,612
Long-term unearned revenue	3,180	4,530
Deferred income taxes	204	233
Operating lease liabilities	7,671	6,188
Other long-term liabilities	10,632	7,581
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Total liabilities	183,007	184,226
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital – shares authorized 24,000; outstanding 7,571 and 7,643	80,552	78,520
Retained earnings	34,566	24,150
Accumulated other comprehensive income (loss)	3,186	(340)
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Total stockholders' equity	118,304	102,330
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Total liabilities and stockholders' equity	\$ 301,311	\$ 286,556

Most firms distinguish between five groups of assets: current assets; long-term investments; property, plant, and equipment (fixed assets); intangible assets; and other assets. Since 2019, many companies also report separately a right-of-use operating lease asset. When long-term investments, intangibles or the right-of-use assets are relatively small, they are included in “other assets.”

Current assets include cash and cash equivalents (e.g., very short-term deposits), short-term investments, and assets that the firm expects to sell (e.g., inventory), realize in cash (e.g., accounts receivable) or consume (e.g., prepaid expenses) during the coming year or the operating cycle, whichever is longer.

Long-term investments may include investments in marketable securities that the company intends to hold for a period longer than the next twelve months, investments in private entities, and investments in entities (public or private) over which the company has significant influence.

Property, plant, and equipment (PP&E or fixed assets) are long-lived assets that provide the firm with operating capacity and have physical substance (e.g., buildings, equipment, furniture, land for plant site).

Right-of-use operating lease assets represent the right to use leased fixed assets. They are generally measured at the present value of future lease payments.

Intangible assets are assets other than financial instruments that lack physical substance and provide the firm with operating capacity (e.g., goodwill, acquired patents, franchise rights). Because expenditures made to internally develop intangible assets are generally expensed as incurred, most reported intangible assets were acquired from others, typically in a business combination.

Other assets include assets that do not belong to any of the other categories.

Liabilities

Similar to reported assets, which exclude some economic resources, reported liabilities omit some obligations. To be reported as liabilities, obligations must represent *probable* future sacrifice of economic benefits (criterion 1), which can be *measured* with reasonable precision (criterion 2) and be a *result of past transactions* (criterion 3). The third criterion means that the party to the obligation has already performed.

Obligations that do not satisfy all three criteria (and therefore remain off balance sheet) include obligations arising from *executory contracts* (e.g., purchase commitments, employment contracts), where the party to the obligation has not performed yet, and *loss contingencies* (e.g., pending lawsuits, unsettled tax positions), where there is significant uncertainty regarding the existence and amount of related obligations.

Liabilities include both current and long-term obligations. *Current liabilities* are liabilities that the firm expects to settle within one year or the operating cycle, whichever is longer. They include *accounts payable* (credit purchases from suppliers), *accrued expenses* (services that have been received by the company from employees or other parties that are yet to be paid), *deferred revenue* (payments that have been received by the company but delivery is yet to occur), and current debt (short-term borrowings and current maturities of long-term debt). Long-term liabilities include long-term debt, operating lease obligation (since 2019), deferred taxes, pension and other post-retirement benefits, and other accrued liabilities (e.g., restructuring, environmental).

Equity

Equity is the residual value of the assets of an entity that remains after the liabilities are deducted. For corporate entities, owners' equity has the following components: contributed capital accounts (common stock, preferred stock, additional paid in capital), treasury stock, retained earnings, accumulated other comprehensive income, and noncontrolling interests.

Contributed capital accounts report the amount invested by shareholders. *Common stock* and *preferred stock* (if issued) are typically reported at the par value of issued shares. *Additional paid in capital* (also referred to as *capital surplus*) reflects the difference between the amount received from shareholders and the par value of issued shares.

Treasury stock measures the reduction in equity due to repurchase of shares from investors.

Retained earnings (also referred to as *reinvested earnings*) represent the excess of cumulative net income over cumulative dividends since the formation of the company. In other words, retained earnings measure the increase in net assets (assets minus liabilities) due to earning activities since the formation of the company, minus assets that have been paid out as dividends. The change in retained earnings each period is generally equal to net income for the period minus declared dividends.

Accumulated other comprehensive income represents the net effect of revaluations of assets and liabilities that did not pass through the income statement. Because all revaluations of assets and liabilities change net assets, revaluations that are not balanced by a change in retained earnings (i.e., revaluations that bypassed the income statement) require a direct adjustment to equity. The equity account that absorbs such adjustments is accumulated other comprehensive income.

Noncontrolling interests are equity claims of outside shareholders on the net assets of consolidated subsidiaries.

The omission of some economic assets and liabilities from the balance sheet is not the only reason for the large difference between the market and book values of equity observed for many companies (e.g., the Microsoft example discussed above). While some assets and liabilities are reported at fair value, most are measured based on the historical (i.e., original) transaction amount, which often deviate significantly from current value. In many cases, *historical cost accounting* results in significant understatement of assets due to inflation. Moreover, while assets

are generally not marked up for increases in fair value, they are marked down when deemed impaired. For example, inventory is generally reported at the lower of cost or net realizable value and fixed and intangible assets are written down to fair value when deemed impaired. These adjustments are motivated by *accounting conservatism*.

1.2 Income Statement

While the balance sheet reports the financial position as of a given day, the income statement reports the results of business activities—primarily operating activities—during the period that ended on that day. Specifically, the income statement lists the resources earned (revenues and gains) and the related resources used up or lost (expenses and losses), and it ends with net income.

$$\text{Revenues} - \text{Expenses} + \text{Gains} - \text{Losses} = \text{Net Income}$$

Revenues and expenses relate to recurring activities, while gains and losses measure the net effect of non-recurring activities such as a gain or loss from disposal of old equipment, sale of investments, or early retirement of debt. Exhibit 1.2 presents Microsoft's income statement for the fiscal year that ended on June 30, 2020.

Most firms—including Microsoft—report subtotals for gross profit, operating income, and pretax income (multiple-step format). Some companies use the single-step format where they subtract all pretax expenses from revenue and do not explicitly report gross profit or operating income.

Operating income is not a well-defined concept. Companies that report this subtotal use different definitions. Items that are reported by some companies as operating are often classified by others as nonoperating. For example, a company that leases out a portion of an owned building that is mostly used for operations may classify the rent income as operating (reflecting the fact that that income effectively offsets the related depreciation) or outside operations (consistent with the fact that renting is not an operating activity for the company). As another example, a company that makes charitable contributions may classify those outflows as an operating item (consistent with the likely motivation for the contribution – to enhance the company's reputation) or outside operations, arguing that they contributions are not related to operations.

The amounts reported in the income statement are based on three basic accounting principles: realization / satisfaction of performance obligations (revenue recognition), matching (expense recognition), and historical cost (affects revenue and expense measurement). Prior to 2018, the revenue recognition standard was referred to as the realization principle. Since 2018 the framework for recognizing revenue has changed to one that emphasizes the satisfaction of performance obligations. However, under both frameworks, revenue is generally recognized at the time of delivery. I first explain the old principle, then the new framework, and finally the key changes. Understanding both frameworks facilitates a better understanding of revenue recognition.

Exhibit 1.2 Microsoft's Income Statement

(In millions, except per share amounts)

Year Ended June 30,	2020	2019	2018
Revenue:			
Product	\$ 68,041	\$ 66,069	\$ 64,497
Service and other	74,974	59,774	45,863
Total revenue	143,015	125,843	110,360
Cost of revenue:			
Product	16,017	16,273	15,420
Service and other	30,061	26,637	22,933
Total cost of revenue	46,078	42,910	38,353
Gross margin	96,937	82,933	72,007
Research and development	19,269	16,876	14,726
Sales and marketing	19,598	18,213	17,469
General and administrative	5,111	4,885	4,754
Operating income	52,959	42,959	35,058
Other income, net	77	729	1,416
Income before income taxes	53,036	43,688	36,474
Provision for income taxes	8,755	4,448	19,903
Net income	\$ 44,281	\$ 39,240	\$ 16,571

The *realization principle* states that revenue should be recognized and reported in the income statement when the amount and timing of net cash flows from the revenue are reasonably determinable (condition 1), and the earnings process with respect to the revenue is complete or virtually complete (condition 2).

The SEC issued further guidance, which effectively interprets the first criterion as requiring that the price be fixed or determinable and collection be reasonably assured. It further specifies that the second criterion requires the existence of persuasive evidence of an arrangement, and that product delivery has occurred or services have been rendered.

For most transactions these criteria were satisfied at the time of delivery, and revenue was recognized accordingly. When companies recognized revenue before cash collection, they increased an asset called accounts receivable instead of cash, and this asset was reduced when cash was collected. When companies received advance payments from customers (i.e., before the delivery of goods or services), they increased a liability called deferred revenue, and this liability was reduced when delivery took place and revenue was recognized.

Under ASC 606, *Revenue from Contracts with Customers*, which is effective since 2018, an entity recognizes revenue to depict the transfer of promised goods or services to customers at an amount that reflects the consideration the entity expects to be entitled in exchange for those goods or services.

The principles in the standard are applied using the following five steps:

1. Identify the contract(s) with a customer (a contract creates enforceable rights and obligations)

2. Identify the performance obligations in the contract (obligations that are both capable of being distinct and distinct in the context of the transaction)
3. Determine the transaction price (including variable consideration)
4. Allocate the transaction price to the performance obligations in the contract (generally based on relative fair values)

5. *Recognize revenue when (or as) the entity satisfies a performance obligation.*

Any consideration received from the customer before all the above criteria are met is generally recognized as a deposit (liability)

As noted, while the framework of ASC 606 is different from that of prior GAAP, under both frameworks revenue is generally recognized at the time of delivery. Primary changes include:

- More multiple elements/deliverables (now called “performance obligations”)
- Recognition at “transfer of control” rather than “transfer of risks and rewards”
- For variable consideration, the expected value or “most likely amount” is used, rather than delayed recognition (until the uncertainty is resolved)
- Some differences for specific transactions such as percentage of completion method and license revenue
- Substantially more disclosure

Companies incur costs in generating revenues. The *matching principle* requires that each cost be expensed in the same period in which the revenues that the cost helped generate are recognized (e.g., the cost of inventory sold is matched against the related sales revenue in the same income statement).

Similar to the revenue recognition, the matching principle can be satisfied before, at the time of, or after the cash payment, with the expense recognized accordingly.

To implement the matching principle, companies first apply the revenue recognition criteria and decide which revenues to recognize. Then, they identify the costs that helped generate those revenues and expense them in the same income statement to measure net income for the period.

Applying the matching principle with respect to costs that are directly related to specific revenues—such as cost of inventory sold or sales commissions—is straightforward (at least conceptually). However, most costs are not directly related to specific revenues but rather provide the capacity to generate revenue during the period (e.g., administrative salaries, headquarter rent, interest). Consistent with the matching principle, these costs are recognized as expenses when they provide the capacity to generate revenue, which is typically when they are incurred. Some costs, such as capital expenditures, jointly benefit several periods and thus require a systematic allocation to the periods that benefit (e.g., through a depreciation schedule).

While most costs are reported in the income statement based on the matching principle, two types of costs are expensed in a way that violates matching. The first type relates to costs that are expected to benefit future periods, but the amount and timing of those future benefits are highly uncertain. Since the future benefits are too uncertain to be recognized as an asset on the balance sheet, these costs are expensed when incurred. Examples include R&D expenditures, advertising, start-up costs, investments in human capital, and some organizational repositioning charges. The

second type of costs that are recognized in violation of matching are those that relate to past periods. For example, new information may indicate that past depreciation was insufficient and thus trigger a write down of fixed assets. Other examples include resolution of lawsuits or other contingent obligations, and most restructuring charges.

The *historical cost principle* governs the measurement of most assets and liabilities; it requires that assets and liabilities be measured based on the amounts paid or received when the asset or liability was originally recognized. Because revenues are inflow of assets (cash, receivables) or settlement of liabilities (deferred revenue), and expenses are reductions in assets (inventory, fixed assets, prepaid expenses) or incurrence of liabilities (accrued expenses), the historical cost principle also affects the reported amounts of revenues, expenses, and income.

Most companies report four major expense items: cost of goods and services sold; selling, general, and administrative expenses; interest expense; and income taxes.

For manufacturing companies, cost of goods sold includes direct materials, direct labor, and manufacturing overhead (including depreciation), which were used to produce units that were sold during the period.

Selling, general and administrative (SG&A) expenses are comprised of marketing expenses, selling expenses, research and development costs, administrative expenses, and other non-manufacturing operating costs (including depreciation and amortization expense on non-manufacturing assets). Companies with significant research and development activities often report these expenditures separately.

Companies typically report impairment, restructuring and similar non-recurring charges under captions such as “other operating charges”.

Gains and losses (e.g., from selling investments or old PP&E) are typically reported net under captions such as “other income (loss) – net”.

1.3 Cash Flow Statement

The cash flow statement explains how cash has been provided and used during the period that ended on the balance sheet date. The sources and uses of cash are classified into three categories: operating, investing, and financing. Exhibit 1.3 presents Microsoft’s cash flow statement for the fiscal year that ended on June 30, 2020.

The *operating section* includes all cash flows used for or provided by purchasing merchandise (raw materials in manufacturing firms), producing the products (in manufacturing firms), marketing the products, and administering the operations.

Although labeled “operating activities”, this section of the cash flow statement also reflects several investing and financing items, including interest income and expense, and dividends received (but not dividends paid out to the shareholders). In addition, essentially all income taxes are included in the operating section, including those related to investing and financing activities

(e.g., income taxes paid on a gain from selling fixed assets). In general, cash from operations includes the cash counterparts of all revenues and expenses reported in the income statement.

The operating section of the cash flow statement is typically presented using the so-called *indirect approach*, which starts with net income and reconciles it to cash provided by (or used for) operating activities. The adjustments “undo” the effects of accruals accounting. For example, depreciation—a noncash expense which is deducted from revenues in calculating income—is added back to net income, and the change in accounts receivable—measuring credit sales which are included in revenues and income but have not been collected yet—is deducted from net income.

The ***investing section*** of the cash flow statement reports cash flows used for acquiring or provided by selling (1) tangible long-lived assets (e.g., land, buildings, and equipment), (2) intangible assets (e.g., patents, franchises, computer software, copyrights, permits, licenses and other contractual rights), (3) businesses, and (4) investment assets (assets that are not used in operations such as securities issued by other firms and loans receivable). Unlike cash from operations, this section is always presented directly—each type of cash inflow or outflow is reported explicitly.

The ***financing section*** reports cash obtained from owners (stock issuance) and lenders (issuance of bonds or notes, other borrowings), cash provided to owners (cash dividends, share repurchases), and principal repaid to lenders. Like the investing section, this section is always presented directly, with each type of cash inflow and outflow reported explicitly.

The cash flow statement is used for assessing liquidity, understanding changes in the financial position, and evaluating earnings quality. Cash flow information is useful for evaluating ***liquidity*** because the different sources and uses of cash have different implications for the company’s ability to meet its short-term obligations. For example, a company that generates a strong cash flow from recurring operating activities is likely to have better liquidity than a company that borrows cash or that increases its cash position by selling a business unit or by cutting capital expenditures.

While the original motivation for requiring companies to disclose cash flow information was to inform about liquidity, the cash flow statement also facilitates a better ***understanding of changes in financial position***. Because assets equal liabilities plus equity, an increase in cash (an asset) must be accompanied by either a decrease in another asset or an increase in a liability or equity account. For example, “capital expenditures”—an investing cash outflow—represent an increase in fixed assets, and “issuance of debt”—a financing cash inflow—represents an increase in debt liabilities. Thus, by providing information about cash transactions, the cash flow statement informs not only on changes in cash but also on changes in other assets, liabilities, and equity accounts. In other words, the cash flow statement provides information about changes in the financial position.

Exhibit 1.3 Microsoft's Statement of Cash Flows

(In millions)			
Year Ended June 30,	2020	2019	2018
Operations			
Net income	\$ 44,281	\$ 39,240	\$ 16,571
Adjustments to reconcile net income to net cash from operations:			
Depreciation, amortization, and other	12,796	11,682	10,261
Stock-based compensation expense	5,289	4,652	3,940
Net recognized gains on investments and derivatives	(219)	(792)	(2,212)
Deferred income taxes	11	(6,463)	(5,143)
Changes in operating assets and liabilities:			
Accounts receivable	(2,577)	(2,812)	(3,862)
Inventories	168	597	(465)
Other current assets	(2,330)	(1,718)	(952)
Other long-term assets	(1,037)	(1,834)	(285)
Accounts payable	3,018	232	1,148
Unearned revenue	2,212	4,462	5,922
Income taxes	(3,631)	2,929	18,183
Other current liabilities	1,346	1,419	798
Other long-term liabilities	1,348	591	(20)
Net cash from operations	60,675	52,185	43,884
Financing			
Repayments of short-term debt, maturities of 90 days or less, net	0	0	(7,324)
Proceeds from issuance of debt	0	0	7,183
Cash premium on debt exchange	(3,417)	0	0
Repayments of debt	(5,518)	(4,000)	(10,060)
Common stock issued	1,343	1,142	1,002
Common stock repurchased	(22,968)	(19,543)	(10,721)
Common stock cash dividends paid	(15,137)	(13,811)	(12,699)
Other, net	(334)	(675)	(971)
Net cash used in financing	(46,031)	(36,887)	(33,590)
Investing			
Additions to property and equipment	(15,441)	(13,925)	(11,632)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	(2,521)	(2,388)	(888)
Purchases of investments	(77,190)	(57,697)	(137,380)
Maturities of investments	66,449	20,043	26,360
Sales of investments	17,721	38,194	117,577
Other, net	(1,241)	0	(98)
Net cash used in investing	(12,223)	(15,773)	(6,061)
Effect of foreign exchange rates on cash and cash equivalents	(201)	(115)	50
Net change in cash and cash equivalents	2,220	(590)	4,283
Cash and cash equivalents, beginning of period	11,356	11,946	7,663
Cash and cash equivalents, end of period	\$ 13,576	\$ 11,356	\$ 11,946

Finally, financial analysts and other sophisticated users of the financial statements utilize the cash flow statement to evaluate *earnings quality*. As discussed above, the operating section of the cash flow statement reports the magnitude of and reasons for the difference between earnings and cash from operations. This information is useful for evaluating the sustainability of earnings

because noncash earnings items are generally less persistent than operating cash flows. For example, an impairment charge, which reduces net income but does not affect cash from operations (and is therefore added to net income in the operating section of the cash flow statement), is likely to be less persistent than other earnings items.

1.4 Statement of Comprehensive Income

The statement of comprehensive income reports gains and losses that are reflected on the balance sheet but haven't yet been reported in the income statement. Adding those items to net income gives a more complete measure of income – comprehensive income. Examples of such gains and losses include: (1) unrecognized changes in the funding status of postretirement benefits, (2) foreign currency translation adjustment (reflects the impact of fluctuations in exchange rates used to translate the book values of assets and liabilities of foreign subsidiaries), and (3) unrealized holding gains/losses from marking-to-market available-for-sale securities and some derivatives.

Companies have the option to present the components of net income and other comprehensive income either in a single continuous statement or in two separate but consecutive statements in annual financial statements. Most companies use the two statements option, as does Microsoft. Exhibit 1.4 presents Microsoft's statement of comprehensive income for the fiscal year that ended on June 30, 2020.

Exhibit 1.4 Microsoft's Statement of Comprehensive Income

(In millions)			
Year Ended June 30,	2020	2019	2018
Net income	\$ 44,281	\$ 39,240	\$ 16,571
Other comprehensive income (loss), net of tax:			
Net change related to derivatives	(38)	(173)	39
Net change related to investments	3,990	2,405	(2,717)
Translation adjustments and other	(426)	(318)	(178)
Other comprehensive income (loss)	3,526	1,914	(2,856)
Comprehensive income	\$ 47,807	\$ 41,154	\$ 13,715

1.5 Statement of Equity

The statement of equity explains changes in each of the equity accounts during the period that ended on the balance sheet date. Examples of line items in this statement include: net income (increases retained earnings), dividends (reduce retained earnings), issuance of new shares (increases common or preferred stock and additional paid in capital), repurchase of shares (increases treasury stock, a contra-equity account),¹ issuance of shares from the treasury (reduces

¹ Instead of increasing treasury stock, some companies—including Microsoft—account for share buybacks by reducing common stock, APIC, and retained earnings.

treasury stock and changes additional paid in capital), and other comprehensive income (increases accumulated other comprehensive income). Exhibit 1.5 presents Microsoft's statement of shareholders' equity for the fiscal year that ended on June 30, 2020.

Exhibit 1.5 Microsoft's Statement of Shareholders' equity

(In millions)

Year Ended June 30,	2020	2019	2018
Common stock and paid-in capital			
Balance, beginning of period	\$ 78,520	\$ 71,223	\$ 69,315
Common stock issued	1,343	6,829	1,002
Common stock repurchased	(4,599)	(4,195)	(3,033)
Stock-based compensation expense	5,289	4,652	3,940
Other, net	(1)	11	(1)
Balance, end of period	80,552	78,520	71,223
Retained earnings			
Balance, beginning of period	24,150	13,682	17,769
Net income	44,281	39,240	16,571
Common stock cash dividends	(15,483)	(14,103)	(12,917)
Common stock repurchased	(18,382)	(15,346)	(7,699)
Cumulative effect of accounting changes	0	677	(42)
Balance, end of period	34,566	24,150	13,682
Accumulated other comprehensive income (loss)			
Balance, beginning of period	(340)	(2,187)	627
Other comprehensive income (loss)	3,526	1,914	(2,856)
Cumulative effect of accounting changes	0	(67)	42
Balance, end of period	3,186	(340)	(2,187)
Total stockholders' equity	\$ 118,304	\$ 102,330	\$ 82,718