Section 1:

Exchange Analysis

In this section, we will describe and explain how the exchange analysis process works. As mentioned in the Introduction, information about the economic events affecting the firm (the inputs) is transformed (through the exchange analysis process) into the information that is reported in the financial statements (the outputs).

Exchange analysis can be visualized as an input-processing-output approach to management control and corporate accountability as shown below.

This exchange analysis process applies to a small business, a business unit within a firm, or to a multi-billion dollar merger like AOL and Time-Warner. For most routine business transactions, the exchange analysis process is taken for granted. Firms develop transaction processing systems that produce financial information in the most efficient and effective manner possible.

The expertise of financial professionals typically becomes visible in two situations.

1. When complex or new business transactions occur, accountants have to develop policies and procedures for transforming
information about the underlying economic events into the information reported in the financial statement.

2. They are often called upon to explain the meaning of the information reported in the financial statements to managers and other users of financial information.

In the first case, accountants rely on their technical expertise to resolve complex business issues. In the second case, they rely on their communication skills to provide an explanation that makes sense to non-accountants.

Most shareholders, analysts, and most middle managers only see financial information after it has been reported in the financial statements (or when it shows up in reports on their computer screens). They see the results of the exchange analysis process without having to know much about the process itself. However, if we are going to make the links between strategy, control, and accountability more explicit, we need to "see" how economic event are converted into financial information.

In Chapter 1, we will explain how financial statements (structured information) are the primary sources of formal, corporate accountability in a capitalist market economy. From a management perspective, we show how the financial statements represent the "tip of the iceberg" in terms of the firm’s full management control system. We begin our discussion of the financial statements by focusing on the balance sheet, the income statement, a restructured balance sheet, and a financial flow statement.\(^1\) As we shall see, each of the financial statements is based on the logic of financial control inherent in a self-balancing equation.

In Chapter 2, we expand on the logic of financial control underlying each financial statement to show how each statement is based on a set of interrelated concepts, categories, and accounts. Furthermore, we show how the information reported in each financial statement is related logically to the information reported in the other financial statements. Each financial statement represents a separate (but interrelated) way of looking at the business.

In Chapter 3, we connect the information reported in these statements back to the basic economic events that affect the firm through the E-MARS model. "E-MARS" stands for Economic Events, Measurement,
Accounting, Recognition, and Structuring. The model provides a systematic and rational procedure for linking the economic events affecting the firm to the information reported in the financial statements.

In Chapter 4, we create an E-MARS matrix to capture all of the economic activity affecting a firm for a given period of time. The E-MARS matrix is based on the logic of financial control inherent in every economic exchange:

\[ \text{Received} = \text{Given} \]

In Chapter 5, we reconstruct an economic history for a firm (Cisco Systems) from the information reported in the financial statements. We use account and model summaries to create a set of economic events that support the financial statements. The logic of financial control inherent in every economic exchange is extended in the following way:

\[ \text{Received} - \text{Given} = 0 \]

As we shall see, the balances in all accounts and model categories will sum to $0 during every stage of the reconstruction process.

\[ ^1 \text{Given our emphasis on integrating strategy, control, and accountability, we will defer our discussion of cash and cash flow analysis until Chapter 5.} \]