
Financial Reporting and Analysis (5th Ed.)

Chapter 1 Solutions

The Economic and Institutional Setting for Financial Reporting Problems

Problems

P1-1. Demand for accounting information

Requirement 1:

a) **Existing shareholders** use financial accounting information as part of their ongoing investment decisions—should more shares of common or preferred stock be purchased, should some shares be sold, or should current holdings be maintained? Financial statements help investors assess the expected risk and return from owning a company's common and preferred stock. They are especially useful for investors who adopt a “fundamental analysis” approach.

Shareholders also use financial accounting information to decide how to vote on corporate matters like who should be elected to the board of directors, whether a particular management compensation plan should be approved, and if the company should merge with or acquire another company. Acting on behalf of shareholders, the Board of Directors hires and fires the company's top executives. Financial statement information helps shareholders and the board assess the performance of company executives. Dismissals of top executives often occur following a period of deteriorating financial performance.

b) Financial statement information helps **prospective (potential) investors** identify stocks consistent with their preferences for risk, return, dividend yield, and liquidity. Here too, financial statements are especially useful for those investors that adopt a “fundamental approach.”

c) **Financial analysts** demand accounting information because it is essential for their jobs. Equity (stock) and credit (debt) analysts provide a wide range of services ranging from producing summary reports and recommendations about companies and their securities to actively managing portfolios for investors that prefer to delegate buying and selling decisions to professionals. Analysts rely on information about the economy, individual industries, and particular companies when providing these services. As a group, analysts constitute probably the largest single source of demand for financial accounting information—without it, their jobs would be difficult, if not impossible, to do effectively.

d) **Managers** demand financial accounting information to help them carry out their responsibilities to shareholders. Financial accounting information is used by managers to assess the profitability and health of individual business units and the company as a whole. Their compensation often depends on financial statement numbers like earnings per share, return on equity, return on capital employed, sales growth, and so on. Managers often use a competitor's financial statements to benchmark profit performance, cost structures, financial health, capabilities, and strategies.

e) **Current employees** demand financial accounting information to monitor payouts from profit-sharing plans and employee stock ownership plans (ESOPs). Employees also demand financial accounting information to gauge a company's long-term viability and the likelihood of continued employment, as well as payouts under company-sponsored pension and health-care programs. Unionized employees have other reasons to demand financial statements, and those are described in Requirement 2 which follows.

f) **Lenders** use financial accounting information to help determine the principal amount, interest rate, term, and collateral required on loans they make. Loan agreements often contain covenants that require a company to maintain minimum levels of various accounting ratios. Because covenant compliance is measured by accounting ratios, lenders demand financial accounting information so they can monitor the borrower's compliance with loan terms.

g) **Suppliers** demand financial accounting information about current and potential customers to determine whether to grant credit, and on what terms. The incentive to monitor a customer's financial condition and operating performance does not end after the initial credit decision. Suppliers monitor the financial condition of their customers to ensure that they are paid for the products, materials, and services they sell.

h) **Debt-rating agencies** like Moody's or Standard & Poor's help lenders and investors assess the default risk of debt securities offered for sale. Rating agencies need financial accounting information to evaluate the level and volatility of the company's expected future cash flows.

i) **Taxing authorities** (one type of government regulatory agency) use financial accounting information as a basis for establishing tax policies. Companies or industries that appear to be earning "excessive" profits may be targeted for special taxes or higher tax rates. Keep in mind, however, that taxing authorities in the United States and many other countries are allowed to set their own accounting rules. These tax accounting rules, and not GAAP, determine a company's taxable income.

Other government agencies are often customers of the company. In this setting, financial information can serve to help resolve contractual disputes between the company and its customer (the agency) including claims that the company is earning excessive profits. Financial accounting information can also be used to determine if the company is financially strong enough to deliver the ordered goods and services.

Financial accounting information is also used in rate-making deliberations and monitoring of regulated monopolies such as public utilities.

Requirement 2:

Student responses will vary, but examples are shareholder activist groups (CalPERS), labor unions, and customers.

- Shareholder activist groups demand financial accounting information to help determine how well the company's current management team is doing, and whether the managers are being paid appropriately.
- Labor unions demand financial accounting information to help formulate or improve their bargaining positions with employer companies. Union negotiators may use financial statements showing sustained or improved profitability as evidence that employee wages and benefits should be increased.
- Customers demand financial accounting information to help determine if the company will be able to deliver the product on a timely basis and provide product support after delivery.

P1-2. Incentives for voluntary disclosure

Requirement 1:

a) Companies compete with one another for financial capital in debt and equity markets. They want to obtain financing at the lowest possible cost. If investors are unsure about the "quality" of a company's debt and equity securities—the risks and returns of investment—they will demand a lower price (higher rate of return) than would otherwise be the case. Companies have incentives to voluntarily provide information that allows investors and lenders to assess the expected risk and return of each security. Failing to do so means lenders may charge a higher rate of interest for the added informational risk, and stock investors will give the company less cash for its common or preferred stock.

b) Companies compete with one another for talented managers and employees. Information about a company's past financial performance, its

current health, and its prospects is useful to current and potential employees who are interested in knowing about long-term employment opportunities, present and future salary and benefit levels, and advancement opportunities at the company. To attract the best talent, companies have incentives to provide financial information that allows prospective managers and employees to assess the risk and potential rewards of employment.

c) Companies and their managers also compete with one another in the “market for corporate control.” Here companies make offers to buy or merge with other companies. Managers of companies that are the target of a *friendly* merger or tender offer—a deal they want done—have incentives to disclose information that raises the bid price. Examples include forecasts of increased sales and earnings growth. Managers of companies that are the target of *unfriendly* (hostile) offers—deals they don’t want done—have incentives to disclose information that shows the company is best left in the hands of current management. Hostile bidders often put a different spin on the same financial information, arguing that it shows just how poorly current management has run the company.

Requirement 2:

Student responses will vary, but here are some examples:

- Competitive forces from within the industry (i.e., other firms in the industry are voluntarily disclosing information about order backlogs, customer turnover, or other key performance indicators).
- Demands by financial analysts for expanded or increased disclosure by the firm.
- Demands by shareholder activist groups such as CalPERS.
- Demands by debt rating agencies such as Moody’s and Standard & Poor’s.
- Pressure from governmental regulatory agencies such as the Securities and Exchange Commission. Firms may believe that disclosing certain information voluntarily may prevent the Securities and Exchange Commission from mandating more detailed disclosures at a later date.
- Demands from institutional investors (e.g., mutual funds, pension funds, insurance companies, etc.) that hold the company’s securities.

Requirement 3:

The following examples are press release items that could be disclosed voluntarily: forecasts of current quarter or annual earnings; forecasts of

current quarter or annual sales; forecasts of earnings growth for the next 3 to 5 years; forecasts of sales growth for the next 3 to 5 years; capital expenditure plans or budgets; research and development plans or budgets;

new product developments; patent applications and awards; changes in top management; details of corporate restructurings, spin-offs, reorganizations, plans to discontinue various divisions and/or lines-of-business; announcements of corporate acquisitions and/or divestitures; announcements of new debt and/or equity offerings; and announcements of short-term financing arrangements such as lines of credit. Other student responses are possible.

The advantage of releasing such information in press releases is that the news is made available to external parties on a far more timely basis than if disclosure occurred in quarterly or annual financial statements. Press releases also give management an opportunity to help shape how the facts are interpreted.

P1-3. Costs of disclosure

Requirement 1:

a) **Information costs** include costs to obtain, gather, collate, maintain, summarize, and communicate financial statement data to external users. Examples are the cost of computer hardware and software, fees paid to audit financial statement data, salaries and wages paid to corporate accounting staff in charge of the firm's financial accounting system, and costs to print and mail annual reports to shareholders or make them available electronically on the company's web site.

b) **Competitive disadvantage** costs occur when competitors are able to use the information in ways detrimental to the company. Examples include highlighting highly profitable products and services or geographical areas, technological innovations, new markets or product development plans, and pricing or advertising strategies.

c) **Litigation costs** are costs to defend the company against actions brought by shareholder and creditor lawsuits. These suits claim that previous information about the company's operating performance and health was misleading, false, or not disclosed in a timely manner. Examples include the direct costs paid to lawyers to defend against the suits, liability insurance costs, loss of reputation, the productive time lost by managers and employees as they prepare to defend themselves and the company against the suit.

d) **Political costs** arise when, for example, regulators and politicians use profit levels to argue that a company is earning excessive profits. Regulators and politicians advance their own interests by proposing taxes on the company or industry in an attempt to reduce the level of “excessive” profitability. These taxes represent a wealth transfer from the company’s shareholders to other sectors of the economy. Managers of companies in

politically sensitive industries sometimes adopt financial reporting practices that reduce the level of reported profitability to avoid potential political costs.

Requirement 2:

Student responses to this question may vary. One possible cost is when disclosure commits managers to a course of action that is not optimal for the company. For example, suppose a company discloses earnings and sales growth rate goals for a new product or market. If these projections become unreachable, managers may drop selling prices, offer “easy” credit terms, or overspend on advertising in an attempt to achieve the sales and earnings growth goals.

P1-4. Determining why financial reporting rules differ

A country’s financial reporting philosophy evolves from and reflects the specific legal, political, and financial institutions within the country. External investors are a much more important source of financial capital in Canada and the United States than they have historically been in Germany and Japan. Consequently, financial accounting and reporting standards in Canada and the U.S. have evolved to meet this public financial market demand for information—what the chapter describes as the economic performance approach.

Financial accounting and reporting standards in German and Japan tend to reflect the commercial and tax law approach described in the chapter. In Germany and Japan, only a small amount of capital has been provided by individual investors through public financial markets. The primary source of capital for German companies has been several large banks—and the government itself. Labor unions have also played an important corporate governance role in German companies. Large banks provide much of the financing in Japan. Along with the German labor unions, these few important capital providers wield great power including the ability to acquire information directly from the firm. Because of this concentrated power and the insignificance of the public financial market in these two countries, financial reporting standards tend to conform to income tax rules or commercial law.

P1-5. Generally accepted accounting principles (GAAP)

Requirement 1:

What are generally accepted accounting principles (GAAP)? GAAP refers to the network of conventions, rules, guidelines and procedures that shape the financial reporting practices of businesses and non-profit organizations. GAAP comes from two main sources: (1) written pronouncements by designated standards-setting organizations such as the FASB, IASB and SEC; and (2) accounting practices that have evolved over time as preparers and auditors dealt with new business transactions and circumstances not yet described in written pronouncements. The FASB's Accounting Standards Codification is now the sole authoritative source for written GAAP, although suggested implementation guidelines are provided by industry trade groups and the AICPA through its various industry guides.

Requirement 2:

Why is GAAP important to independent auditors and to external users? Independent auditors provide reasonable assurance that the financial statements of the companies they audit "present fairly, in all material respects" the financial position, results of operations, and cash flows "in conformity with U.S. generally accepted accounting principles." It is therefore essential that independent auditors possess a thorough understanding of GAAP and how it applies to each specific client.

The goal of GAAP in the United States and most other developed countries is to ensure that a company's financial statements represent faithfully its economic condition and performance. GAAP achieves this goal by providing a framework for determining when to record a business transaction or event (recognition), what dollar amount to record (measurement), how summary information is to be displayed in financial statements (presentation), and what additional information to provide in the notes (disclosure). External users benefit when the GAAP framework ensures that the resulting statements and notes accurately convey information about a company's true economic condition and performance.

Requirement 3:

Describe the FASB organization and how it establishes new accounting standards. Although the Securities and Exchange Commission (SEC) has ultimate legal authority to determine accounting principles in the United States, it has looked to private-sector organizations to establish these principles. Today, the private sector standards setting organization is the FASB. It exists as an independent group with seven full-time members and a large staff. Board members are appointed for five-year terms and are required to sever all ties with the companies and institutions they served prior to joining the board.

The FASB follows a "due process" procedure in developing accounting standards and updates that involves three steps: (1) Discussion-memorandum

stage; (2) Exposure-draft stage; and (3) Voting stage. Public comments on discussion memoranda and exposure drafts are invited, and public hearings are sometimes held.

Requirement 4:

Describe the IASB organization and its role in establishing new accounting standards. The International Accounting Standards Board, formed in 1973, works to formulate accounting standards, promote their worldwide acceptance, and achieve greater convergence of financial reporting regulations, standards, and procedures across countries. Members are drawn from professional accounting organizations and businesses around the world.

Requirement 5:

How does the Securities and Exchange Commission (SEC) influence the financial reporting practices of U.S. companies? The SEC retains statutory power over the financial accounting and reporting practices of registrant companies. This power includes the ability to issue financial accounting and reporting rules as well as to enforce compliance with the rules it issues or those issued by standards-setting organizations (e.g., FASB) as designated by the SEC.

P1-6. Relevant versus faithful representation

Requirement 1:

The Blue Book average price is more **relevant** to the car buying decision than is the list (or “sticker”) price shown on the manufacturer’s web site. Why? Because it better represents the price you can expect to pay for the automobile.

The Blue Book price describes the average price actually paid by recent buyers for comparably equipped automobiles. Actual prices are the result of arms-length negotiations between willing buyers and sellers, and thus reflect what you can expect to pay (on average) when you negotiate your automobile purchase. The list (“sticker”) price is just a suggested retail price—the actual negotiated price is often considerably less (but sometimes can be more) than the manufacturer’s list price.

Requirement 2:

The Blue Book price of \$19,500 is less **representationally faithful** than the manufacturer’s list price. To understand why, notice that recent selling prices have ranged from \$18,000 to \$22,000. This means that while you can expect to pay \$19,500 on average for the automobile, it may cost you as little as \$18,000 or as much as \$22,000. On the other hand, there is little (if any)

variation in the manufacturer's list price—comparably equipped cars have essentially the same list price.

In this setting, reliability refers to price variation and there is more variation (less reliability) in the underlying Blue Book prices than there is in the manufacturer's list price.

P1-7. Accounting Information Characteristics

Requirement 1:

“Cash” and “Net accounts receivable” are both *relevant* to the loan decision because they provide information about cash flows and thus about the company's ability to make principal and interest payments as they come due. The balance in “Accumulated depreciation”, on the other hand, says nothing about the company's current or future cash. Consequently, this information is not relevant to the loan decision.

Requirement 2:

“Cash” is the most *representationally faithful* balance sheet item. The amount of cash on hand and in the bank at a particular moment in time can be determined with a high degree of accuracy. “Net accounts receivable” is less so because its determination requires estimates of future sales returns and bad debts. These estimates, which are essential to the accounting process, reduce the faithful representation of this balance sheet item. “Accumulated depreciation” is also less representationally faithful than “Cash” because its measurement requires estimates of salvage (residual) value and useful life.

P1-8. Accounting Conservatism

Requirement 1:

Accounting conservatism requires that the land now be shown on the balance sheet at the lower amount \$3 million, its estimated fair market value, rather than at the \$5 million you paid two months ago. Conservatism is the practice of recording possible losses—in this case, the decline in value of the land—as soon as they become probable and measurable.

Requirement 2:

Accounting conservatism requires that the land continue to be shown on the balance sheet at the price paid two months ago (\$3 million) rather than the higher estimated fair value (\$5 million). Conservatism records losses as soon as they are probable and measurable, but additional requirements must be met to record gains (as you will soon discover in Chapter 2).

P1-9. Your position on the issues

1) Accounting is **not** an exact science. One reason this is the case is that many financial statement numbers are based on estimates of future conditions (e.g., future bad debts and warranty claims). Another reason is that there is no single accounting method that is best for all companies and situations. Thus, different companies use different methods to account for similar transactions (e.g., depreciation of property and the valuation of inventory).

2) While some managers may select accounting methods that produce the most accurate picture of a company's performance and condition, other managers may make financial reporting decisions that are self-serving and strategic. Consider the following examples:

- Managers who receive a bonus based on reported earnings or return on equity may make financial reporting decisions that accelerate revenue recognition and delay expense recognition in order to maximize the present value of their bonus payments.
- Managers who must adhere to limits on financial accounting ratios in debt covenants may make reporting decisions designed to avoid violation of these contracts.
- More generally, managers are likely to make financial reporting decisions that portray them in a good light.

The moral is that financial analysts should approach financial statements with some skepticism because management has tremendous influence over the reported numbers.

3) This is probably true. Financial accounting is a slave to many masters. Many different constituencies have a stake in financial accounting and reporting practices—existing shareholders, prospective shareholders, financial analysts, managers, employees, lenders, suppliers, customers, unions, government agencies, shareholder activist groups, and politicians. The amount and type of information that each group demands is likely to be different. As a result, accounting standards in the United States reflect the

outcome of a process where each constituency tries to advance its interests.

Examples illustrating the politics of accounting standards are interspersed throughout this book.

4) This is false. Even without mandatory disclosure rules by the FASB and SEC, companies have incentives to voluntarily disclose information that helps them obtain debt and equity financing at the lowest possible cost. Failure to do so results in higher cost of debt and equity capital.

5) This is true. If the information is value-relevant—meaning, important for investors to know—there is no obvious reason not to disclose the information except when doing so places the company at a competitive disadvantage.

6) The best response is that the statement is false because:

- Managers have incentives to develop and maintain a good relationship with financial analysts. Failing to disclose value-relevant information (good or bad) on a timely basis can damage this relationship.
- Under the U.S. securities laws, shareholders can sue managers for failing to disclose material financial information on a timely basis. To reduce potential legal liability under shareholder lawsuits, managers have incentives to disclose even bad news in a timely manner.

7) This may be true or false. If a company discloses so little information that investors and lenders cannot adequately assess the expected return and risk of its securities, then its cost of capital will be high. In this case, managers are doing shareholders a disservice by not disclosing more information to financial markets. If, on the other hand, increased disclosure harms the company's competitive advantage, managers have helped shareholders.

P1-10. Economic Consequences of Accounting Standards

Requirement 1:

There are several economic consequences that could arise when companies are forced to alter their past accounting methods—in this case, by recording a new liability and corresponding expense.

Mandatory changes in accounting methods of this sort can disrupt contracts that are defined in terms of accounting ratios. One example is a loan agreement that restricts the firm from exceeding some maximum debt-to-equity ratio. The accounting change will add additional dollars to debt and

simultaneously subtract dollars from equity, and thus may cause the firm to violate its lending agreement. The costs associated with violating the agreement represent an economic consequence of the accounting change.

In response to the possibility of violating the loan agreement, management may decide to sell some otherwise productive assets. The cash raised could then be used to pay down debt, and the accounting gain would increase reported equity. This would soften the adverse effect of the accounting change on the company's debt-to-equity ratio. But notice that the asset sale is occurring only in response to the accounting change—and thus it too represents an economic consequence of the change.

And, as described in requirement 2, management may decide to reduce or curtail employee healthcare benefits so that the recorded liability (and expense) is as small as possible. This benefit reduction becomes an economic consequence borne by employees of the company.

Requirement 2:

There are widely divergent views on whether the FASB should consider the economic consequences of its actions when formulating accounting standards.

On the one hand, *SFAC No. 2* states that “neutrality” is a desired characteristic of financial statement information. Neutrality means that the information cannot be selected to favor one set of interested parties over another. So, real liabilities cannot remain unrecorded just because recording them may cause some firms to violate their lending agreements. When applied to the standard setting process, neutrality means that the FASB should ignore the economic consequences of alternative accounting practices.

A more practical problem is that it is exceedingly difficult to quantify those consequences in any meaningful way. How can the FASB determine which firms will likely violate their lending agreements or what it will cost them if they do so? And what about the economic consequences of likely changes in management's actions (e.g., asset sale, reduced employee benefits, etc.)? Even if the FASB was able to quantify all of the potential consequences associated with a particular proposed accounting change, it would still face the gargantuan task of deciding whether the total benefits outweighed the total costs to the various parties involved. For example, should lenders be

avored and employees harmed by requiring health care liabilities to be shown on the balance sheet? Or, should lenders be harmed and employees favored by keeping health care liabilities off the balance sheet?

Of course, the interested parties themselves fervently believe the FASB should consider the economic consequences of alternative accounting practices when formulating standards. To do otherwise, they argue, is to ignore a simple fact that mandatory accounting changes sometimes have real consequences.

P1-11. Two Sets of Books

Requirement 1:

Companies maintain a set of “tax” books to properly compute taxable income according to IRS rules. Companies maintain a set of GAAP books to properly compute net income, balance sheet amounts, and cash flows according to SEC and FASB rules. Because IRS rules differ from GAAP, two sets of books are required.

Requirement 2:

There are several reasons why it might not be a good idea to force companies to issue the same financial statements for both IRS and SEC purposes. For instance:

- The two regulatory agencies have entirely different financial reporting goals. The IRS is concerned with the timely collection of tax revenues in accordance with federal income tax law. The SEC (and the FASB) is concerned with ensuring that firms provide timely information useful for decision making purposes. There is no reason to believe that the same set of “books”—accounting procedures—can serve both purposes equally well.
- IRS rules for computing taxable income are determined by tax laws intended to achieve a variety of social purposes. The resulting income measure may not be particularly useful for other purposes like equity valuation or credit risk assessment.
- Political compromises have a substantial impact on tax law, and thus on IRS accounting. Requiring IRS and SEC conformity (i.e., a single set of

books) would expose GAAP financial reporting standards to these same political winds.

P1-12. Accounting quality and the audit committee

1) By identifying the key business and financial risks facing the company, the audit committee can ensure that those risks are properly disclosed in the MD&A (Management Discussion & Analysis) section of the annual report. A second reason is that management's answers may also flag areas where subjective accounting judgments and estimates are used in preparing the financial statements (see 2).

2) By identifying areas where subjective judgments and estimates are used, the audit committee can probe management about the "quality" (objectivity and accuracy) of the estimates, benchmark to estimates of other firms, and gauge the impact of estimate changes on the financial statements. Estimated uncollectible accounts receivable is a concrete example. Here the audit committee will want to know how this year's estimate was determined, the reason for any change from last year, and how the estimate compares to estimates for other firms in the industry.

The answers to this question—how are those judgments made and estimates determined—are important for the reasons outlined above. They help the audit committee gauge the "quality" of the accounting judgments (e.g., when to record revenue) and estimates (e.g., the uncollectible portion of accounts receivable).

3) By identifying significant areas where the company's accounting policies were difficult to determine, the audit committee can probe management about its choice of accounting methods in situations where GAAP may not provide clear guidance. This way the audit committee can uncover practices that might be overly aggressive or overly conservative in portraying the firm's true economic performance and condition.

4) Significant accounting deviations from usual industry practice are a "red flag" for stock analysts and investors. That's because the deviation is often viewed as an indication that the financial statements are being "managed" to look better than they should. The audit committee will want to probe management about the reason for any deviation from industry practice, and gain confidence that the chosen practice more accurately reflects the economic fundamentals of the business or transaction. The audit committee may also want management to better explain its choice of accounting practices in the annual report.

5) Changes in accounting methods can sometimes have a dramatic impact on financial statements and on the company's stock price if investors react negatively to the change. The audit committee will want to probe management about the reason for the change, and gain confidence that the new accounting method better reflects the economic fundamentals of the business or transaction. The audit committee may also want management to take special steps in communicating the change to the marketplace.

6) Here the audit committee is asking for a "heads up" about potential changes in accounting practices—both those required by GAAP and those made voluntarily by management. See 4 and 5 above for reasons why the audit committee might want to know about possible accounting changes in advance.

7) "Serious problems" can include internal control lapses, incomplete documentation of transactions, errors (inadvertent failure to record a transaction), and accounting "irregularities" (intentionally booking revenue earlier than GAAP allows). The audit committee is interested in knowing about these problems because they can signal accounting system weaknesses, lax internal controls, and culture of dishonesty or deception that threatens management credibility and financial statement integrity.

8) There are two reasons the audit committee is interested in the answer to this question. First, outsiders may have uncovered a real accounting quality threat that is as yet unknown to the committee. Second, the committee may want management to address outsiders' concerns—real or imagined—so that management credibility and financial statement integrity remains intact.

9) The answers to this question can also uncover areas where accounting quality can be threatened. The committee will want to also hear from the auditor about the nature of the dispute and its resolution.

P1-13. Worldwide Convergence of Accounting Standards

Requirement 1:

There are at least two arguments supporting worldwide convergence of accounting standards. These arguments involve the claimed benefits of increased financial statement **transparency** and **comparability**.

One argument for a common set of accounting standards is the global convergence of financial markets themselves. Foreign stocks and foreign investors make up an increasing fraction of the trading activity on most major stock exchanges today. A single set of worldwide accounting standards

would eliminate local financial reporting differences, provide a common frame of reference for interpreting corporate financial reports, and thereby facilitate market efficiency. The gist of this argument is that convergence yields enhanced *comparability* across companies domiciled in different countries.

A second—and more controversial—argument is based on the notion that IASB standards are superior to those in use locally. According to this view, worldwide convergence eliminates local GAAP deficiencies and thus yields financial statements that better reflect the underlying economics of the business (enhanced *transparency*). These improvements in the quality of financial statement information then yield increased financial market efficiency.

As this chapter has stressed, the economics of accounting standard setting involves complicated cost and benefit tradeoffs. So, an obvious potential disadvantage of worldwide convergence is that, for many individual firms, the cost of convergence may exceed the benefits obtained. This might be especially true for small, publicly traded companies that rarely need access to new financial capital. A second disadvantage is the potential loss of competition in the market for accounting standards themselves. No single set of standards are likely to be universally preferred by all firms and all investors at all of the time. Elimination of local standards may stifle financial reporting innovation.

Requirement 2:

According to Mr. Tweedie's remarks, convergence will likely increase investor confidence in China's capital markets and financial reports. This benefits the Chinese investor who buys stocks in local companies by ensuring that: (1) high quality financial information is readily available to support buy/sell decisions (better transparency); and (2) capital markets are efficient in reflecting that information in stock prices.

Requirement 3:

U.S. investors benefit in several ways. First, the cost of processing financial statement information about Chinese companies is reduced because U.S. investors would no longer need to be knowledgeable in both local and global GAAP (enhanced comparability). Second, the firm's cost of compliance with diverse accounting standards (a point mentioned in Mr. Tweedie's remarks) may also be reduced. This savings presumably makes the firm more valuable which benefits all investors.

P1-14. Debt Covenants and Aggressive Accounting Practices

Requirement 1:

When a company violates its debt covenants, lenders can respond in any of several ways. They can simply waive the violation which is akin to a “slap on the wrist”. Or, they can amend the loan agreement and thereby charge a higher rate of interest, accelerate repayment terms, or impose more stringent covenants on the borrower. (Chapter 7 tells you more.) If the lender refuses to waive or amend the loan terms, the borrowed amount becomes due immediately and this action may force the borrower to declare bankruptcy.

Requirement 2:

Although the details of the company’s EBITDA covenant are not spelled out in the company’s press release, Friedman’s is required to maintain a minimum level of profitability (measured using EBITDA) over several periods. Aggressive accounting practices—premature revenue recognition or delayed expense recognition—could be used to keep EBITDA above the minimum required in the loan agreement. Examples might include underestimation of future uncollectibles, inappropriate capitalization of operating expenses, recognizing as sold items jewelry that is just being held pending approval by the customer.

Requirement 3:

Friedman’s is required to maintain a minimum ratio of accounts payable to inventory. To avoid violating this minimum ratio requirement, the company could understate its actual inventory balance.

P1-15. Proxy Contests and Aggressive Accounting Practices

Heinz management is confronting a proxy contest waged by Trian Group. In a proxy contest, managements’ personal stakes are high because dissident shareholders (e.g., Trian and its supporters) can vote to “throw the bums out.” Demonstrating profitable growth is one way to mute Trian’s criticisms of management and to persuade shareholders that the current executive team should continue running the business. And that is what the company’s quarterly earnings release does: profits are up 29% (\$0.58 compared to \$0.45), sales are up 8.4% and unit sales volume is up 5.1%. Financial statement readers should take a careful look behind the numbers to make certain that the reported sales and profitability improvements are real. After all, management has a strong incentive to make the numbers look better than they truly are.

P1-16. Toshiba Corporation

Requirement 1:

The company's 2009 annual report opens with a Management Discussion and Analysis typical of U.S. companies. This MD&A contains a five-year summary of selected income statement and balance sheet accounts, a review of operations and key performance indicators (e.g., ROE, Debt/Equity), results by geographical region and industry segment, capital expenditures and construction plans, along with a discussion of cash flows and treasury stock transactions. The MD&A also describes significant risk factors that the company and its businesses must confront.

Requirement 2:

The following financial statements are included in the 2009 annual report: Consolidate Balance Sheets, Statements of Income, Shareholders Equity and Cash Flows each denominated in Japanese yen and for the most recent year, in U.S. dollars.

Requirement 3:

According to Note 2 Summary of Significant Accounting Policies, the company's financial statements are prepared in accordance with Japanese GAAP. However, "certain adjustments and reclassifications have been incorporated in the accompanying consolidated financial statements to conform with accounting principles generally accepted in the United States. These adjustments were not recorded in the statutory books of account." In other words, Toshiba uses Japanese GAAP for its statutory (domestic) financial statements but U.S. GAAP in the consolidated statements displayed in this English-language annual report. Conformity to U.S. GAAP is confirmed in the Report of Independent Auditors.

Requirement 4:

In this case, the answer lies in the response to Requirement 3: No difference exist because Toshiba uses U.S. GAAP in the consolidated financial statements displayed in the company's English-language annual report.

P1-17. Carrefour Group

Requirement 1:

The company's 2008 "annual report" contains summary consolidated financial statements of income, financial position, and cash flow. No financial statement notes are included in the annual report, although selected financial results by geographical segment are reported.

Requirement 2:

Most of the annual report is devoted to describing the company, its strategic goals and core values including the customer value proposition: brand strategy, store configuration and development goals, convenience and pricing. A section of the annual report discusses the company's commitment to socially responsible business activities including employee relations and environmental footprint. The concluding section of the annual report provides biographical information about the company's board of directors and top executives.

Requirement 3:

The company's 2008 "financial report" contains detailed consolidated financial statements (financial position, income, shareholders' equity, and cash flows) along with comprehensive notes to those statements. The financial statement amounts are denominated in euros.

Requirement 4:

Carrefour's consolidated financial statements are prepared in accordance with International Financial Reporting Standards (IFRS) as approved by the European Union.

Requirement 5:

The order in which individual accounts are listed by Carrefour Group on the asset side and liabilities/equity side of the statement of financial position is the reverse of what is common among U.S. companies. For example, the first asset listed is Goodwill, followed by other intangibles and long-term investments. Next come current assets, starting with inventories and ending with Cash and non-current assets held for sale. The liabilities/equity portion of the balance sheet lists shareholders' equity accounts first, followed by long-term borrowing and other long-term obligations, with current liabilities (short-term borrowing and accounts payable) shown last.

Financial Reporting and Analysis (5th Ed.)

Chapter 1 Solutions

The Economic and Institutional Setting for Financial Reporting Cases

Cases

C1-1. AST Research: Restating quarterly results

The situation involved (a) dollar amounts that were “large” in absolute amount and relative to reported sales and earnings; (b) the accounting change had no direct cash flow impact; and (c) the accounting change involved the SEC.

Why didn't investors penalize AST when its accounting change transformed \$14.1 million of profits into an \$8.1 million loss? One explanation is that AST investors did penalize the share price, but they did so prior to the company's formal announcement of the accounting change on June 8, 1995. If investors correctly *anticipated* the AST accounting change and thought that it was bad news, the company's share price would have fallen *before* the June 8 announcement date. In point of fact, AST's stock price had not declined during the weeks before its accounting change was announced.

When might you expect to see a negative share price reaction to an accounting change like that made by AST?

- When the firm is using a method that few other companies in the industry use. Investors may mistakenly fail to adjust for the accounting difference when valuing the company. The accounting change alerts investors to the difference and they accordingly revalue the firm.
- Concerns are raised about the firm's economic viability and its ability to finance continued expansion. (Recall AST transformed profit into a loss!) Investors may lower the stock price to reflect less optimistic forecasts of profitability and growth.
- The company's use of capitalization is described by analysts and the financial press as an attempt to “manage” its reported earnings. The accounting change may cause investors to question the quality of the firm's financial statements and management's commitment to shareholder value.

The AST accounting change seems, on the surface, to have resulted from a simple difference of opinion regarding acquisition accounting rules in effect at

that time. There is nothing in the news article to suggest lower growth opportunities or questionable behavior on the part of company managers.

Some instructors may want to use this case to explore notions of market efficiency.

AST Research reported operating losses in both 1995 and 1996. In April 1997, the company was acquired by Samsung Electronics for \$5.40 per share. This price is substantially below the \$17.63 per share market price at the time of the Wall Street Journal article.

C1-2. Henley Manufacturing Inc.: Announcing sales and earnings goals

Requirement A:

1) Potential **costs** of announcing earnings and sales goals include: (a) possible shareholder lawsuits if goals are not met; (b) loss of reputation if goals are not met; (c) disclosure may convey information to competitors about the profitability of products or market territories; (d) managers may take dysfunctional actions—ease credit terms, decrease advertising expenditures, reduce R&D expenditures—near the end of the accounting period if it looks like the goals will not be met.

Potential **benefits** include: (a) investors can better understand the risks and rewards of stock ownership because they know more about the management's plans; (b) disclosure may improve relationships with lead investors and analysts, especially if it's part of an ongoing communications strategy and not just a one-time event; (c) investor and creditor uncertainty may be reduced, thus lowering the company's cost of debt and equity financing.

2) Should management disclose its earnings and sales goals? It depends on whether the benefits outweigh the costs, and on how confident management is that the goals can be achieved.

Easily achievable goals are likely to be disclosed without much reservation. Difficult goals are less likely to be disclosed because management may not want to risk disappointing investors if results fall short of target. One way to avoid disappointment is to make the goals less specific—for example, “sales are expected to increase by as much as 15%” or “sales are expected to be up substantially next year.”

3) In all likelihood, the recommendation would change. Consideration would now be given to the fact that, as the planning horizon increases, it becomes

more and more difficult to forecast accurately. For example, major changes in market-wide and industry-wide competitive conditions over the next two or three years could have a dramatic impact on whether or not the goals can be achieved.

Requirement B:

In this case, the nature of the goals is quite varied. In all likelihood, investors and financial analysts are going to be more interested in profitability and cash flow forecasts than in other financial aspects of the company. As a result, it is reasonable to recommend disclosure of the following goals—subject to the cost and benefit considerations mentioned earlier: annual sales growth of 15%; annual earnings growth of 20%; a return on net tangible assets of 16%; a return on common equity of 20%; a minimum profit margin of 5%.

C1-3. Whirlpool Corporation: Disclosing major customers

1) The SEC requires firms to alert financial statement readers about major customers that contribute 10% or more to annual sales. Such information helps investors and analysts assess sales volatility and the potential impact on profitability of the loss of a major customer. The information is especially important for companies operating in industries where customers are concentrated and competition for customers is intense.

2) Financial analysts might use these disclosures in the following ways:

- To assess customer risk. The more revenue a company derives from a single customer or small group of customers, the greater the adverse impact on profitability if one or more of these customers is lost to a competitor or simply goes out of business.
- By studying a firm's major customers (i.e., the products they sell, expected future demand for such products, untapped markets in other countries or geographical areas), an analyst can determine the likelihood of increased future sales to that customer and, hence, profits to the selling company. However, the name of a major customer need not be disclosed so analysts may not always be able to specifically target such information.

3) The primary reason Sears monitors Whirlpool's financial health is to ensure that Whirlpool can be relied upon as a supplier of durable goods (refrigerators, air conditioners, washers, and dryers, etc.) to be sold at Sears. The buyer (Sears) wants to make certain that goods will be produced, delivered, and available in Sears' stores when consumers want them.

Sears is likely to monitor the following aspects of Whirlpool's operations: inventory levels, expenditures for research and development, overall profitability (i.e., the income statement), financial health and the mix of debt and equity financing (i.e., the balance sheet), and cash flow generating ability (i.e., the cash flow statement).

Whirlpool probably provides Sears with financial information beyond that contained in the company's shareholder financial statements. This additional information might well include inventory levels for individual products, production lead times for various products, new products in development, features being considered for new products, and product improvements being considered.

4) Whirlpool monitors the financial health of Sears to ensure that Sears will be a continuing source of demand for its products in the future. Whirlpool is likely to monitor the following aspects of Sears' operations: inventory levels, sales, advertising expenditures, overall profitability, financial health and debt levels, and cash flow generating ability.

Sears may provide Whirlpool with information beyond that reported in its shareholder financial statements. For example, additional information could include days' sales in inventory for Whirlpool products, market surveys results about features consumers want to see in new products, and special promotions that will feature Whirlpool products.

C1-4. The gap in GAAP

1) Advantages of allowing managers some flexibility in the choice of financial reporting methods include:

- Accounting must serve as a slave to many masters. Stated differently, financial accounting information is used for many purposes including valuation, credit analysis, and contracting, and no single set of financial reporting methods would serve each of these purposes equally well. By allowing managers some latitude in the choice of financial reporting methods, they can weigh the trade-offs implicit in making the firm's financial reports informative for each of these potential uses.
- If managers have some latitude in their choice of financial reporting methods, they can adapt the firm's financial reporting practices to changes in the firm's economic characteristics and/or environment over time. For example, a change in the rate of technological advance in a firm's industry may mean that new long-term assets should be written off at a faster rate than was previously the case. For example, a company that previously

used straight-line depreciation may now find that accelerated depreciation presents the most accurate picture of the firm's economic environment.

2) The current financial reporting system in the United States is really a combination of the two approaches.

On the one hand, firms have latitude in the selection of accounting methods to summarize various transactions and events. Examples include inventory valuation where firms may select from LIFO, FIFO, or weighted average; depreciation policy where they may select from straight-line or accelerated methods such as sum-of-the-years'-digits or declining-balance methods; and accounting for oil and gas exploration costs where firms may apply the full-cost or the successful-efforts method.

On the other hand, there are numerous cases where the FASB (or SEC) has mandated a single accounting method or treatment for various transactions or events. Examples include research and development expenditures which must be expensed in the year incurred; leases which must be capitalized and reported as liabilities on the balance sheet if certain criteria are met; accounting for foreign currency translation; and accounting for pension benefits and other postemployment benefits other than pensions.

3) The **advantages** of a single set of accounting methods include:

- Facilitates comparability of financial information across firms at a point in time and over time. This may be appealing to financial analysts because it potentially makes their work easier.
- Ease of verification by the auditing profession. This may lead to fewer shareholder lawsuits against the company or its auditors for aggressive financial reporting decisions made by managers. External auditors may find the ease of verification beneficial to them.

The **disadvantages** of a single set of accounting methods include:

- Assumes that the financial performance and condition of all firms can adequately be captured by a single set of accounting methods. Implicitly assumes that firms are homogeneous. Moreover, that all firms have identical economic features and characteristics and face identical economic environments.
- Assumes that a single set of accounting methods serves all the potential uses of financial statement information (e.g., valuation, credit analysis, and contracting).

The **advantages** of allowing flexibility in the choice of financial reporting methods include:

- Firms can tailor their choice of financial reporting methods to the specifics of their economic environment and circumstances. For example, depending on whether the prices of its input products are increasing or decreasing, FIFO may be a more realistic choice of inventory valuation method for income determination purposes when compared to LIFO (or vice versa). As another example, in industries where long-term aspects are subject to a rapid rate of technological advance and change, accelerated depreciation methods may be superior for income determination purposes when compared to straight-line (or vice versa).

The **disadvantages** of allowing some flexibility in the choice of financial reporting methods include:

- May detract from making comparisons across firms at a point in time and over time.
- Managers may use their discretion over reporting methods to distort the firm's performance. They might adopt financial reporting practices that create the appearance of profitability in an attempt to hide or cover up poor operating performance. They might also adopt financial reporting practices that accelerate the recognition of revenues and delay the recognition of expenses in an attempt to maximize the present value of payouts from bonus plans tied to reported profitability.

C1-5. Federal Express: Making sense of an earnings announcement

Let's start with the "good news" in FedEx's earnings announcement: net income for the quarter was \$1.53 per share, up 39% from the \$1.10 per share earned the same quarter one year ago. In addition, sales revenue was up 11% for the quarter compared to one year earlier. The company also raised its earnings "guidance" (meaning managements' forecast) for the year from \$6.30 per share to \$6.65.

So, why did the share price fall (rather than rise) when investors learned about this "good news"? One reason may be that there was little surprise to the "news" from FedEx. After all, the Standard & Poor's analyst was already predicting quarterly earnings of \$1.52 and the company beat this forecast by just a penny. A second reason may be that prospects for next year are now looking less rosy: the Standard & Poor's analyst lowered his 2007 (next year) forecast from \$6.80 per share to \$6.65 per share. Both factors may explain why investors seemed to overlook the apparent "good news" in the FedEx earnings announcement.

C1-6. Landfil's accounting change

Here are the major positions outlined at the meeting:

- "It's consistent with GAAP and fully disclosed." While true, this approach may not be comforting to analysts and investors concerned about whether capitalization makes the company look more profitable than it really is. Given the steep price decline at Chambers Development, analysts and investors will be scanning their radar screens for other capitalization companies, and they will surely discover Landfil's accounting. Unless capitalization can be strongly defended, the company's share price is likely to fall.
- "We capitalize, and we're proud of it!" The heart of this strategy is the notion that the company has already made the "correct" accounting decision—one that fairly portrays the profit performance and asset base of Landfil. If investors and analysts can be convinced, continued use of capitalization should not result in a share price decline...but can they be convinced?
- "We can afford to change." Even if capitalization is the "best" (most appropriate) accounting method for Landfil, it still might be advantageous to change. First, a change to immediate expensing will dispel any remaining skepticism on the part of investors and analysts. Second, it demonstrates management's confidence in the company's prospects and its ability to absorb the dollar impact of the change. But this strategy is risky—investors and analysts may incorrectly presume that capitalization was being used to "manage" reported earnings. This may cause them to question the company's other accounting methods and the quality of its financial reports.