

Chapter 1—Solutions

Questions

1. Because it reflects financial performance at a point in time.
2. You could call them “videos,” in that they describe performance over a period of time.
3. Because shareholders’ equity represents a residual claim against the assets of the firm. Therefore, it will expand or contract to whatever size it needs to be to ensure that the two sides of the balance sheet are equal.
4. It’s an attestation by independent public accountants on the reliability of a company’s financial statements. The auditor tell us whether the financial statements were prepared in accordance with GAAP or IFRS, and therefore whether readers can rely on them in making economic decisions such as whether or not to invest in the firm.
5. A law that was passed in the U.S. in the aftermath of the Enron scandal. Among other things it requires all companies (including non-American) that file with the Securities and Exchange Commission to provide an attestation on the trustworthiness of the company’s financial statements from the CEO, the CFO, and maybe the chief accountant. A statement is also required on the quality of the company’s internal controls. Similar requirements have since been imposed in several other countries, although they tend to be less onerous than Sarbanes-Oxley.
6. The first issue is the sheer volume of information readers and analysts must contend with. The obvious risk is one of information overload, and determining which of the many pieces of data are truly important for gaining an accurate understanding of a company’s financial strength and performance. Second, accounting choice can profoundly impact the figures reported on the financial statements. The implication is that financial accounting is a far from being an objective discipline. Three, financial statements can be manipulated. Fourth, the financial statements, and even the accompanying notes, can exclude critical attributes of a company that will profoundly influence future performance. Examples include investment in intellectual capital or brands. Current accounting practice is limited in what it can tell the reader about such assets.
7. Financial accounting exists to help us understand the underlying economic truth of a company. That way, the world’s scarce resources are allocated more efficiently, with the result being greater wealth creation. However, because so much estimation and judgment is required in the accounting process, error is inevitable. Some of that error arises from good faith mistakes on the part of managers who are trying their best to come up with the right numbers. But a lot of that error can be deliberate. This happens when managers deliberately bias accounting numbers upwards or downwards to achieve certain financial reporting goals.
8. Although financial reporting under GAAP and IFRS is separate from tax reporting, companies will often choose financial reporting practices to support a controversial tax position. For example, it may be difficult to defend a position that leads to lower income

than the tax authorities believe is reasonable when GAAP or IFRS lead to far higher profits. In such cases, the biasing of accounting numbers to yield lower profits may result in tax savings. We'll leave the ethics of this behavior to another day. Also, companies may bias accounting numbers to avoid the violation of restrictive covenants in debt contracts. Such violations can be costly, because they may lead to debt getting called in by the bank or a renegotiation of the debt on more onerous terms.

9. They are linked in many ways, but three obvious links are (1) the reconciliation of beginning and ending cash from the balance sheet on the statement of cash flows, (2) the net income figure on the income statement which serves to reconcile beginning and ending retained earnings, and (3) the reconciliation between net income and cash flow from operations.
10. The notes provide amplifying details on financial statement line items. Placing all of that detail on the face of the statements would render them confusing and difficult to read. So the details are reported in the notes that follow the financial statements. An example would be financial details on operating divisions. Another example would be the detailed breakdowns for debt, provisions and income taxes. The notes also describe the accounting policy choices made by management, allowing the reader to better understand the reporting assumptions that underlie the financial statements.
11. To reconcile beginning and ending balances for every account in the shareholders' equity section of the balance sheet. In this way, the way can see the movements into and out of those accounts.
12. Although GAAP and IFRS provide guidelines for financial reporting, many choices must be made by management. For example, what depreciation method to use, the estimated useful lives of depreciable assets, etc. Will we revalue property, plant & equipment, or continue to use acquisition cost? What will be the specific policies we adopt regarding revenue recognition? Managers have some latitude in making these decisions. This is what is meant by "accounting choice." The concept is not only important for business managers but for financial statement readers too. Different policy choices can lead to very different outcomes on the financial statements. The reader must be aware of these choices and determine whether the choices made by the management of a particular firm were appropriate.
13. Earnings management is the conscious act of biasing accounting numbers to achieve specific financial reporting results. Such acts are often driven by executive bonus plans linked to specific accounting numbers, such as EPS or operating income, or by a desire to manage or finesse the company's share price. Planned public offerings or management buyouts can also create incentives for earnings management.

Problem 1.1

Problem 1.2

2011:

Total assets = 12,999

Noncurrent assets = 8,389

Total liabilities = 7,039

Total shareholders' equity = 5,960

Share capital = 2,659

2010:

Total assets = 13,037

Total liabilities and shareholders' equity = 13,037

Retained earnings = 1,808

Total shareholders' equity = 4,958

Total liabilities = 8,079

Noncurrent liabilities = 5,510

2009:

Current assets = 3,763

Noncurrent assets = 7,830

Total liabilities and shareholders' equity = 11,593

Share capital = 3,983

Noncurrent liabilities = 3,791

Total liabilities = 6,410

Problem 1.3

- a. Unqualified, also known as a "clean" opinion.
- b. True and fair means that, in the auditor's view, the financial statements are free from material misstatements and faithfully represent the financial performance and financial position of the company.
- c. It means that investors and any external parties have the right to rely on the statements and the supplemental disclosures in making decisions regarding the company. For example, should we invest in it? Should we lend it money? Is this a good company to work for?
- d. Management has the responsibility for preparing the financial statements in a manner that is true and fair, and for creating and maintaining a system of internal controls that help ensure the integrity of the reported accounting numbers. Auditors have the responsibility of rendering an opinion on whether or not the financial statements conform with accounting guidelines, such as IFRS or U.S. GAAP.

Case 1.1

Balance Sheet

1. What was the magnitude and direction of the change to *Total assets* for 2010?

An increase of 27,682 (58.3%)

2. What was the magnitude and direction of the change to *Total liabilities* for 2010?

An increase of 11,531 (72.7%)

3. What was the magnitude and direction of the change to *Total shareholders' equity* for 2010?

An increase of 16,151 (51.1%)

4. Verify that the sum of your answers to 2. and 3. equals your answer to number 1.

$27,682 = 11,531 + 16,151$

5. What specific accounts explain the majority of the changes to *Total Assets*?

Cash and cash equivalents increased 5,998

Long-term marketable securities increased 14,863

Those two accounts explain 75% of the change.

6. Based on your own experience, think about what makes Apple a valuable company.

Does this “asset” that you’ve imagined appear on Apple’s balance sheet? Are you satisfied that the balance sheet accurately reflects this value? Why or why not?

Apple’s customer loyalty, and it’s ability – at least recently – to introduce products that lead the market as opposed to following others, have made the company successful. While some of the outcomes are on the balance sheet (e.g., the huge pile of cash and investments), these assets themselves are not.

From an economic perspective, most analysts would consider customer loyalty and ability to innovate to be “assets”. However, the accountant does not record such items on the balance sheet as assets. The subjectivity and uncertainty involved in determining the value are too great, therefore these do not appear.

Income Statement (“Consolidated Statement of Operations”)

7. What was the magnitude and direction of the change to *Net sales*?

An increase of 22,320 (52.0%) in 2010, and 5,414 (14.4%) in 2009.

8. What was the magnitude and direction of the change to *Net income*?

An increase of 5,778 (70.2%) in 2010, and 2,116 (34.6%) in 2009.

9. Do the changes above seem consistent with the changes in *Total assets* you calculated previously?

Yes, as the success of the firm continues in terms of sales and income, the result is the increase in the assets previously observed.

10. Based on your own experience, think about the various product lines that generate these revenues (another word for “sales”) for Apple. Do you see the revenue from the individual product lines on the statement? Are you satisfied that the income statement accurately reflects these revenues? Why or why not?

While Apple is a consumer electronics company, that includes a variety of products: phones, various computers, music and material available for download, etc. While the revenues from all of these lines are on the income statement, they are in a highly aggregated form: a single line of “Net sales”. This is not helpful from a forward looking standpoint, especially if the rates of growth in the product lines differ. That is, it would be difficult to forecast a single sales number when it is made up of a basket of products that grow at different rates.

Statement of Cash Flows

11. What are the names of the three sub-sections that present the different sources of cash flow for the year?

Operating, investing, and financing.

12. Note that *Net income* is the first figure used in calculating *Cash generated by operating activities*. How does *Net income* compare to *Cash generated by operating activities*?

Net income is consistently lower than cash from operations.

13. What does Apple appear to be doing with the cash that it generates from its day to day operations? Hint: review *Investing activities*.

For the most part, the company is investing the cash in securities (stocks and bonds), rather than significantly expanding productive capacity. While the company sells a lot of securities or lets them mature each year (roughly \$46.7 billion in 2010), it plows the cash back into these markets (\$57.8 billion in 2010).

14. Does Apple appear to have significant *Financing activities* to report?

Not really. Cash from financing activities is 6.8% of that from operations in 2010, and 9.1% of outflows for investing. It is much smaller than these other categories.

Case 1.2

No. While the official GAAP numbers reveal 12% growth, supplemental disclosure reveal that a significant portion of that growth (5%, or 5/12 of the total) regarding from currency changes and acquisitions. A more accurate reflection of growth can be seen from the table shown at the end of the case. The growth in volume (3%) and effective net pricing (4%) represent true growth for PepsiCo in 2007. Growth of 7% is still very good, but it's not 12%.