**Chapter 1: Solutions to Real-World Review Box Questions**

**Pratt & Peters 10e**

Section [page number]

The Demand for Financial Information: A User’s Orientation [pg. 13]

Sales [$11.9B] (Income Statement); net income [$0.957B] (Income Statement); total assets [$6.8B] & total liabilities [$4.0B] (Balance Sheet): net cash flows from operating activities [$1.2B] (Statement of Cash Flows).

Total expenses: $11.9B – total expenses = $0.957B; therefore, total expenses = $10.943B

Shareholders’ equity: $6.8B – $4.0B = $2.8B

Net income/sales: $0.957B / $11.9B = .08

The Economic Environment in Which Financial Reports Are Prepared and Used [pg. 17]

Net income represents a measure of the company’s past performance. In a sense it represents the wealth created by management’s business decisions for the shareholders during a specific period of time. To the extent that the past is an indication of the future past net income trends are often helpful when predicting future net income amounts. Many companies based management’s compensation on the net income management creates from its business decisions because these kinds of compensation arrangements align management’s incentives with those of the shareholders. Increasing net income benefits both parties.

The Economic Environment in Which Financial Reports Are Prepared and Used [pg. 18]

Manufacturing (Boeing, Tommy Hilfiger, DuPont, Microsoft, General Electric)

Service (American Express, eBay, Southwest Airlines, Sprint)

Corporate Governance [pg. 19]

When the shares of a publicly-traded company are purchased by entities (like KKR and Blackstone) and the publicly-traded company is “taken private,” the shares of that company are no longer available for purchase and sale on the public stock exchanges. This gives the acquiring entity total control over the acquired company. In addition, the acquired company is no longer subject to the reporting regulations required of publicly-traded companies, which are extensive and can be quite costly.

Corporate Governance [pg. 20] – Box 1

Chipotle’s shares are publicly-traded and the prices (or value) of those shares are based on how the investment community assesses the prospects of the company. If the prospects for the company’s success are assessed to be good, investors tend to buy the shares and the value goes up; if the prospects for the company are assessed to be poor, investors tend to sell the shares and the value goes down. Thus, stock prices are set by investor assessments of a company’s prospects, which create expectations. Chipotle’s stock price dropped because the investment community expected revenues and earnings to be higher than Chipotle ultimately reported – simply, investors were disappointed; their expectations were not achieved. This encourages the managers of companies to carefully manage the expectations of the investment community, so company management spends much time and effort communicating with company shareholders and potential investors.

Corporate Governance [pg. 20] – Box 2

Motorola compensates its employees on whether they achieve high levels of financial numbers such as sales and net income. These compensation systems are designed to encourage the employees to make business decisions that increase these financial numbers, which also increases the wealth of the shareholders. These systems, therefore, align the incentives of a company’s employees with those of the shareholders, and at the same time allow the employees to benefit from the overall successes of the company. However, they also require the employees to bear risk because low levels of numbers like sales and net income tend to lead to lower levels of compensation.

Corporate Governance [pg. 21]

Publicly-traded companies are required to publish a complete set of financial statements, including the necessary disclosures, on an annual basis; and these statements must be audited by an independent accounting firm and the audit opinion must be unqualified, meaning that the statements have been prepared using generally accepted accounting standards. It appears that Dell and its auditor (PricewaterhouseCoopers) were in disagreement on the way in which the financial statements had been prepared, and the two parties needed time to sort out that disagreement before publishing the statements.

Corporate Governance [pg. 25]

This issue illustrates the tension existing between accounting standard-setters, who are charged with providing standards that lead to financial statements that fairly reflect the actual financial performance and condition of companies, and company management, who wants the statements to reflect as positively as possible on its performance. Most people believe that financial statements that fairly reflect the actual financial performance and condition of companies lead to a more effective and efficient economic system. The real question is whether financial accounting standards, which can be quite costly, represent the best way to achieve that goal.

International Perspective: Financial Statement Users Need to Be Bilingual [pg. 26]

The primary problem with two sets of reporting standards is that it makes interpreting the financial statements more difficult for investors (i.e., investors have to be bi-lingual), especially in cases where the investors are attempting to compare across companies that use different financial reporting standards. In such cases the financial statements may differ, not because the firms differ in an economic sense, but only because the two firms used different methods to compute financial numbers like net income. While using a single set of standards would address this comparability problem, it could introduce other problems because the situations faced by different companies may differ so significantly that a single set of standards is not broad enough to reflect each company’s financial performance and condition fairly.