

## Chapter 2

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# Financial Statements and the Annual Report

**After studying this chapter, students should be able to:**

- Describe the objectives of financial reporting. (Module 1–LO1).
- Describe the qualitative characteristics of accounting information. (Module 1–LO2).
- Explain the concept and purpose of a classified balance sheet and prepare the statement. (Module 2–LO3).
- Use a classified balance sheet to analyze a company’s financial position. (Module 2–LO4).
- Explain the difference between a single-step and a multiple-step income statement and prepare each type of income statement. (Module 3–LO5).
- Use a multiple-step income statement to analyze a company’s operations. (Module 3–LO6).
- Identify the components of the statement of retained earnings and prepare the statement. (Module 3–LO7).
- Identify the components of the statement of cash flows and prepare the statement. (Module 3–LO8).
- Read and use the financial statements and other elements in the annual report of a publicly held company. (Module 4–LO9).

## Chapter Outline

### MODULE 1 FINANCIAL REPORTING OBJECTIVES AND CHARACTERISTICS OF USEFUL INFORMATION

#### Module 1

#### LO 1

#### Financial Reporting Objectives and Characteristics of Useful Information

Financial reporting has one overriding objective: to provide useful information to those who must make financial decisions.

- To external users, the financial statements and the notes and other information found in the annual report are the key sources of information needed to make their business decisions.
  - Balance sheet shows what obligations are due in near future and what assets are available to satisfy them.
  - Income statement shows revenue and expenses for a period of time.
  - Statement of cash flows shows where cash came from and how it was used during the period.
  - Notes provide essential details about accounting policies and other key factors that affect the company's financial condition and performance.
- In preparing the financial statements, accountants must consider:
  - The objectives of financial reporting.
  - The characteristics that make accounting information useful.
  - The most useful way to display the information in the financial statements.
- Financial information users are the main reason financial statements are prepared.
  - They must make economic decisions based on these statements.
- Financial reporting has one overall objective and a set of related objectives, all concerned with how the information may be most useful to the readers.
- The overall objective of financial reporting is to provide financial information to permit external users of the information to make informed decisions on whether to provide resources to the company.
  - Users include management of a company (internal users) and others not involved in the daily operations of the business (external users).
  - External users make their decisions based on general-purpose financial statements prepared by management.
- The purpose of financial reporting is to help the users reach their decision in an informed manner.
  - Investors need information about prospective cash receipts. How much cash will be received from:
    - ◆ Dividends.
    - ◆ Sale of stock.
  - Creditors need information about prospective cash receipts:
    - ◆ How much cash will be received from interest on the loan.

- ◆ When and if the loan will be repaid.
- The company needs information on its own prospective cash flows.
- The company needs information about its resources and claims to those resources.

Module 1  
LO 2

## What Makes Accounting Information Useful? Qualitative Characteristics

Qualitative (i.e., non-numerical) characteristics that make accounting information useful (EXAMPLE 2-2 summarizes these characteristics):

### Understandability

- **Understandability:** the quality of accounting information that makes it comprehensible to those willing to spend the necessary time to understand it. Two fundamental characteristics make accounting information useful – the information must be relevant and it must be a faithful representation.

### Relevance

- **Relevance:** the capacity of information to make a difference in a decision.
  - Predictive value – help determine if a decision should be made.
  - Confirming value – confirm that the right decision was made.

### Faithful Representation

- **Faithful representation:** the quality of information that makes it complete, neutral, and free from error.
  - Neutral: information is not slanted to make a company's position look any better or worse than the actual circumstances would dictate.

### Comparability and Consistency

- **Comparability:** for accounting information, the quality that allows a user to analyze two or more companies and look for similarities and differences.
  - Not necessarily uniformity – alternative methods are acceptable under GAAP.
    - ◆ Companies can choose from several depreciation methods. **Depreciation** is the process of allocating the cost of a long-term tangible asset over its useful life.
  - Disclosure allows reader to make adjustments for these differences.
- **Consistency:** allows the financial statements to be compared within a single company from one accounting period to the next.
  - If a company makes an accounting change, accounting standards require various disclosures to help the reader evaluate the impact of the change.

## Materiality

- **Materiality:** the magnitude of an accounting information omission or misstatement that will affect the judgment of someone relying on the information.
  - The issue is whether the error is large enough to affect the judgment of someone relying on the information.
  - The threshold varies from one company to the next depending largely on the company's size.
    - ◆ The amount of a transaction may be immaterial but still be considered significant because of the type of transaction – transactions involving illegal or unethical behavior by a company officer.

## Conservatism

- **Conservatism:** the practice of using the least optimistic estimate when two estimates of amounts are about equally likely.
  - Applies when there is uncertainty about how to account for a particular item or transactions.
  - Various accounting rules are based on the concept of conservatism.
    - ◆ Inventory is reported at the lower-of-cost-or-market value.

## An International Perspective on Qualitative Characteristics

- The International Accounting Standards Board (IASB) has the same objectives and qualitative characteristics of financial reporting as the FASB.

## MODULE 2 CLASSIFIED BALANCE SHEETS

Module 2  
**LO 3**

### Classified Balance Sheets

#### Understanding the Operating Cycle

- The operating cycle for a company that sells a product is the period of time between the purchase of inventory and the collection of any receivable from the sale of the inventory.
- Begins when cash is invested in inventory and ends when cash is collected by the enterprise from its customers.

#### Current Assets

The basic distinction on a classified balance sheet is between current and noncurrent items (EXAMPLE 2-4 is an example of a classified balance sheet).

- Current assets are assets that are expected to be realized in cash or sold or consumed during the operating cycle of a business or within one year, if the cycle is shorter than one year.
  - Most businesses have an operating cycle shorter than one year.

- Cash, accounts receivable, and inventory are current assets because they are cash or will be realized in (converted to) cash within one year.
- Short-term investments or marketable securities are investments of excess cash made for the short term.
- Prepaid assets represent a prepayment of expenses such as rent, office supplies and insurance. They are current because they are usually consumed within one year.

## Noncurrent Assets

Noncurrent assets (also called long-term assets) are any assets not meeting the definition of a current asset. Noncurrent assets include:

- Investments:
  - Securities not expected to be sold within the next year.
  - Land held for future use or buildings not currently used in operations.
  - Funds reserved for a special purpose.
- Property, Plant, and Equipment: tangible, productive assets used in the operations of a business rather than held for resale.
  - The distinction between inventory and equipment depends on the company's intent when acquiring the asset.
  - The relative size of property, plant, and equipment depends on a company's business (Carnival Corporation versus Microsoft).
  - Assets in this category are depreciated, except for land.
    - ◆ Separate accumulated depreciation account is used to account for depreciation recorded on the asset over its life.
- Intangible assets: provide benefits to the firm over the long-term.
  - They lack physical substance.
  - Include trademarks, copyrights, franchise rights, patents and goodwill.
  - The cost principle governs the accounting for intangibles.
  - Amortization is the process of writing off intangibles to expense over their useful life.

## Current Liabilities

Current liabilities are obligations that will be satisfied within the next operating cycle or one year, if the cycle is shorter than one year.

- The classification of a note payable depends on its maturity date.
  - If the note will be paid within the next year, it is current. Otherwise, it is long-term.
- Includes accounts payable, wages payable, income taxes payable.
- Most liabilities are satisfied by the payment of cash.
- Some liabilities are satisfied by performing services.

## Long-Term Liabilities

Long-term liabilities are any obligations that will not be paid within the next year or the operating cycle, whichever is longer.

- Includes long-term notes payable and bonds payable.

## Stockholders' Equity

Stockholders' equity represents owners' claims on the assets of the business that arise from contributed capital and earned capital.

- Capital stock indicates the owners' investment in the business.
  - Common stock – the most basic form of ownership.
  - Preferred stock – form of capital stock that carries with it certain preferences and has priority over common stock.
  - May appear as two separate items on the balance sheet – Par Value and Paid-In Capital in Excess of Par Value.
    - ◆ Total represents the amount that has been paid by the owners for stock.
- Retained earnings represents the accumulated earnings, or net income of the business since its inception less all dividends paid during that time.

Module 2  
**LO 4**

## Using a Classified Balance Sheet: Introduction to Ratios

A company's ability to pay its debts as they come due can be measured by computing the working capital and current ratio.

### Working Capital

- Liquidity is the ability of a company to pay its debts as they come due.
- Working capital is a measure of liquidity.
- Current Assets less Current Liabilities equals working capital at a point in time.
- Bankers and other creditors are interested in a company's liquidity.
- Companies strive for a balance – too little working capital may make it difficult to pay debts; too much working capital indicates the company is not investing enough in productive assets.

### Current Ratio

- Working capital is limited in its informational values because it is an absolute dollar amount.
- The current ratio allows comparison of working capital for companies of various sizes and of a single company over time.
  - Measures short-term liquidity.
  - $\text{Current Assets} \div \text{Current Liabilities}$

- In general, the higher the current ratio, the more liquid the company.
- General rule of thumb 2:1 current ratio is good. Also depends on industry company is in.
- *Composition* of assets as well as the numerical calculation is important.
  - ◆ Examining the relative sizes of the various current assets for a company may reveal strengths and weaknesses not evident in the current ratio.
  - ◆ The frequency with which assets (accounts receivable, inventory) turnover is also important.

## MODULE 3 INCOME STATEMENTS, STATEMENTS OF RETAINED EARNINGS, AND STATEMENTS OF CASH FLOWS

Module 3

**LO 5**

### Income Statements, Statements of Retained Earnings, and Statements of Cash Flows

The income statement summarizes the results of operations for a period of time. All companies prepare income statements at least annually. Companies that report to the SEC prepare financial statements every three months. Monthly income statements can be prepared for internal use by management.

#### What Appears on the Income Statement?

- The income statement reports the excess of revenues over expenses –the net income of the period. Or in the event of an excess of expenses over revenues, the income statement reports the net loss for the period.
  - The terms profits or earnings are synonyms for net income.
- Revenue is the inflow of assets resulting from sale of products and services; an expense is the outflow of assets resulting from the sale of goods and services.
- Gains and losses are special types of revenues and expenses reported on the income statement.

#### Format of the Income Statement

Corporations use one of two formats to prepare the income statement. Both forms are generally accepted, although more companies use the multiple-step format.

- **Single-step:** all expenses and losses are added together and deducted in a single step from the sum of all revenues and gains to arrive at net income. (Example 2-6)
  - No attempt to classify revenues or expenses.
  - Advantage is simplicity.
- **Multiple-step:** subdivides statement into specific sections, and provides the reader with important subtotals. (Example 2-7)
  - Gross Profit: Sales less Cost of Goods Sold.
    - ◆ Cost of goods sold is the cost of the units of inventory sold during the period.
  - Income from Operations: Gross Profit less Operating Expenses.

- ◆ Operating expenses are further subdivided into selling expenses and general and administrative expenses.
- Income before Income Taxes: Operating income adjusted by other revenue and expenses not generated or used by operations.
- Income tax expense is then deducted to arrive at Net Income.

Module 3  
**LO 6**

## Using an Income Statement

The income statement can be used to evaluate the profitability of a business.

- **Profit margin:** Net income ÷ Sales.
  - If the profit margin is high, generally means that the company is generating revenue but that it is also controlling its costs.
  - Also called return on sales.
- When evaluating any financial statement ratio, must consider:
  - How does this year's ratio differ from ratios of prior years?
  - How does the ratio compare with the industry norms?

Module 3  
**LO 7**

## The Statement of Retained Earnings

The statement of stockholders' equity explains the changes in the components of owners' equity during the period. (EXAMPLE 2-9)

- Retained earnings and capital stock are the two primary components of stockholders' equity.
- If there were no changes to the company's capital stock during the period, the company may choose to present a statement of retained earnings instead.
- Statement of retained earnings reports the net income and any dividends declared during the period. It provides an important link between the income statement and balance sheet.
  - Net income from the income statement is added to retained earnings.
  - Dividends do not appear on the income statement since they are a distribution to the owners. Direct deduction from retained earnings.

Module 3  
**LO 8**

## The Statement of Cash Flows

All publicly held corporations are required to present the statement of cash flows in their annual reports. (Example 2-10)

- The statement of cash flows summarizes a company's operating, investing, and financing activities for the period. Each of these categories can result in a net inflow or net outflow of cash.

- **Operating activities** involve the sale or purchase of a product or sale of a service.
- **Investing activities** involve the acquisition and sale of long-term or noncurrent assets.
- **Financing activities** involve the issuance and repayment, or retirement, of long-term liabilities and capital stock and the payment of dividends.
- The balance of cash on the bottom of the statement of cash flows must agree with the balance for cash as shown on the balance sheet.

## MODULE 4 READING AND USING THE ANNUAL REPORT

Module 4

### LO 9 Reading and Using the Annual Report

#### Panera Bread's Balance Sheet (EXHIBIT 2-1)

- Consolidated financial statements – reflect the position and results of all operations that are controlled by a single entity.
- Panera Bread owns other companies that are called subsidiaries.
- SEC requires balance sheets as of the two most recent year-ends and income statements for each of the three most recent years.
- Amounts generally stated in thousands of dollars (materiality concept).

#### Panera Bread's Income Statement (EXHIBIT 2-2)

- Multiple-step income statements for a three-year period are presented.
- The term “Cost of food and paper products” is used instead of cost of goods sold.
- Inclusion of data for three years allows for the analysis of certain trends.
- For Panera Bread, note the steady increase in net sales.

## Making Business Decisions

### The Current Ratio

- **Ratio Analysis Model:** used to determine the company's liquidity.
  - Formulate the Question: How liquid is Panera Bread?
  - Gather the Information from the Financial Statements: Current ratios and current liabilities can be found on the balance sheet.
  - Calculate the Ratio: Current Ratio: = Current Assets/Current Liabilities =  $\$406,166/\$352,712 = 1.15$  to 1
  - Compare the Ratio with Other Ratios: Panera's current ratio for the last two years (2014 and 2013) are 1.15 and 1.00, respectively. Chipotle's current ratio for the period are 3.58 and 3.34, respectively.
  - Interpret the Results: Panera's ratio increased slightly from 2013 to 2014. Chipotle's current ratios for both years are much higher than Panera's. This is due to the fact that Chipotle has a large amount of investments classified as current assets.

■ **Business Decision Model:**

- Formulate the Question: Should a banker loan money to Panera Bread?
- Gather Information from the Financial Statements and Other Sources: This information will come from a variety of sources, not limited to, but including the following:
  - ◆ The balance sheet, income statement, and statement of cash flows.
  - ◆ The outlook for the restaurant industry.
  - ◆ The outlook for the economy during the period of time the loan would be outstanding. Is inflation projected to increase or decrease?
  - ◆ Projections for interest rates for similar loans during the term of the loan.
  - ◆ Alternative uses for the bank's money.
- Analyze the Information Gathered:
  - ◆ Compare Panera Bread's current ratio with Chipotle's as well as with industry averages.
  - ◆ Look at trends over time in the current ratios.
  - ◆ Review projections for economic outlook and interest rates.
- Make the Decision: Taking into account all of the various sources of information, decide to either:
  - ◆ Loan money to Panera Bread or
  - ◆ Find an alternative use for the money.
- Monitor the Decision: If the loan is made, periodically monitor the loan by assessing the company's continuing liquidity as well as other factors considered before making the loan.

## The Profit Margin

■ **Ratio Analysis Model:** used to determine the company's profitability.

- Formulate the Question: How profitable is Panera Bread?
- Gather the Information from the Financial Statements: Net income and net sales or revenues can be found on the income statement.
- Calculate the Ratio:  $\text{profit margin} = \text{net income} / \text{net sales or revenues} = \$179,293 / \$2,529,195 = 7.1\%$ .
- Compare the Ratio with Other Ratios: Panera's profit margin for the last two years (2014 and 2013) is 7.1% and 8.2%, respectively. Chipotle's profit margin for the period are 10.8% and 10.2%, respectively.
- Interpret the Ratios: Both companies' profit margins indicate that the companies are able to control their expenses while increasing their revenues. Panera Bread's profit margin decreased by 1.1% over the two-year period, while Chipotle's increased by 0.6%.

■ **Business Decision Model:**

- Formulate the Question: If you were an investor, would you buy stock in Panera Bread?
- Gather Information from the Financial Statements and Other Sources: This information will come from a variety of sources, not limited to, but including the following:
  - ◆ The balance sheet, income statement, and statement of cash flows.
  - ◆ The outlook for the restaurant industry.

- ◆ The outlook for the economy during the period of time you expect to hold the stock. Is inflation projected to increase or decrease?
- ◆ Projections for interest rates for similar loans during the term of the loan.
- ◆ Alternative uses for your money.
- Analyze the Information Gathered:
  - ◆ Compare Panera Bread's profit margin with Chipotle's as well as with industry averages.
  - ◆ Look at trends over time in the profit margins.
  - ◆ Review projections for economic outlook.
- Make the Decision: Taking into account all of the various sources of information, decide to either:
  - ◆ Buy stock in Panera Bread or
  - ◆ Find an alternative use for the money.
- Monitor the Decision: If you decide to buy the stock, periodically monitor the investment by assessing the company's continuing profitability as well as other factors considered before making the investment.

### **Other Elements of an Annual Report**

- Privately held companies tend to distribute only financial statements, without the additional information normally included in the annual reports of public companies.
- Although the formats of annual reports vary, certain basic elements have become standard in the annual reports of publicly held companies:
  - Letter from the president or chair of the board of directors.
  - A section describing the company's products and markets.
  - The financial report or review, which consists of the financial statements accompanied by notes to explain various items on the statements.
- Report of Independent Accountants (Auditors' Report) (Exhibit 2-3).
  - The opinion rendered by a public accounting firm concerning the fairness of the presentation of the financial statements.
  - States "in our opinion" and "present fairly."
  - Management is responsible for the statements.
    - ◆ Auditors express an opinion on the statements.
  - Do not certify to the total accuracy.
    - ◆ Render an opinion as to the reasonableness of the statements.
    - ◆ Auditing firms perform various tests of the accounting records to be able to assure itself that the statements are free of material misstatement.
- Ethical responsibility of management and auditors to stockholders.
  - Stockholders need assurances that the financial statements are a fair representation of the company's operations and financial position.
  - Management and auditors have an ethical responsibility to the shareholders.
- Management Discussion and Analysis provides explanation for certain amounts in the statements and provides insights concerning future trends in the business.

INSTRUCTOR'S MANUAL

- Gives management opportunity to provide insights into future trends.
- Notes to consolidated financial statements satisfy the requirement for full disclosure.
  - Discloses all the relevant facts to a company's results and financial position.
  - Note 2 is a summary of significant accounting policies for Panera Bread.

## Lecture Suggestions

- Module 1**  
**LO 1**
- Where can external users obtain financial information about a company? Discuss the convenience, for both the user and the company, of having standard, published financial statements, instead of responding to requests for information as they come in. Also, discuss the convenience of having this information available on the company's and SEC's web sites.
- Module 1**  
**LO 2**
- These characteristics are fundamental to all future topics, so a brief discussion of each one is useful. The following is one approach (The balance sheet for Dixon Sporting Goods is illustrated in Example 2-4):
- *Understandability*: Are the Dixon Sporting Goods statements written in clear, concise language?
  - *Relevance*: What information in the Dixon Sporting Goods balance sheet is of interest to a supplier who is considering selling to the company on a 30-day account?
  - *Reliability*: Can a stockholder verify the information in Dixon Sporting Goods's balance sheet concerning shares of stock outstanding and their book value? What makes this information reliable?
  - *Comparability*: Where in Dixon Sporting Goods annual report is information found that allows the reader to make comparisons with other companies? Where is information that allows comparison with Dixon Sporting Goods past performance?
  - *Materiality*: Why does the threshold vary from one company to the next?
  - *Conservatism*: Why are expenses recognized when they are likely, but revenues only when they are certain?
- Module 2**  
**LO 3**
- Have students list as many businesses as they can to fit into each type of business: service, merchandiser, and manufacturer. Encourage them to think about small, local businesses, not just big corporations. Then, ask them to discuss types of assets and liabilities that could be found in these businesses and classify as current or noncurrent. Ask them to estimate the operating cycle for each type of business. Are some assets and liabilities common to all types of businesses?
- Module 2**  
**LO 4**
- Have students review a classified balance sheet and identify the subtotals presented. Practice comparing components of a balance sheet from year to year to get an idea of trends.
- Module 3**  
**LO 5**
- Identify the important subtotals presented on a multiple-step income statement and their importance to income statement analysis. Which format do students prefer and why? Can you determine the gross profit from a single-step income statement?

**Module 3**  
**LO 6**

Students have calculated a number of ratios, and will try to memorize all of them in anticipation of an exam. Point out that for most of the ratios the calculation is obvious. Once you know what gross profit is, what else could the gross profit ratio be but the ratio of gross profit to sales? Note that most of the ratios that use strictly income statement numbers are calculated with sales as a denominator. Assign a number of exercises from both the end of the text chapter and from the Projects and Activities section of this manual for practice in working *with* these ratios, not just calculating them, so that by the time they finish, students will have become thoroughly familiar with the ratios and will not have to memorize, which is a useless exercise. Always require a few words of comment on the ratio, if only to compare with a prior year or to ask what a “logical” level for that item might be. It is important to stress from the beginning that ratios are least useful taken alone. They must be compared to the company itself in past years, and to related companies, or industry averages. Can you compare the ratios of a grocery store to a manufacturing company?

**Module 3**  
**LO 7**

How does the statement of retained earnings link the income statement and the balance sheet? What causes owners' equity to increase? What causes owners' equity to decrease? Would a net loss cause owners' equity to increase or decrease?

**Module 3**  
**LO 8**

Discuss the difference between a cash inflow and a cash outflow, with examples of each.

**Module 4**  
**LO 9**

Briefly discuss the types of audit opinion: unqualified, qualified, adverse, and disclaimer. What does each mean for the company? How might each affect the opinions of current and potential investors? Have the students pick a company and go online and look at their financial statements. Who are the auditors? What kind of an opinion did they receive? What kind of opinion did companies such as Enron and WorldCom receive before their frauds were exposed?

## Projects and Activities

**Module 1**  
**LO 2**

### What Makes Accounting Information Useful? Qualitative Characteristics

**In-class discussion: How understandable are the financial statements of Dixon Sporting Goods?**

You have been introduced in these opening chapters to the concept of presenting financial data in the form of organized statements, and have not learned much detail about how and why items find their way into these statements. You have, however, had the opportunity to look at the reports of more than one large corporation. Examine the income statement, balance sheet, and statement of cash flows of Dixon Sporting Goods.

- **Team presentation:** Work together with four or five classmates to prepare a presentation for your class to explain the Dixon Sporting Goods financial statements: the income statement, the balance sheet, the statement of retained earnings, and the statement of cash flows, or the equivalents of these for Dixon Sporting Goods. Explain what each line item is.
- **Class response and discussion:** What is difficult to understand in the Dixon Sporting Goods financial statements? Is it the overall presentation, or just a few items? Do these difficulties make it doubtful that you could make a meaningful decision based on these statements? Were your classmates able to clarify any of these items for you?
- **Would some additional training in accounting probably clear up a lot of your questions, or is it the presentation itself that makes the statements difficult to understand? What would you change about the statements?**
- **Do the statements, taken as a whole, fulfill the goal of understandability as set out by the FASB? Review the definition of “understandability” given in this chapter.**

***Solution***

- Students once again look closely at a set of financial statements. They will find the Dixon Sporting Goods statements reasonably straightforward and probably understandable by most people since revenues, costs and expenses, cash, and supplies are all nearly every day terms. However, make sure students understand the real definition of these terms – not what they think they are. Accounting has a “jargon” of its own. Few will question at this point in their learning where the numbers came from, so complicated accounting procedures are not a worry. The sorting of items between the statements probably would not make much sense at all to many laymen, but the students have had enough of an introduction that they should begin to see what goes where, and why. You might want to take a little time while they are looking at these statements to review this, since students continue to mix items within the statements well into the course.
- The statement of cash flows will be the most difficult, and mainly in the operating section where it is not intuitively obvious to students.
- The students will have their own opinions about understandability, and about possible format changes.

### **In-class discussion: Asset valuation**

Look at Dixon Sporting Goods balance sheet, and consider the total listed for Property, Plant and Equipment, of \$219,400.

- What, physically, might this number represent?
- Could they sell these assets for \$219,400? Is it what they paid for them?

#### **Solution**

- These are tangible, productive assets used in the operation of Dixon's business. Land and buildings are self-explanatory. Store furniture and fixtures could include the sales registers and shelving, etc to place their products. It would not include anything that would be sold to customers. You may also want to point out that the land and building are currently being used in operations. If they were not, for example, vacant land being held for a future store site, it would not be part of property, plant, and equipment since it is not being used in current operations.
- The amount given is what the items cost less the depreciation taken on these assets. Students sometimes mistakenly assume these assets are "worth" \$219,400. They continue to see these items in the abstract, unconnected to physical realities, and need to be reminded about specifically what balance sheet amounts represent. Nowhere on the financial statements will one find the selling price of the property, plant, and equipment, unless the company chose to disclose this information in the footnotes.

### **In-class discussion: Materiality**

All businesses are subject to various types of legal proceedings. Merck & Co. Inc., a global health care company that manufactures prescription medicines, has been a defendant in a number of product liability lawsuits. In the notes to Merck's 2014 financial statements, the company states:

"The Company is involved in various claims and legal proceedings of a nature considered normal to its business, including product liability, intellectual property, and commercial litigation, as well as certain additional matters including environmental matters. Except for the *Vioxx* Litigation (as defined below) for which a separate assessment is provided in this Note, in the opinion of the Company, it is unlikely that the resolution of these matters will be material to the Company's financial position, results of operations or cash flows."<sup>1</sup>

"There are various other pending legal proceedings involving the Company, principally product liability and intellectual property lawsuits. While it is not feasible to predict the outcome of such proceedings, in the opinion of the Company, either the likelihood of loss is remote or any reasonably possible loss associated with the resolution of such proceedings is not expected to be material to the Company's financial position, results of operations or cash flows either individually or in the aggregate."<sup>2</sup>

- Explain in your own words what Merck means by this statement. In particular, include what they mean by "material" and "remote." Who is in the best position to determine the outcome of a lawsuit?

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<sup>1</sup> Merck & Co., Inc., December 31, 2014 10-K, p. 106.

<sup>2</sup> Merck & Co., Inc., December 31, 2012 10-K, p.115-116.

***Solution***

An item with material effect would influence the decision of an informed reader of the financial statements. Merck believes that if the outcome of the litigation is not favorable, the numbers on the financial statements will not be significantly different. The Company's legal counsel is in the best position to determine the outcome of the legal proceedings.

Module 3  
LO 6

## Using an Income Statement

### Outside assignment: Whose statement?

It is often possible to tell a lot about a company by looking at one or more of their financial statements, without knowing anything else about them. Carefully look over the following financial statement from an actual company.

**XXX Corporation<sup>3</sup>**  
**Consolidated Statement of Operations**  
**Year Ended December 31, XXXX**  
**(\$ millions)**

|                                    |                     |
|------------------------------------|---------------------|
| OPERATING REVENUES:                |                     |
| Passenger                          | \$ 17,658           |
| Freight                            | 175                 |
| Other                              | <u>772</u>          |
| Total operating revenues           | 18,605              |
| OPERATING EXPENSES:                |                     |
| Salaries, wages, and benefits      | 5,434               |
| Fuel and oil                       | 5,293               |
| Maintenance, materials and repairs | 978                 |
| Aircraft rentals                   | 295                 |
| Landing fees and other rentals     | 1,111               |
| Depreciation and amortization      | 938                 |
| Acquisition and integration        | 126                 |
| Other operating expenses           | <u>2,205</u>        |
| Total operating expenses           | 16,380              |
| OPERATING INCOME                   | 2,225               |
| OTHER EXPENSES (INCOME):           |                     |
| Interest expense                   | 130                 |
| Capitalized interest               | (23)                |
| Interest income                    | (7)                 |
| Other (gains) losses, net          | <u>309</u>          |
| Total other expenses (income)      | <u>409</u>          |
| INCOMME BEFORE INCOME TAXES        | 1,816               |
| PROVISION FOR INCOME TAXES         | 680                 |
| NET INCOME                         | <u><u>1,136</u></u> |

- Which financial statement is this? Did the title confuse you, or is it an accurate description of what follows? Do you think it is *better* than the title you are accustomed to?
- Does this business appear to be a retailer, a manufacturer, or a service company? How can you tell?
- What business do you believe they are in? Again, what tells you this?
- Can you calculate gross profit for this company? Can you calculate their profit margin? Why or why not?

<sup>3</sup> Southwest Airlines Co., December 31, 2014 10-K, p.72.

**Solution**

- The statement is the income statement. The statement of operations is an equally acceptable title for it, reflecting what the statement is - a summary of the company's operations for the year cited.
- This is the 2014 income statement for Southwest Airlines, a service company. The lack of a gross profit line or any reference to cost of goods sold indicates a service company. Line items such as Passenger and Freight revenues signal a transportation company, and expenses such as Landing Fees and Aircraft Rentals clearly indicate an airline.
- Southwest Airlines has no gross profit (no cost of goods sold) so they have no gross profit rate. The profit margin on the other hand can be calculated. The computation is net income ÷ sales ( $\$1,136 \div \$18,605 = 6.11\%$ ).

Module 4  
LO 9

**Other Elements of an Annual Report****Outside assignment: Annual reports**

Have students pick a company and obtain their annual report online. Look at the Management's Discussion and Analysis. In your own words, what is management's outlook for the future? What are their major strengths and weaknesses?

Look at the Report of the Independent Auditors. Who audited the financial statements? What type of audit opinion did they give?

- Solution

Answers will vary depending on the company chosen by the student.

**Food for thought: Auditor obligations**

An article in *The Wall Street Journal* said that the auditors for Wiz Technology resigned in a dispute over the company's accounting for executive salaries. Even though the article was published many years ago, the issues are timeless especially in light of the current accounting scandals. The article said,

In a filing with the Securities and Exchange Commission, the vendor of low-price computer software said its accountants, Corbin & Wertz of Irvine, Calif., disagreed with management's decision to capitalize an undisclosed amount of executive salaries and other costs as "inventory."

Corbin & Wertz resigned after Wiz Technology filed its quarterly results with the SEC despite the accountants' objections, according to the 8-K filing. A Corbin & Wertz official declined to discuss the matter.<sup>4</sup>

Explain why, in your opinion, the auditors felt compelled to resign.

**Solution**

Auditors certify that the statements are prepared in accordance with generally accepted accounting principles, consistently applied. If this was not the case, and if the company did not agree to an acceptable

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<sup>4</sup>*The Wall Street Journal*, July 3, 1995, "Accountants Resign At Wiz Technology Over Salary Entries."

audit qualification in the auditors' opinion, the auditors could only choose between rendering an opinion that they did not believe to be true, or resigning to avoid rendering any opinion.

Another article in *The Wall Street Journal* noted that audit firms are dropping risky clients more frequently, in the wake of stockholder lawsuits against accountants, to avoid the costs of litigation.<sup>5</sup> With litigation settlement costs for the Big Five ( now Big Four) accounting firms in excess of \$1 billion a year, the firms feel that they must protect themselves by eliminating clients with potential problems.

### **Ethical decision: Auditor's report**

As a member of a small CPA firm, you have been asked to review the December 31 year-end financial statements of a small (\$2 million revenue) company in an East Coast city. The company has applied for a long-term loan from the bank. You are interested to note as you begin your review of the company's records that a principal stockholder is your former college roommate. You are preparing your report and wonder about the following items:

- The company decided during the last month of the year to change their method of accounting for depreciation for this year's financial statements. You do not believe that any adjustments were made to prior years' reported results as a consequence of this change.
- You have been working at the bookkeeper's desk while she is away on vacation. You pushed the desk blotter aside at one point and noticed underneath it a bill to the company from a local florist for \$55. The bill is dated December, but you do not see it recorded anywhere in the company's books. A number of other unopened envelopes are under the blotter, the contents of which cannot be judged from the outside.
- You read in yesterday's newspaper that a local manufacturer is seriously contemplating a move to Atlanta. You know from your audit that they are an important customer of the company you are reviewing.

Should these items be disclosed in your report? Why or why not? If you disclose, how should your disclosure be phrased? Should you disclose any other facts to the company, to your employer, or in your report? Should the audit have been conducted differently? In your answers, try to keep in mind some of the fundamental qualitative principles underlying financial reporting and cite them where relevant.

#### **Solution**

First, you probably should have stopped and called in another member of the firm to do the review the moment you discovered the identity of the principal stockholder. Even if you have no ongoing relationship with your former roommate (and no indication is given one way or the other), it is always prudent to avoid even the appearance of impartiality or a conflict of interest.

- The change in accounting method should be disclosed. It affects comparability of the statements to prior years. As the statements now stand, they cannot be compared to prior years. Students are probably not going to realize that restatement is necessary, but they should note the lack of comparability, and therefore the inconsistency.
- On the other hand, the florist's bill is immaterial and may not be a concern in and of itself. Perhaps worth questioning is its location. Why was it under the blotter, and what else was under there? This appears to be an unusual mail sorting system.
- The customer's planned exodus is a potential problem for the company. This disclosure may cause a conflict between the management of the company and the auditor. The auditor will see it as a contingency that should be a footnote to the statements. Management may prefer to ignore it,

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<sup>5</sup>*The Wall Street Journal*, June 26, 1995, "Big Accounting Firms Weed out Risky Clients."

claiming it will not be a problem. The bank wants to be sure their loan will be repaid. The departure of a customer may influence their decision on the loan. They may hear about it from another source. The company will make a more positive impression if it discloses and explains the customer's move rather than allow the bank to find out, perhaps from only partial information, what the business implications of this event will be. A major loss of business will be seen as a possibility unless the company can produce evidence that their customer will still be sending orders from Atlanta, or that potential new customers exist to fill the gap. The auditor has a responsibility to disclose anything that could significantly impact the company financially. This item appears to fall into that category.

## Decision Models Using Decision Models

### Outside assignment: Grizzly, Inc. Current ratio, Business Decision Model, and Ratio Analysis Model

Assume that you are a lending officer for a large bank. The management of Grizzly Inc. has come to you asking for a loan. They have provided you with their Income Statement and Balance Sheet as of December 31, 2016. (Note: this information is located in the solution to the review problem).

#### **Required:**

One of the first steps you undertake is to determine Grizzly's liquidity. Use the five steps in the ratio analysis model to analyze the current ratio.

As a loan officer, you must consider a variety of factors, including financial ratios, before making the loan. Use the Business Decision Model to decide if the bank should make a loan offer to Grizzly.

#### **Solution: Ratio Analysis Model**

- 1. Formulate the Question.** Is Grizzly Inc. liquid enough to pay its obligations as they come due?
- 2. Gather the Information from the Financial Statements.** Current assets and current liabilities are both found on the balance sheet.

- 3. Calculate the Ratio.**  $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

$$\text{Current Assets} = \$20,500$$

$$\text{Current Liabilities} = \$9,700$$

$$\text{Current ratio} = \frac{20,500}{9,700} = 2.11 \text{ to } 1$$

- 4. Compare the Ratio With Other Ratios.** There are no other ratios in this problem to compare this ratio to. The ratio appears reasonable if compared to the 2 to 1 rule of thumb.
- 5. Interpret the Ratio.** You may want to ask Grizzly for their 2015 financial statements so you can see the trend of the current ratio. Is it going up or down? The components of the current ratio are also important when assessing a company's liquidity. Accounts receivable and inventory account for approximately 70% of Grizzly's current assets, while cash accounts for only 12% of current assets. You may want to determine how current the receivables are. You may also want to compare their ratio with other companies in the same line of business.

**Solution – Business Decision Model**

1. **Formulate the Question.** After considering all relevant information, should I (the bank) loan money to Grizzly Inc.?
2. **Gather Information From the Financial Statements and Other Sources.** The information will come from a variety of sources, including:
  - a. The balance sheet will provide information about liquidity and the items that make up current assets and current liabilities.
  - b. The income statement will provide information about profitability.
  - c. The statement of cash flows will provide information about the company's cash receipts and cash payments from operating, investing, and financing activities.
  - d. The notes to the financial statements will provide additional information about the company to supplement the financial statements.
  - e. An internet search will provide current and historical information on the company, the industry it is in, and its competitors. Look for the outlook for the industry, any news items about the company, including lawsuits.
  - f. Alternative uses for the bank's money.
3. **Analyze the Information Gathered.**
  - a. Use the Ratio Decision Model to compute and analyze the liquidity ratios. Analyze the composition of the current assets to determine how liquid they really are. Can all of the receivables be collected? Is there any obsolete inventory that can't be sold?
  - b. Can we obtain prior year financial statements to see a trend in the ratio?
  - c. Are there any other liquidity ratios that can be computed?
  - d. How much long-term debt does the company have? When is this debt due?
  - e. What is the company's share of sales in the entire Northwest?
  - f. Is the company considering expansion of other stores? Are they considering expanding to other sections of the country?
  - g. What is the outlook for interest rates during the term of the loan?
4. **Make the Decision.** Taking into account all of the information gathered, decide to loan the money to Grizzly Inc., or find an alternative use to the money.
5. **Monitor the Decision.** If the loan is made, it will need to be periodically monitored. Interim financial statements may be requested from Grizzly, Inc. The outlook for the economy in general and for outdoor recreational stores in particular, will need to be monitored.