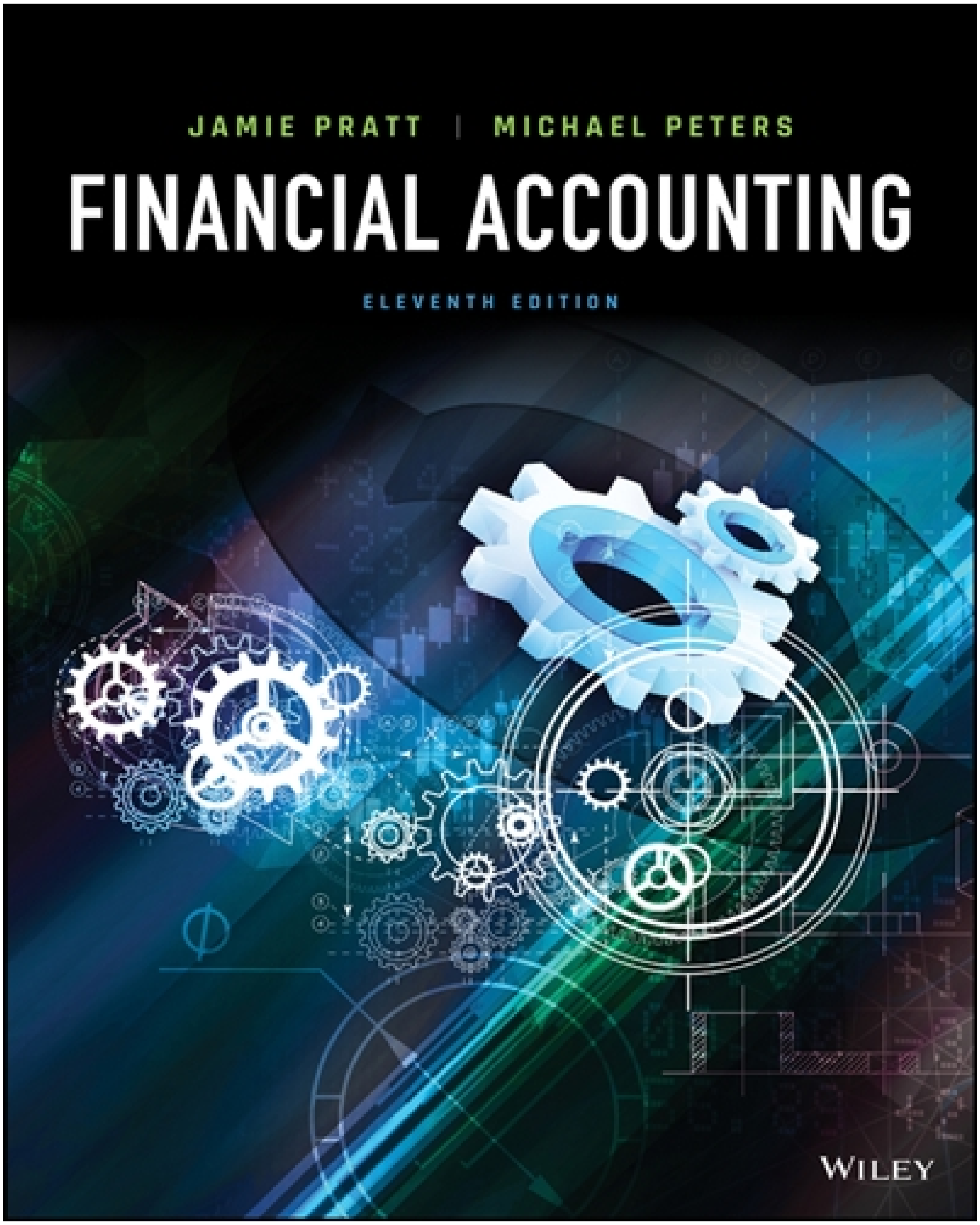
Solutions for Financial Accounting 11th Edition by Pratt



Solutions

PRATT & PETERS, *FINANCIAL ACCOUNTING*, 11E

SOLUTIONS MANUAL CHAPTER 1: FINANCIAL ACCOUNTING IN AN ECONOMIC CONTEXT

ISSUES FOR DISCUSSION

ID1.1

Equity analysts and shareholders: These users would use financial statements to try to estimate the future earnings and cash flow potential of the company, which would be used to calculate a value for the company's stock.

Bank loan officers: These users would use the financial statements to determine the ability of a company to repay loans to the bank.

A company's customers and suppliers: These users would use financial statements to determine whether to extend credit to the company (suppliers) or whether to rely upon the company to be a supplier (customers). Both suppliers and customers would also use the financial statements to monitor the company's profit margins.

Public utilities: This group would use the financial statements to determine the company's growth rate and how that might impact upon the company's utility needs. Also, they would evaluate the company's ability to pay its bills.

Labor unions: These groups would use the financial statements to monitor the profitability of the company to help determine the amount of pay raises and benefits that it will negotiate for from the company.

A company's managers: The company's managers will use the financial statements to assess the overall financial health of the company. This could impact the managers in many ways: raises, promotion opportunities, performance of other departments, etc.

LO: 1 **BT:** K; **Difficulty:** Easy; **Total Time:** 10 minutes; **AACSB:** Analytic; **AICPA:** Reporting

ID1.2

The board of directors serves various functions for a company. One is to represent and protect the interests of the shareholders who are not on the board. Another is to provide oversight and input to management. The managers are involved in running the business on a day-to-day basis whereas the board is more focused on the bigger, long-term picture. A weak board may not ask probing questions of management but instead may take everything at face value and believe anything that management says to them. A healthy management team would want a strong board that delivers valuable input. A management team that wants a weak board of directors may be trying to hide something (management fraud).

Auditors are concerned with management fraud because, if there is a problem, the auditors may be sued by the shareholders on the basis that the auditors should have detected the fraud.

LO: 5 **BT:** K; **Difficulty:** Easy; **Total Time:** 10 minutes; **AACSB:** Ethics; **AICPA:** Reporting

ID1.3

The function of the audit committee of the board of directors is to provide a channel whereby the auditors can report their findings and concerns. Typically there are outside members of the board that are on the audit committee so that if the auditors have concerns about management's financial statements or activities, then the auditors have a way to communicate directly to the board of directors.

The auditors are in a sensitive position because they audit financial statements and activities that are prepared by the same people who hire and pay them. Therefore, the auditors may be reluctant to jeopardize their relationship with the company by being too negative.

LO: 5 **BT:** E; **Difficulty:** Easy; **Total Time:** 10 minutes; **AACSB:** Ethics; **AICPA:** Reporting

ID1.4

Banks make loans to customers and depend on those customers to repay the loans (called the "principal") plus interest for the banks to earn a profit. If customers are not able to pay the interest, the banks cannot make a profit; further, if the customers are not able to repay the principal, the banks will show a loss that reduces the equity on the balance sheet. Banks look at many factors, both "macro" and "micro" in nature. Banks will look at the overall strength of the economy and the likelihood for future growth; these are the macro issues a bank considers. Banks will also examine the specifics of a company's individual performance within the economy; these micro issues often are seen in the financial statements of companies. Issues such as the amount of debt, the level of profits, the amount of cash on hand and the amount of cash generated by the business, and the quality and size of the assets can all be seen from the financial reporting system. Banks require borrowers to submit financial statements to show these performance measures. During the 2008-2009 recession and related credit crunch, banks were concerned about the macro issues shown in general economic data, as well as the micro issues shown in companies' individual financial reports. The reluctance of banks to lend has been cited as one of the reasons for the length of the economic downturn.

LO: 4 **BT:** AN; **Difficulty:** Medium; **Total Time:** 10 minutes; **AACSB:** Analytic; **AICPA:** Risk

ID1.5

Sales for Home Depot increased during this period because of improvements in the economy and housing market. As conditions improved, homeowners and homebuilders purchased more materials from Home Depot to improve and construct houses. Profits increased because the bump in sales was not offset with an equal increase in expenses, probably due to some economies of scale experienced by the large hardware retailer. Assets and shareholders' equity decreased due to the company returning cash to shareholders (which is reflected by the decrease in financing activities of $12.4 billion). Finally, the cash balance decreased moderately because the decrease in investing and financing activities slightly offset the increase operating activities.

LO: 4; **BT:** AN; **Difficulty:** Medium; **Total Time:** 15 minutes; **AACSB:** Analytic; **AICPA:** Measurement

ID1.6

Creditors would impose these types of restrictions on United Continental so that the creditors would be protected for their loans. These types of restrictions are common and act as a trip wire to warn the creditors that business may not be going well. The cash restriction would force United Continental to have enough cash to pay the interest on the debt and the minimum cash flow coverage assures that the airline's operations are functioning well enough to generate sufficient cash flow to meet obligations.

These restrictions act as trip wires in that as soon as a restriction is violated the creditors can call the debt and force the company to pay back the loans. It is more typical for the loans to be restructured. This usually means higher interest rates and fees to do the restructuring. These restrictions put the creditors in a better position to protect their loans.

LO: 4 **BT:** AP; **Difficulty:** Medium; **Total Time:** 10 minutes; **AACSB:** Analytic; **AICPA:** Measurement

ID1.7

Companies would usually engage in this type of behavior to try to improve their stock price. By showing higher revenues or lower expenses investors are more likely to reward the company with a higher stock price. Companies that have negative cash flow are under a lot of pressure to maintain a high stock price since selling stock is the primary way to fund the business. This type of incentive can lead to questionable behavior.

The ethical implications are significant because if investors lose faith in the financial statements, it will severely impact the stock market. A strong driver to a robust economy is access to capital (stock markets). If this source is reduced because investors do not believe the numbers that are reported, a very bad impact on the overall economy would result.

LO: 4 **BT:** E; **Difficulty:** Easy; **Total Time:** 10 minutes; **AACSB:** Ethical; **AICPA:** Reporting

ID1.8

This is the normal statement that an auditor would make about a company whose books it had audited and found no significant problems. This would be part of what is called a "non-qualified opinion". If there was a particular item that the auditors did not agree with, they would issue a "qualified opinion", in this case, they would agree with everything except the qualified item that would be identified.

"In our opinion", shows that the statement represents the auditor's opinion and not a fact; "fairly, in all material respects" means that the auditors cannot say that every single number is exactly accurate to the penny but that the numbers are generally accurate. This reflects the concept of materiality; the auditors believe that all material items have been presented accurately. Finally, "in conformity with accounting principles generally accepted in the United States of America" means that the financial statements have been compiled in a way that meets all of the accounting principles that are called GAAP in the U.S but not necessarily in conformance with international standards.

LO: 3 **BT:** E; **Difficulty:** Easy; **Total Time:** 10 minutes; **AACSB:** Analytic; **AICPA:** Reporting

ID1.9

Corporate governance describes the relationship among the stakeholders of a company, mainly the shareholders, the Board of Directors, management and the company's auditors. Corporate governance mechanisms encourage management and the Board of Directors to act in the best interest of the shareholders and to provide the shareholders with accurate and timely financial information. The Sarbanes-Oxley Act was passed to upgrade the financial transparency of corporate operations, requiring increased financial disclosures and management responsibilities to help assure the integrity of the financial statements. Improved information provided to shareholders and other providers of capital will strengthen the confidence in the financial system, ultimately benefitting both providers and users of capital.

LO: 5 **BT:** C; **Difficulty:** Easy; **Total Time:** 10 minutes; **AACSB:** Analytic; **AICPA:** Reporting

ID1.10

Management is charged with the responsibility to benefit the shareholders' investment in the company. Choosing investments that will boost the short-term results of the company in lieu of long-term gains does not meet this requirement. While satisfying the expectations of Wall Street analysts for short-term results, a management decision to forego larger long-term returns violates the relationship between the owners of the company and the management of the company. Many observers feel that short-term profit pressures from analysts have caused management to ignore its responsibility to work for the long-term benefit of the shareholder.

LO: 5 **BT:** AP; **Difficulty:** Medium; **Total Time:** 10 minutes; **AACSB:** Ethics; **AICPA:** Measurement

ID1.11

Financial analysts are charged with the task of following companies in specified industries and evaluating the past financial performance of those companies, as well as providing guidance for expectations for future financial performance. Until financial reporting is consistent across global lines, analysts must be able to understand, interpret, analyze, and forecast financial performance using different financial systems. An analyst following the pharmaceutical industry needs to understand how companies compare against each other, how Novartis stacks up against Johnson & Johnson. Now, not only does an analyst have to understand two sets of financial reporting systems (IFRS and GAAP), but that analyst then has to perform some type of conversion, so the companies can be compared under the same ("apples to apples") basis. Fluency in GAAP is not sufficient; an analyst must also speak the language of IFRS and be able to translate back and forth between the two systems.

LO: 6 **BT:** C; **Difficulty:** Easy; **Total Time:** 10 minutes; **AACSB:** Diversity; **AICPA:** Measurement

ID1.12

Managerial accounting is the accounting system that generates information that is used primarily by the managers of the company. Financial accounting refers to the financial statements that are prepared and are available to be distributed outside of the company. So, in many cases management accounting information is the operational information used by the managers of the company. This information is often proprietary to the company and so is not made available to the public. Management accounting numbers are not subject to audit and therefore are prepared in whatever form is helpful to the manager.

Financial accounting information is audited and therefore must follow GAAP. Its primary purpose is to be used by people outside of the company.

LO: 1,7 **BT:** C; **Difficulty:** Easy; **Total Time:** 10 minutes; **AACSB:** Analytic; **AICPA:** Reporting

ID1.13

a. Disney is primarily a service business but also has retail operations, providing entertainment services and selling merchandise associated with their brand.

b. The firm of PricewaterhouseCoopers audits the financial statements of Disney. The audit report states what years and financial statements were audited and therefore being commented upon by the auditor. The second paragraph explains what an audit is intended to do and how the company has gone about doing this audit. The company's internal control procedures are discussed. The audit report devotes some space toward the critical audit matters; that is, those matters which required more attention and did not have an easy, identifiable solution. Finally, the report states the auditors' opinion regarding the financial statements that have been audited. The auditors do not evaluate the financial strength of the company; the auditor states that the financial statements "present fairly" the position of Disney; it is up to the user of the financial statements to analyze the company's performance.

c. Net income in 2017 was $8,980,000,000, 2018 net income was $12,598,000,000 and for 2019 net income was $11,054,000,000.

d. The amounts shown below are in millions:

	2019	**2018**
Total liabilities	$100,095	$45,766
Total assets	$193,984	98,598
TL/TA (%)	51.60%	46.42%

Total liabilities include both Current and Long-Term liabilities. From 2018 to 2019 Disney increased the percentage of its assets that were financed by liabilities. This increase was likely due to the significant acquisition it made during the 2019 fiscal year. Of course, it also means that the company decreased the percentage of its assets that were financed by equity.

e. Cash from operating activities was $12,343,000,000 in 2017, $14,295,000,000 in 2018, and $5,984,000,000 in 2019.

f. From 2017 through 2018, Disney increased its profitability (in dollar terms) but also as a percentage of revenue (see below chart). The increase in the popularity of certain movies and merchandise (e.g. Frozen, Marvel Superheroes) might be one explanation. The company showed a decrease in net income in both dollars and as a percentage of revenue from 2018 to 2019. Despite this decrease, the company is quite strong and well positioned for the future.

	2019	**2018**	**2017**
Total net income (TNI)	$11,054	$12,598	$ 8,980
Total revenues (TR)	$69,570	$59,434	$55,137
TNI/TR (%)	15.89%	21.20%	16.28%

LO: 3 **BT:** AN; **Difficulty:** Medium; **Total Time:** 25 minutes; **AACSB:** Analytic; **AICPA:** Research

DATA AND ANALYTICS

DA1.1

Ford	**2019**	**2018**	**2017**
Sales	$155,900	$160,338	$156,776
Total assets	$258,537	$256,540	$258,496
Growth rate - Sales	(2.8%) *	2.3%*	
Growth rate – Total assets	0.8% **	(0.8%) **	

GM	2019	2018	2017
Sales	$137,237	$147,049	$145,588
Total assets	$228,037	227,339	212,482
Growth rate - Sales	(6.7%) *	1.0%*	
Growth rate – Total assets	0.3% **	7.0%**	

From 2017 to 2018 both companies experienced growth in sales (Ford by 2.3% and GM by 1.0%), while only GM recorded growth in assets (7%). From 2017 to 2018 Ford's total assets decreased by a little less than 1%. From 2018 to 2019, both GM and Ford reported a decrease in sales – 2.8% decrease for Ford and 6.7% decrease for GM. From 2018 to 2019, both companies recorded a very small growth in total assets; specifically, a 0.8% growth for Ford and 0.3% growth for GM.

* <u>Growth rate - Sales:</u>

Ford 2018: ($160,338 – $156,776) / $156,776 = 2.3%
GM 2018: ($147,049 – $145,558) / $145,558 = 1.0%
Ford 2019: ($155,900– $160,338) / $160,338 = (2.8%)
GM 2019: ($137,237– $147,049) / $147,049 = (6.7%)

** <u>Growth rate – Total Assets:</u>

Ford 2018: ($256,540 – $258,496) / $258,496 = (0.8%)
GM 2018: ($227,339 – $212,482) / $212,482 = 7.0%
Ford 2019: ($258,537– $256,540) / $256,540 = 0.8%
GM 2019: ($228,037– $227,339) / $227,339 = 0.3%

LO: 7; **BT:** AN; **Difficulty:** Moderate; **Total Time:** 15 minutes; **AACSB:** Technology; **AICPA:** Leverage Technology