

Chapter 1 - Solutions

Overview:

<i>Problem Length</i>	<i>Problem #s</i>
{S}	1 to 23
[M]	24

- 1.{S}(i) Short-term lenders are concerned primarily with liquidity. Accounting standards would focus primarily on near-term cash flows and might include cash flow forecasting. Performance reporting would likely emphasize cash-based measures.
 - (ii) Long-term equity investors are primarily concerned with the earning power of the firm. Income measurement would be the focus of standards for such users.
 - (iii) Tax authorities are concerned with the generation of tax revenue. Accounting standards might limit the ability of firms to shift income from one period to another and place strict controls on the recognition and timing (accrual) of both revenues and deductible expenditures.
 - (iv) Corporate managers seek to control their reported earnings, to cast the best possible light on their stewardship. Accounting standards set by managers would be highly flexible, with little supplementary information and footnote disclosure.
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- 2.{S}The matching principle states that revenues should be matched with the expenses that generate them. As the revenues and related expenditures may be incurred in different accounting periods, accrual accounting is required to recognize them in the same period.
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- 3.{S}The going concern assumption states that the enterprise will continue operating in a normal fashion. This assumption permits financial statements to record assets and liabilities based on the cash flows that they will generate as the firm operates. If this assumption were absent, all assets and liabilities would have to be evaluated on a

liquidation basis. Accrual accounting could not be used, as the assumption that expenditures would produce future revenues could no longer be made.

- 4.{S}Public companies must provide current investors with detailed financial statements, mandated by the FASB and the SEC. Because of SEC filing requirements, annual and quarterly financial data are publicly available to potential investors as well. Private companies may not prepare audited financial data. When audited financial statements are prepared, they will lack some disclosures (e.g., earnings per share) and certain SEC-mandated data (such as the management discussion and analysis). In addition, these statements may not be made available to potential investors.
- 5.{S}All public companies in the United States are required to issue financial statements whose form and content are determined by the FASB after much public debate. The SEC oversees this process and supplements these standards with additional disclosure requirements. As U. S. GAAP have an investor and user orientation, they require detailed disclosures. Financial statements issued by non-U.S. firms follow local (in some cases, IASB) accounting standards, with less disclosure. Local standards reflect legal and political requirements and often do not have the same investor protection objective as in the United States. Foreign firms generally do not provide quarterly reports; semi-annual reporting is the norm.
- 6.{S}The FASB sets accounting standards for all audited financial statements prepared under U.S. GAAP. The SEC has jurisdiction over all public companies. Given the overlapping jurisdiction, the SEC generally relies on the FASB to set standards but supplements those standards with additional disclosure requirements deemed necessary to inform and protect investors in public companies.
- 7.{S}The balance sheet includes only those economic events that qualify as assets and liabilities. As accounting standards define, in effect, assets and liabilities they determine which economic events are accounted for and which are ignored. Events ignored (such as many contracts) are excluded from the process of preparing financial statements.

The recognition rules also influence managers' decisions regarding the form of contractual agreements used to acquire assets and incur liabilities, thereby affecting the preparation of financial statements.

- 8.{S}Liabilities represent the assets of the firm funded by trade and financial creditors. Equity represents the permanent capital of the firm, and is the residual after all liabilities have been satisfied. Thus the distinction between liabilities and equity is the difference between prior claims and permanent capital. Misclassification will over- or understate the firm's reported debt and the degree of leverage or financial risk.
- 9.{S}Historical cost is more reliable as it reflects actual past transactions. Market values are less reliable as they may require assumptions and estimates. However, general inflation and specific price changes make historical costs less useful (relevant) as time passes. Market values always have relevance as they represent the current value of the firm's resources. The nature of the markets (liquidity, volatility, and transparency) affects the reliability of the values reported.
- 10.{S}Contra accounts are deductions from asset or liability accounts that accumulate valuation or other adjustments (such as accumulated depreciation) and reduce the asset or liability account to its "net" amount. Adjunct accounts accumulate certain adjustments outside the historical cost framework (such as fair value adjustments for marketable securities under SFAS 115) and other adjustments (for example, premiums and discounts on debt issues). Adjunct accounts are often reported separately.
- 11.{S}Revenues and expenses result from the firm's operating activities; gains and losses result from valuation and other non-operating events. The latter are peripheral to the normal activities of the firm and, therefore, should be separated for analytic purposes.
- 12.{S}Comprehensive income includes all changes in equity other than transactions with stockholders. It encompasses operating earnings, "non-recurring" items, valuation adjustments, and the cumulative effect of accounting changes. As it includes all changes in stockholders' equity (excluding transactions with owners), comprehensive income is more complete than "income from continuing operations" (most useful for earnings forecasting).

13.{S}Recurring income refers to income from continuing operations, the best measure of the operating profits of the firm for that time period, and therefore the best base for forecasting and valuation. Non-recurring items are unusual and/or infrequent in nature, and usually result from non-operating factors.

14.{S}The classification of cash flows into three categories highlights their differing natures. Cash from operations reports the cash generated or used by the firm's operating activities. Cash for investment measures the outflow for investments in capacity, for acquisitions, or for long-term investments. Cash from financing indicates the source (debt or equity) of any financing required by the firm as well as distributions to preferred and common stockholders.

These classifications should be viewed over time as indicators of the firm's liquidity and solvency. The relationship among these classifications is especially important.

15.{S}Footnotes are an integral part of the financial statements and are audited. They supply details that augment financial statement data (e.g. employee benefit plan data). Supplementary schedules may be included within the financial statements (e.g. oil and gas disclosures) but may not be audited.

16.{S}The Management Discussion and Analysis is intended to explain changes and trends in reported income statement, balance sheet, and cash flow items and therefore help financial statement users to interpret these financial statements. The MD&A should discuss trends, including those expected to continue in the future. This discussion should aid the prediction of future cash flows and earnings.

17.{S} Global accounting standards offer the possibility of comparability, as all companies would be required to prepare financial statements using the same accounting methods.

There may also be the following disadvantages:

- (i) Lack of comparability if there is no body empowered to enforce uniform application of global standards.
- (ii) Loss of the information provided by reconciliations from one set of accounting standards to another, which sometimes highlight important aspects of a firm's operations.
- (iii) Different economic and social structures may require differing accounting standards. For example, in an environment where financing comes primarily from banks rather than through issuance of shares, accounting standards would be *appropriately* geared to the needs of creditors rather than equityholders.

18.{S}(i) The opinion should report any changes in accounting principles used and may refer to the footnote providing additional information on the change.

(ii) Changes in accounting estimates are not referred to in the auditor's opinion.

(iii) The auditor's report must describe uncertainties when they are material to the firm's financial position.

(iv) While the auditor's opinion provides reasonable assurance that there are no material errors in the financial statements, it is not a guarantee against error or even fraud.

Statement on Auditing Standards (SAS) 82 (1997), requires auditors to assess the risk of financial statement fraud.

- 19.{S}a. Without knowledge of the effects of accounting changes, the analyst may draw incorrect conclusions about trends within the enterprise over time. Comparisons with other companies may also be made incorrectly if differences in accounting methods or the effects of accounting changes are ignored.
- b. Changes in accounting methods should be highlighted in the auditor's opinion to inform financial statement users that year-to-year comparability is absent. The accounting changes that Roche adopted in 2000 have significant effects on reported data.
- 20.{S}The preparer gathers financial data, chooses accounting principles and estimates, and assembles the data into financial statements using those methods and estimates. The auditor examines the financial statements for errors, and checks that the accounting methods and assumptions are permissible under GAAP and whether they have been applied consistently over time.
- 21.{S}Companies generally prepare financial statements using the accounting principles of their home country. When selling securities in a foreign jurisdiction, they may be required to prepare supplementary financial statements using the accounting standards of that country. The cost and inconvenience of this extra work may dissuade the firm from selling securities in that country, thus depriving that country's investors of the opportunity to invest.
- On the other hand, investors must choose between that firm's securities and those of home country firms using local accounting principles. If the foreign firm uses different accounting principles, investors may make poor investment decisions because of their inability to separate real differences between firms from differences caused by alternative accounting principles.
- 22.{S}a. Because the probability of loss is so low (less than one in ten thousand), Bonnywill will report no loss. If a fire occurs, the firm will then accrue the estimated loss.
- b. An alternative method would accrue the expected value of the loss, computed by multiplying the number of units sold by the expected loss per unit. The result would be $10,000 \times .00009 \times \$100,000 = \$90,000$.