CHAPTER 1

FINANCIAL ACCOUNTING IN AN ECONOMIC CONTEXT

ISSUES FOR DISCUSSION

ID1–1

Security analysts and stockholders: 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 project 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 a number of ways: raises, promotion opportunities, performance of other departments, etc.

ID1–2

The board of directors serves various functions for a company. One is to represent and protect the interests of the stockholders 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, in many cases the auditors will be sued by the stockholders on the basis that the auditors should have detected the fraud.

ID1–3

The function of the audit committee is to provide a channel whereby the auditors report their findings and concerns, if any, to the board of directors. 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 speak directly to the board of directors.

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

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 a number of 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.

ID1–5

Sales for Home Depot decreased because of the economic conditions during the years shown. One of the hardest hit sectors of the economy was housing, which means that builders purchased less materials from Home Depot to construct houses; existing homeowners were hurt during the recession and had less money to purchase goods from the company for home improvements. Profits decreased because the drop in sales was not offset with an equal drop in expenses. Home Depot was not able to reduce its fixed and variable expenses as quickly as the company saw its revenue drop. Assets decreased as the company depreciated existing stores without adding new locations—again, due to the weakness in the economy. Equity remained flat because the company kept ("retained") more of its profits by lowering its dividends paid to shareholders. Finally, the cash balance slightly increased due to less cash outflows for investments in new stores; due to the economy, the company did not invest nearly as much cash in building new stores, keeping that cash in the business for the time being.

ID1–6

Creditors would impose these types of restrictions on Continental Airlines so that the creditors would be protected for their loans. These types of restrictions are fairly common and act as a trip wire to warn the creditors that business may not be going well. The cash restriction would force Continental to have enough cash to pay the interest on the debt, the minimum stockholders' equity makes sure that there are assets to act as collateral for the loans, and the restriction of dividends insures that management doesn't distribute cash or assets out to the stockholders and not leave assets in the company to satisfy the creditors.

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. What is more typical is for the loans to be restructured. This usually means higher interest rates and fees to do the restructuring. These all put the creditors in a better position to protect their loans.

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 only 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 that are reported this would 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 don't believe the numbers that are reported, a very bad impact on the overall economy would result.

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" – 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 can not 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.

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 for the intergrity of the financial statements. Improved information provided to shareholders and other providers of capital will strenghten the confidence in the financial system, ultimately benefitting both providers and users of capital.

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 needs 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.

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 in a position 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.

ID1–12

Accounting guidelines that are established based on a number of general **principles** have the advantage of being simplified and easier to understand and document. On the other hand, guidelines that are principle-based are more ripe to be exploited by companies desiring to present their financial statements in good light. Guidelines that are based on a detailed set of **rules** are, by definition, lengthy and complicated, trying to anticipate every possible business situation. However, some argue that the more detailed rules-based approach allows the users of financial statements to review companies' financial performance from a consistent perspective.

ID1–13

Management accounting is the accounting system that generates information that is used exclusively by the managers of the company. Financial accounting refers to the financial statements that are prepared and distributed outside of the company. So in many cases management accounting information is the operational information used by the managers of the company. This can be very proprietary to the company and so is not made 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 has to follow GAAP. Its primary purpose is to be used by people outside of the company.

ID1-14

a. Nike is a manufacturing company, primarily engaged in the manufacture and distribution of athletic footwear and apparel.

b. The firm of PriceWaterhouseCoopers audits the financial statements of Nike. 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. 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 Nike; it is up to the user of the financial statements to analyze the company's performance.

c. Net income in 2007 was $1,491,500,000, for 2008 net income was $1,883,400,000 and for 2009 net income was $1,486,700,000.

d. The amounts shown below are in millions:

	2009	**2008**
Total liabilities	$4,556.5	$4,617.4
Total assets	$13,249.6	$12,442.7
TL/TA (%)	34.39%	37.11%

Total liabilities include both Current and Long Term liabilities. From 2008 to 2009 Nike decreased the percentage of its assets that were financed by liabilities. This fact, of course, means that the company increased the percentage of its assets that were financed by equity.

e. Cash from operating activities was $1,878,700,000 in 2007, in 2008 it was $1,936,300,000 and in 2009 it was $1,736,100,000.

f. Nike decreased its profitability (in both raw dollars and as a percentage of revenue) and decreased the amount of cash it generated from operating its core businesses. The company, however, reduced liabilities (in both raw dollars and as a percentage of total assets) and increased its shareholder equity. The economy certainly affected Nike, but the company is quite strong and well-positioned for the future.