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# Financial Reporting and Analysis

## Chapter 1 Solutions

### The Economic and Institutional Setting for Financial Reporting Problems

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#### Problems

#### P1-1. Demand for accounting information

##### Requirement 1:

a) **Existing shareholders** use financial accounting information as part of their ongoing investment decisions—should more shares of common or preferred stock be purchased, should some shares be sold, or should current holdings be maintained? Financial statements help investors assess the expected risk and return from owning a company's common and preferred stock. They are especially useful for investors who adopt a “fundamental analysis” approach.

Shareholders also use financial accounting information to decide how to vote on corporate matters like who should be elected to the board of directors, whether a particular management compensation plan should be approved, and if the company should merge with or acquire another company. Acting on behalf of shareholders, the Board of Directors hires and fires the company's top executives. Financial statement information helps shareholders and the board assess the performance of company executives. Dismissals of top executives often occur following a period of deteriorating financial performance.

b) Financial statement information helps **potential (prospective) investors** identify stocks consistent with their preferences for risk, return, dividend yield, and liquidity. Here too, financial statements are especially useful for those investors that adopt a “fundamental approach.”

c) **Financial analysts** demand accounting information because it is essential for their jobs. Buy-side and sell-side analysts provide a wide range of services ranging from producing summary reports and recommendations about companies and their securities to actively managing portfolios for investors that prefer to delegate buying and selling decisions to professionals. Analysts rely on information about the economy, individual industries, and particular companies when providing their services. As a group, analysts constitute probably the largest single source of demand for financial accounting information—without it, their jobs would be difficult, if not impossible, to do effectively.

d) **Managers** demand financial accounting information to help them carry out their responsibilities and because their compensation often depends on financial statement numbers like earnings per share, return on equity, return on capital employed, sales growth, and so on. Managers often use a competitor's

financial statements to benchmark profit performance, cost structures, financial health, capabilities, and strategies.

e) **Current employees** demand financial accounting information to monitor payouts from profit-sharing plans and employee stock ownership plans (ESOPs). Employees also demand financial accounting information to gauge a company's long-term viability and the likelihood of continued employment, as well as payouts under company-sponsored pension and health-care programs. Unionized employees have other reasons to demand financial statements, and those are described in Requirement 2 which follows.

f) **Lenders** use financial accounting information to help determine the principal amount, interest rate, term, and collateral required on loans they make. Loan agreements often contain covenants that require a company to maintain minimum levels of various accounting ratios. Because these covenants contain accounting ratios, lenders demand financial accounting information so they can monitor the borrower's compliance with loan terms.

g) **Suppliers** demand financial accounting information about current and potential customers to determine whether to grant credit, and on what terms. The incentive to monitor a customer's financial condition and operating performance does not end after the initial credit decision. Suppliers monitor the financial condition of their customers to ensure that they are paid for the products, materials, and services they sell.

h) **Debt-rating agencies** like Moodys or Standard & Poor's help lenders and investors assess the default risk of debt securities offered for sale. Rating agencies need financial accounting information to evaluate the level and volatility of the company's expected future cash flows.

i) **Taxing authorities** (one type of government regulatory agency) use financial accounting information as a basis for establishing tax policies. Companies or industries that appear to be earning "excessive" profits may be targeted for special taxes or higher tax rates. Keep in mind, however, that taxing authorities in the United States and many other countries are allowed to set their own accounting rules. These tax accounting rules, and not GAAP, determine a company's taxable income.

Other government agencies are often the customer. In this setting, financial information can serve to help resolve contractual disputes between the company and its customer (the agency) including claims that the company is earning excessive profits. Financial accounting information can also be used to determine if the company is financially strong enough to deliver the ordered goods and services.

Financial accounting information is also used in rate-making deliberations and rate monitoring of regulated monopolies such as public utilities.

**Requirement 2:**

Student responses will vary, but examples are shareholder activist groups (CalPERS), labor unions, and customers.

- Shareholder activist groups demand financial accounting information to help determine how well the company's current management team is doing, and whether the managers are being paid appropriately.
- Labor unions demand financial accounting information to help formulate or improve their bargaining positions with employer companies. Union negotiators may use financial statements showing sustained or improved profitability as evidence that employee wages and benefits should be increased.

**P1-2. Incentives for voluntary disclosure**

**Requirement 1:**

a) Companies compete with one another for financial capital in debt and equity markets. They want to obtain financing at the lowest possible cost. If investors are unsure about the "quality" of a company's debt and equity securities—the risks and returns of investment—they will demand a lower price (higher rate of return) than would otherwise be the case. Companies have incentives to voluntarily provide information that allows investors and lenders to assess the expected risk and return of each security. Failing to do so means lenders will charge a higher rate of interest, and stock investors will give the company less cash for its common or preferred stock.

b) Companies compete with one another for talented managers and employees. Information about a company's past financial performance, its current health, and its prospects is useful to current and potential employees who are interested in knowing about long-term employment opportunities, present and future salary and benefit levels, and advancement opportunities at the company. To attract the best talent, companies have incentives to provide financial information that allows prospective managers and employees to assess the risk and potential rewards of employment.

c) Companies and their managers also compete with one another in the "market for corporate control." Here companies make offers to buy or merge with other companies. Managers of companies that are the target of a *friendly* merger or tender offer—a deal they want done—have incentives to disclose information that raises the bid price. Examples include forecasts of increased sales and earnings growth. Managers of companies that are the target of *unfriendly* (hostile) offers—deals they don't want done—have incentives to

disclose information that shows the company is best left in the hands of current management. Hostile bidders often put a different spin on the same financial information, arguing that it shows just how poorly current management has run the company.

**Requirement 2:**

- Competitive forces from within the industry (i.e., other firms in the industry are voluntarily disclosing information about order backlogs or customer turnover).
- Demands by financial analysts for expanded or increased disclosure by the firm.
- Demands by shareholder activist groups such as CalPERS.
- Demands by debt rating agencies such as Moody's and Standard & Poor's.
- Pressure from governmental regulatory agencies such as the Securities and Exchange Commission. Firms may believe that disclosing certain information voluntarily may prevent the Securities and Exchange Commission from mandating more detailed disclosures at a later date.
- Demands from institutional investors (e.g., mutual funds, pension funds, insurance companies, etc.) that hold the company's securities.

**Requirement 3:**

The following examples are press release items that could be disclosed voluntarily: forecasts of current quarter or annual earnings; forecasts of current quarter or annual sales; forecasts of earnings growth for the next 3 to 5 years; forecasts of sales growth for the next 3 to 5 years; capital expenditure plans or budgets; research and development plans or budgets; new product developments; patent applications and awards; changes in top management; details of corporate restructurings, spin-offs, reorganizations, plans to discontinue various divisions and/or lines-of-business; announcements of corporate acquisitions and/or divestitures; announcements of new debt and/or equity offerings; and announcements of short-term financing arrangements such as lines of credit. Other student responses are possible.

The advantage of these press releases is that the information is made available to external parties on a far more timely basis than if disclosure occurred in quarterly or annual financial statements. Press releases also give management an opportunity to help shape how the facts are interpreted.

### P1-3. Costs of disclosure

#### Requirement 1:

a) **Information costs** include costs to obtain, gather, collate, maintain, summarize, and communicate financial statement data to external users. Examples are the cost of computer hardware and software, fees paid to audit financial statement data, salaries and wages paid to corporate accounting staff in charge of the firm's financial accounting system, and costs to print and mail annual reports to shareholders.

b) **Competitive disadvantage** costs occur when competitors are able to use the information in ways detrimental to the company. Examples include highlighting highly profitable markets or geographical areas, technological innovations, new markets or product development plans, and pricing or advertising strategies.

c) **Litigation costs** are costs to defend the company against actions brought by shareholder and creditor lawsuits. These suits claim that information about the company's operating performance and health was misleading, false, or not disclosed in a timely manner. Examples include the direct costs paid to lawyers to defend against the suits, liability insurance costs, loss of reputation, the productive time lost by managers and employees as they prepare to defend themselves and the company against the suit.

d) **Political costs** arise when, for example, regulators and politicians use profit levels to argue that a company is earning excessive profits. Regulators and politicians advance their own interests by proposing taxes on the company or industry in an attempt to reduce the level of "excessive" profitability. These taxes represent a wealth transfer from the company's shareholders to other sectors of the economy. Managers of companies in politically sensitive industries sometimes adopt financial reporting practices that reduce the level of reported profitability to avoid potential political costs.

#### Requirement 2:

Student responses to this question may vary. One possible cost is when disclosure commits managers to a course of action that is not optimal for the company. For example, suppose a company discloses earnings and sales growth rate goals for a new product or market. If these projections become unreachable, managers may drop selling prices, offer "easy" credit terms, or overspend on advertising in an attempt to achieve the sales and earnings growth goals.

#### **P1-4. Proxy statement disclosures**

The financial analyst might use the information contained in proxy statements in the following ways:

1) To determine which members of the board of directors are “outside” versus “inside” directors. Outside directors are people that are not also employees of the company. Knowing how many board members are outside directors tells the analyst something about board independence. Company executives are more accountable to an independent board, and the board itself is more effective at monitoring the performance and decisions of top managers.

2) Information about the background of each board member helps the analyst determine how knowledgeable and effective the board is likely to be in monitoring the decisions and strategies of management. Do board members have business experience, or are they celebrities and politicians who know little about the company and its industry?

3) Proxy statements report the share ownership of company executives and board members. As their share ownership increases, managers’ personal wealth becomes more closely tied to the success of the company. As a result, they are more like owners when it comes to strategic decisions and operating tactics. Managers with little (or no) stock in the company don’t have the same incentives to make sound business decisions.

4) Proxy statements help analysts understand management compensation (salary, bonus, stock options, and other pay components), and how much of that compensation is performance-based or guaranteed (salary). If a large portion of managerial compensation is in the form of salary, managers have little incentive to work hard or create value for shareholders because pay doesn’t depend on performance. On the other hand, if a large portion of compensation is in the form of bonuses or stock options, managers have stronger incentives to work hard and create value for shareholders because pay and performance are linked.

5) The proxy statement also describes any changes that year in executive compensation. Knowing how and why compensation has changed alerts analysts to possible changes in managerial decisions.

6) Other student responses are possible.

## P1-5. Your position on the issues

a) Accounting is **not** an exact science. One reason this is the case is that many financial statement numbers are based on estimates of future conditions (e.g., future bad debts and warranty claims). Another reason is that there is no single accounting method that is best for all companies and situations. Thus, different companies use different methods to account for similar transactions (e.g., depreciation of property and the valuation of inventory).

b) While some managers may select accounting methods that produce the most accurate picture of a company's performance and condition, other managers may make financial reporting decisions that are strategic. Consider the following examples:

- Managers who receive a bonus based on reported earnings or return on equity may make financial reporting decisions that accelerate revenue recognition and delay expense recognition in order to maximize the present value of their bonus payments.
- Managers who must adhere to limits on financial accounting ratios in debt covenants may make reporting decisions designed to avoid violation of these contracts.
- More generally, managers are likely to make financial reporting decisions that portray them in a good light.

The moral is that financial analysts should approach financial statements with some skepticism because management has tremendous influence over the reported numbers.

c) This is probably true. Financial accounting is a slave to many masters. Many different constituencies have a stake in financial accounting and reporting practices—existing shareholders, prospective shareholders, financial analysts, managers, employees, lenders, suppliers, customers, unions, government agencies, shareholder activist groups, and politicians. The amount and type of information that each group demands is likely to be different. As a result, accounting standards in the United States reflect the outcome of a process where each constituency tries to advance its interests.

d) This is false. Even without mandatory disclosure rules by the FASB and SEC, companies have incentives to voluntarily disclose information that helps them obtain debt and equity financing at the lowest possible cost. Failure to do so results in higher cost of debt and equity capital.

e) This is true. If the information is value-relevant, there is no obvious reason not to disclose except when doing so places the company at a competitive disadvantage.

f) The best response is that the statement is false because:

- Managers have incentives to develop and maintain a good relationship with financial analysts. Failing to disclose value-relevant information (good or bad) on a timely basis can damage this relationship.
- Under the U.S. securities laws, shareholders can sue managers for failing to disclose material financial information on a timely basis. To reduce potential legal liability under shareholder lawsuits, managers have incentives to disclose even bad news in a timely manner.

g) This is false. Fundamental analysis is the detailed study of financial accounting information for purposes of identifying over- and under-priced securities. Financial statement information is essential to fundamental analysis.

h) This is false. Financial accounting information has value in an efficient market to the extent that it aids investors in the prediction of a firm's systematic risk (i.e., beta).

i) This may be true or false. If a company discloses so little information that investors and lenders cannot adequately assess the expected return and risk of its securities, then its cost of capital will be high. In this case, managers are doing shareholders a disservice by not disclosing more information to financial markets. If, on the other hand, increased disclosure harms the company's competitive advantage, managers have helped shareholders.

j) This is false. Other sources include: industry-wide reports; analyst reports about the firm or its industry; governmental reports about macroeconomic trends and conditions; and the financial statements of other firms in the industry.



## P1-6. How managers and professional investors rate information

The following is a ranking by the various company performance measures based on a 1996 survey done by Ernst & Young.

(Source: Ernst & Young Center for Business Innovation)

	Importance Ranking		
	<u>Corporate Managers</u>	<u>Professional Investors</u>	
Business Segment Results	4	7	
Capital Expenditures	14	6	
Cash Flow	2	2	(tie)
Cost Control	5	4	
Customer Satisfaction	3	11	
Earnings	1	2	(tie)
Market Growth	10	1	
Market Share	13	5	
Measures of Strategic Achievement	9	12	
New Product Development	6	3	
Product and Process Quality	7	13	
R&D Productivity	12	9	
Research & Development	11	8	
Strategic Goals	8	10	

## P1-7 Accounting quality and the audit committee

1) By identifying the key business and financial risks facing the company, the audit committee can ensure that those risks are properly disclosed in the MD&A (Management Discussion & Analysis) section of the annual report. A second reason is that the answer(s) to this question might also flag areas where subjective accounting judgments and estimates are used in preparing the financial statements (see 2 on the following page).

2) By identifying areas where subjective judgments and estimates are used, the audit committee can probe management about the “quality” (objectivity and accuracy) of the estimates, benchmark to the estimates of other firms, and gauge the impact of estimate changes on the financial statements. Estimated uncollectible accounts receivable is a concrete example. Here the audit committee will want to know how this year’s estimate was determined, the reason for any change from last year, and how the estimate compares to estimates for other firms in the industry.

3) By identifying significant areas where the company’s accounting policies were difficult to determine, the audit committee can probe management about its choice of accounting methods in situations where GAAP may not provide clear guidance. This way the audit committee can uncover practices that might

be overly aggressive or overly conservative in portraying the firm's true economic performance and condition.

4) Significant accounting deviations from usual industry practice are a “red flag” for stock analysts and investors. That’s because the deviation is often viewed as an indication that the financial statements are being “managed” to look better than they should. The audit committee will want to probe management about the reason for any deviation from industry practice, and gain confidence that the chosen practice more accurately reflects the economic fundamentals of the business or transaction. The audit committee may also want management to better explain its choice of accounting practices in the annual report.

5) The answers to this question are important for the reasons outlined in 2 above. They help the audit committee gauge the “quality” of the accounting judgments (e.g., when to record revenue) and estimates (e.g., the uncollectible portion of accounts receivable).

6) Changes in accounting methods can sometimes have a dramatic impact on financial statements—remember AOL?—and on the company’s stock price if investors react negatively to the change. The audit committee will want to probe management about the reason for the change, and gain confidence that the new accounting method more accurately reflects the economic fundamentals of the business or transaction. The audit committee may also want management to take special steps in communicating the change to the marketplace.

7) By identifying major transactions or events that required significant accounting or disclosure judgments, the audit committee can ensure that these “special situations” have been dealt with properly.

8) Here the audit committee is asking for a “heads up” about potential changes in accounting practices—both those required by GAAP and those made voluntarily by management. See 4 and 6 above for reasons why the audit committee might want to know about possible accounting changes in advance.

9) “Serious problems” can include incomplete documentation of transactions, errors (inadvertent failure to record a transaction), and accounting “irregularities” (intentionally booking revenue earlier than GAAP allows). The audit committee is interested in knowing about these problems because they can signal accounting system weaknesses, lax internal controls, and culture of dishonesty or deception that threatens management credibility and financial statement integrity.

10) There are two reasons the audit committee is interested in the answer(s) to this question. First, outsiders may have uncovered a real accounting quality threat that is as yet unknown to the committee. Second, the committee may

want management to address outsiders' concerns—real or imagined—so that management credibility and financial statement integrity remains intact.

11) The answers to this question can also uncover areas where accounting quality can be threatened. The committee will want to also hear from the auditor about the nature of the dispute and its resolution.

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# Financial Reporting and Analysis

## Chapter 1 Solutions

### The Economic and Institutional Setting for Financial Reporting Cases

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#### Cases

#### C1-1. AST Research: Restating quarterly results

The two situations—AST and America Online (AOL)—have several things in common: (a) the dollar amounts involved were “large” in absolute amount and relative to reported sales and earnings; (b) the accounting change had no direct cash flow impact; and (c) both accounting changes involved the SEC.

Why didn't investors penalize AST when its accounting change transformed \$14.1 million of profits into an \$8.1 million loss? One explanation is that AST investors did penalize the share price, but they did so prior to the company's formal announcement of the accounting change on June 8, 1995. If investors correctly *anticipated* the AST accounting change and thought that it was bad news, the company's share price would have fallen *before* the June 8 announcement date. (The same could have been true at AOL.) In point of fact, AST's stock price had not declined during the weeks before its accounting change was announced. When might you expect to see a negative share price reaction to an accounting change like that made by AST or AOL?

- When the firm is using a method that few other companies in the industry use. Investors may mistakenly fail to adjust for the accounting difference when valuing the company. The accounting change alerts investors to the difference and they accordingly revalue the firm.
- Concerns are raised about the firm's economic viability and its ability to finance continued expansion. (Recall AST transformed profit into a loss!) Investors may lower the stock price to reflect less optimistic forecasts of profitability and growth.
- The company's use of capitalization is described by analysts and the financial press as an attempt to manage its reported earnings. The accounting change may cause investors to question the quality of the firm's financial statements and management's commitment to shareholder value.

The AST accounting change seems, on the surface, to have resulted from a simple difference of opinion regarding acquisition accounting rules. There is nothing to suggest lower growth opportunities or questionable behavior on the part of company managers.

Some instructors may want to use this case to explore notions of market efficiency.

How is the company doing today (May 1998)? AST Research reported operating losses in both 1995 and 1996. In April 1997, the company was acquired by Samsung Electronics for \$5.40 per share.

**C1-2. Henley Manufacturing Inc. (CW):** Announcing sales and earnings goals

**Requirement A:**

1) Potential **costs** of announcing earnings and sales goals include: (a) possible shareholder lawsuits if goals are not met; (b) loss of reputation if goals are not met; (c) disclosure may convey information to competitors about the profitability of products or market territories; (d) managers may make dysfunctional decisions—ease credit terms, increase advertising expenditures, reduce R&D expenditures—near the end of the accounting period if it looks like the goals will not be met.

Potential **benefits** include: (a) investors can better understand the risks and rewards of stock ownership because they know more about the company's plans; (b) disclosure may improve relationships with lead investors and analysts, especially if it's part of an ongoing communications strategy and not just a one-time event; (c) investor and creditor uncertainty may be reduced, thus lowering the company's cost of debt and equity financing.

2) Should management disclose its earnings and sales goals? It depends on whether the benefits outweigh the costs, and on how confident management is that the goals can be achieved.

Easily achievable goals are likely to be disclosed without much reservation. Difficult goals are less likely to be disclosed because management may not want to risk disappointing investors if results fall short of target. One way to avoid disappointment is to make the goals less specific—for example, "sales are expected to increase by as much as 15%" or "sales are expected to be up substantially next year."

3) In all likelihood, the recommendation would change. Consideration would now be given to the fact that, as the planning horizon increases, it becomes more and more difficult to forecast accurately. For example, major changes in market-wide and industry-wide competitive conditions over the next two or three years could have a dramatic impact on whether or not the goals can be achieved.

## **Requirement B:**

In this case, the nature of the goals is quite varied. In all likelihood, investors and financial analysts are going to be more interested in profitability and cash flow forecasts than in other financial aspects of the company. As a result, it seems reasonable to recommend disclosure of the following goals—subject to the cost and benefit considerations mentioned earlier: annual sales growth of 15%; annual earnings growth of 20%; a return on net tangible assets of 16%; a return on common equity of 20%; a minimum profit margin of 5%.

### **C1-3. Whirlpool Corporation (CW): Disclosing major customers**

1) The SEC requires firms to alert financial statement readers about major customers that contribute 10% or more to annual sales. This information helps investors and analysts assess sales volatility and the potential impact on profitability of the loss of a major customer. The information is especially important for companies operating in industries where competition for customers is intense.

2) Financial analysts might use these disclosures in the following ways:

- To assess customer risk. The more revenue a company derives from a single customer or small group of customers, the greater the adverse impact on profitability if one or more of these customers is lost to a competitor or simply goes out of business.
- By studying a firm's major customers (i.e., the products they sell, expected future demand for such products, untapped markets in other countries or geographical areas), an analyst can determine the likelihood of increased future sales to that customer and, hence, profits to the company.

3) The primary reason Sears monitors Whirlpool's financial health is to ensure that Whirlpool can be relied upon as a supplier of durable goods (refrigerators, air conditioners, washers, and dryers, etc.) to be sold at Sears. The buyer (Sears) wants to make certain that goods will be produced, delivered, and available in Sears' stores when consumers want them.

Sears is likely to monitor the following aspects of Whirlpool's operations: inventory levels, expenditures for research and development, overall profitability (i.e., the income statement), financial health and the mix of debt and equity financing (i.e., the balance sheet), and cash flow generating ability (i.e., the cash flow statement).

Whirlpool probably provides Sears with financial information beyond that contained in the company's shareholder financial statements. This additional information might well include inventory levels for individual products,

production lead times for various products, new products in development, features being considered for new products, and product improvements being considered.

4) Whirlpool monitors the financial health of Sears to ensure that Sears will be a continuing source of demand for its products in the future. Whirlpool is likely to monitor the following aspects of Sears' operations: inventory levels, sales, advertising expenditures, overall profitability, financial health and debt levels, and cash flow generating ability.

Sears may provide Whirlpool with information beyond that reported in its shareholder financial statements. For example, additional information could include days' sales in inventory for Whirlpool products, market surveys results about features consumers want to see in new products, and special promotions that will feature Whirlpool products.

#### **C1-4. The gap in GAAP (CW)**

1) Advantages of allowing managers some flexibility in the choice of financial reporting methods include:

- Accounting must serve as a slave to many masters. Stated differently, financial accounting information is used for many purposes including valuation, credit analysis, and contracting, and there is no reason to believe that a single set of financial reporting methods would serve each of these purposes equally well. By allowing managers some latitude in the choice of financial reporting methods, they can weigh the trade-offs implicit in making the firm's financial reporting data informative for each of these potential uses.
- If managers have some latitude in their choice of financial reporting methods, they can adapt the firm's financial reporting practices to changes in the firm's economic characteristics and/or environment over time. For example, a change in the rate of technological advance in a firm's industry may mean that new long-term assets should be written off at a faster rate than was previously the case. Assuming the firm had been using straight-line, a change to an accelerated depreciation method might be optimal, assuming that managers want the numbers reported in the income statement and balance sheet to present the most accurate picture of the firm's economic environment.

2) The current financial reporting system in the United States is really a combination of the two approaches.

On the one hand, firms have latitude in the selection of accounting methods to summarize various transactions and events. Examples include inventory valuation where firms may select from LIFO, FIFO, or weighted average;

depreciation policy where they may select from straight-line or accelerated methods such as sum-of-the-years'-digits or declining-balance methods; and accounting for oil and gas exploration costs where firms may apply the full-cost or the successful-efforts method.

On the other hand, there are numerous cases where the FASB (or SEC) has mandated a single accounting method or treatment for various transactions or events. Examples include research and development expenditures which must be expensed in the year incurred; leases which must be capitalized and reported as liabilities on the balance sheet if certain criteria are met; accounting for foreign currency translation; and accounting for pension benefits and other postemployment benefits other than pensions.

3) The **advantages** of a single set of accounting methods include:

- Facilitates comparability of financial information across firms at a point in time and over time. This may be appealing to financial analysts because it potentially makes their work easier.
- Ease of verification by the auditing profession. Might lead to fewer shareholder lawsuits and suits against auditors for aggressive financial reporting decisions made by managers. External auditors may find the ease of verification beneficial to them.

The **disadvantages** of a single set of accounting methods include:

- Assumes that the financial performance and condition of all firms can adequately be captured by a single set of accounting methods. Implicitly assumes that firms are homogeneous. Moreover, that all firms have identical economic features and characteristics and face identical economic environments.
- Assumes that a single set of accounting methods serves all the potential uses of financial statement information (e.g., valuation, credit analysis, and contracting).

The **advantages** of allowing some flexibility in the choice of financial reporting methods include:

- Firms can tailor their choice of financial reporting methods to the specific aspects of their economic environment and circumstances. For example, depending on whether the prices of its input products is increasing or decreasing, FIFO may be a more realistic choice of inventory valuation method for income determination purposes when compared to LIFO (or vice versa). As another example, in industries where long-term aspects are subject to a rapid rate of technological advance and change,



accelerated depreciation methods may be superior for income determination purposes when compared to straight-line (or vice versa).

The **disadvantages** of allowing some flexibility in the choice of financial reporting methods include:

- May detract from making comparisons across firms at a point in time and over time.
- Managers may use their discretion over reporting methods to distort the firm's performance. They might adopt financial reporting practices that create the appearance of profitability in an attempt to hide or cover up poor operating performance. They might also adopt financial reporting practices that accelerate the recognition of revenues and delay the recognition of expenses in an attempt to maximize the present value of payouts from bonus plans tied to reported profitability.

### **C1-5. IES Industries: Voting on a merger**

#### **Requirement 1:**

As an employee-stockholder, two issues would seem to be of most concern: Which deal—the three-way merger or the takeover—will have the most favorable impact on share value and on my continued employment with the company? Because only 100 shares are owned, most of the employee's concerns are likely to focus on job issues.

- What plans do the merger partners have for reducing the workforce at the three companies? What jobs are likely to be affected, and what severance benefits will be offered? How will positions in the merged company be filled?
- Why didn't the IES share price increase following announcement of the three-way merger? Does this mean that there are no benefits to IES shareholders or employees?
- What will happen to my job if MidAmerican buys IES? The extra \$500 I will receive from a MidAmerican buyout (100 shares × \$5 per share) seems small in proportion to my employment risk.

IES financial statements are not likely to be of much help in answering these questions. The merger prospectus probably identifies key areas of duplication and, thus, may shed some light on where cost savings are likely to be found—but the prospectus will not say much about specific jobs. Nor will MidAmerican say much about possible job reductions at IES because to do so would lessen its chance of receiving a favorable vote from IES shareholders (some of whom are employees).

## **Requirement 2:**

Most institutional investors own stocks for the long term. Historically, utility stocks are held because they have little risk (regulated monopoly) and predictable dividends. This implies that the institutional investor will be concerned about long-term value (share price appreciation) and dividends in an increasingly competitive environment. Questions might include:

- How will the combined companies position themselves for an increasingly competitive energy environment? What specific plans does management have, are they realistic, and will the combined companies have the capabilities to execute those plans?
- How will the three-way merger affect dividends? Are the three companies generating excess operating cash now, what are they doing with that cash, and how will that change as competition increases?
- Why didn't the share price of IES increase when the three-way merger was announced? What is the market saying about merger benefits to IES shareholders?
- How would MidAmerican position itself for an increasingly competitive energy environment? Which strategy seems to hold the most promise?
- What will MidAmerican do about dividends? Is it generating excess operating cash now? If so, what's being done with the money?
- What specific cost reductions and redundancies have been identified? Are the estimated cost savings realistic? What is the timetable for capturing those cost reductions?

Company financial statements will prove to be of some help in answering these questions, particularly with respect to excess operating cash flows and future dividends. It will also be the case that an institutional investor with 5% ownership will be the target of proxy solicitation attempts by both sides—the merger partners and MidAmerican.

## C1-6. Trans World Airlines' (TWA) (CW) Earnings announcement

For discussion purposes, here are some useful comparisons between 1992 and 1993 (\$ in millions).

	<u>1993</u>	<u>1992</u>
Net income (loss)	\$ 623.8	(\$317.7)
Gain on debt retirement	1,080.0	0
"Pre-gain" loss <sup>1</sup>	(451.8)	(317.7)

<sup>1</sup>  $(623.8 - 1,080.0) = -456.2$  is not equal to the -451.8 million TWA reports in the article. The difference probably reflects some additional credits that TWA does not separately break out in the article.

Operating income before taxes, misc. credits, and charges	(\$ 281.3)	(\$404.6)
Revenue (decline of 13%)	3,160.0	3,630.0
Load factor	63.5%	64.7%

There are several things that you might tell your father, almost all of which are bad news.

### The bad news:

- TWA was not really profitable in 1993. The one-time gain from debt retirement increased reported income by \$1,080.0 million, but had no impact on TWA's cash flow. Perhaps more importantly, this income is not a recurring source of sustainable earnings that TWA will earn year in and year out.

The gain arose because TWA exchanged debt whose face amount exceeded the equity shares that were issued. The transaction was part of TWA's bankruptcy process and its negotiations with creditors.

To see the effect of this transaction more clearly, consider the following journal entry:

<b>DR</b> Various bonds/LTD	\$XXX	
Various notes	XXX	
<b>CR</b> Stockholders' equity		\$XXX
Gain on retirement of debt		1.08 Billion

- TWA's "pre-gain" loss for 1993 was much larger than in 1992 (i.e., \$451.8 million versus \$317.7 million). This means that, before considering the debt retirement gain, TWA was even more unprofitable in 1993 than it was in 1992.

- Revenues fell by 13%, although part of the reason for the drop is that it appears that TWA reduced airline service in some markets.
- TWA's load factor (percentage of seats filled on a given flight) fell by over 1%.

#### **The good news:**

- The loss before taxes, misc. credits and charges decreased from \$404.6 million in 1992 to \$281.3 million in 1993. Of the numbers reported in the article, this item probably comes closest to a measure of TWA's ongoing (sustainable) income. The fact that it is negative is not good, but the fact that it improved from the prior year means there's hope. It would be important for an analyst to investigate the nature of the misc. credits and charges that were made in 1992 and 1993. This would enable the analyst to make a more meaningful comparison of the numbers TWA reports for loss before taxes, misc. credits and charges.

#### **The bottom line:**

"Not all earnings are created equal!" The large gain TWA reported in 1993 creates the illusion of profitability, when, in fact, the company is still operating at a loss.

What should you tell your father? It seems clear that based on current year results, your father should not expect TWA to begin paying dividends, restore any pilots' wage concessions, or to purchase any new aircraft.

### **C1-7. Landfil's accounting change**

- "It's consistent with GAAP and fully disclosed." While true, this approach may not be comforting to analysts and investors concerned about whether capitalization makes the company look more profitable than it really is. Given the steep price decline at Chambers Development, analysts and investors will be scanning their radar screens for other capitalization companies, and they will surely discover Landfil's accounting. Unless capitalization can be strongly defended, the company's share price is likely to fall.
- "We capitalize, and we're proud of it!" The heart of this strategy is the notion that the company has already made the "correct" accounting decision—one that fairly portrays the profit performance and asset base of Landfil. If investors and analysts can be convinced, continued use of capitalization should not result in a share price decline...but can they be convinced?
- "We can afford to change." Even if capitalization is the "best" (most appropriate) accounting method for Landfil, it still might be advantageous to change. First, a change to immediate expensing will dispel any remaining skepticism on the part of investors and analysts. Second, it demonstrates

management's confidence in the company's prospects and its ability to absorb the dollar impact of the change. But this strategy is risky—investors and analysts may incorrectly presume that capitalization was being used to “manage” reported earnings. This may cause them to question the company's other accounting methods and the quality of its financial reports.

### **C1-8. AstroText Company:** Questions for the stockholders' meeting

#### **Requirement 1:**

An employee shareholder might be interested in the following sorts of questions:

- Why is AstroText willing to pay a \$7 per share (\$21 million) premium for TextTool?
- How will the premium be financed—operating cash flows, debt, stock, or the sale of TextTool assets?
- What impact will the premium and form of financing have on the value of my AstroText shares and stock options?
- How will the acquisition premium affect our ability to maintain or increase our new product R&D?
- How will my job be affected by the merger/acquisition?

The financial statements of both companies could shed light on some of these questions. For example, we could learn if cash balances and operating cash flows are sufficient to finance the transaction. We might also uncover significant non-operating assets that could be sold to raise cash. R&D spending patterns might suggest financing concerns or indicate redundancies that could be eliminated. SG&A cost comparisons might also identify redundancies that could be eliminated.

The employee-shareholder has two concerns: What will happen to the value of my shares and options, and will I still have a job? Neither question can be fully answered by analyzing company financial reports but the reports will shed some light on the questions.

#### **Requirement 2:**

The lead banker for AstroText will have two concerns: How does the proposed transaction affect the risk of loans currently placed with the company, and what are the long-term prospects for the combined companies? Specific questions might include:

- How will AstroText finance its acquisition of TextTool, and will the transaction increase the credit risk of loans we now have with AstroText?
- Does the acquisition require lender approval, and, if so, should we approve the transaction?
- How has TextTool been financing its activities? Who is the lead bank, and do we have an opportunity to increase our business as a result of the acquisition?
- What financing needs will the combined companies have going forward, and how can we help structure credit facilities consistent with those needs?
- Will either company be selling assets as part of the transactions? If so, which assets and for how much? How will the proceeds be used?

Company financial statements will prove to be quite helpful to the lender. TextTool's report will outline its current lending agreements and may even identify its lead banker. This will help identify the competition for future business. The combined cash flow statements will help the lender determine if credit risk has changed. This analysis, coupled with information from management about future plans, can also help uncover new business opportunities.