Understanding Financial Statements 11th edition Fraser Solutions Manual

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Solutions to Study Questions, Problems, and Cases

Chapter 1

1.1 The types of questions that can be answered include the following:

- Would an investment generate attractive returns?
- What is the degree of risk inherent in the investment?
- Should existing investment holdings be liquidated?
- Will cash flows be sufficient to service interest and principal payments to support the firm's borrowing needs?
- Does the company provide a good opportunity for employment, future advancement, and employee benefits?
- How well does this company compete in its operating environment?
- Is this firm a good prospect as a customer?

1.2 The annual report is published primarily for shareholders, while the 10-K report is filed with the Securities and Exchange Commission and is used by regulators, analysts, and researchers. The financial statements and much of the financial data are identical in the two documents; but the 10-K report contains more detail (such as schedules showing management remuneration and transactions, a description of material litigation and governmental actions, and elaborations of many financial statement accounts) than the annual report; and the annual report presents additional public relations type material such as colored pictures, charts, graphs, and promotional information about the company.

1.3 The analyst should use the financial statements: the balance sheet, the income statement, the statement of stockholders' equity, and the statement of cash flows; the notes to the financial statements; supplementary information such as financial reporting by segments; the auditor's report; management's discussion and analysis of operating performance and financial condition; and the five-year summary of financial data.

Use the public relations "fluff," such as colored pictures and descriptive material with caution.

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1.4 The SEC has the legal authority to write accounting rules in the United States; however, they choose to delegate writing rules, for the most part, to the FASB. The SEC plays a supportive role and at times will encourage FASB to write particular rules or make changes to policies.

1.5 The annual report or Form 10-K includes the following four financial statements:

1. The *balance sheet or statement of financial position* shows the financial position—assets, liabilities, and stockholders' equity—of the firm on a particular date, such as the end of a quarter or a year.
2. The *income or earnings statement* presents the results of operations—revenues, expenses, net profit or loss, and net profit or loss per share—for the accounting period.
3. The *statement of stockholders' equity* reconciles the beginning and ending balances of all accounts that appear in the stockholders' equity section of the balance sheet. Some firms prepare a statement of retained earnings, frequently combined with the income statement, which reconciles the beginning and ending balances of the retained earnings account. Companies choosing the latter format will generally present the statement of stockholders' equity in a footnote disclosure.
4. The *statement of cash flows* provides information about the cash inflows and outflows from operating, financing, and investing activities during an accounting period.

1.6 The notes are, in fact, an integral part of the statements and must be read in order to understand the presentation on the face of each financial statement. The notes to the financial statements provide a summary of the firm's accounting policies, any changes in accounting policies during the reporting period, details about particular accounts, such as inventory, property, plant, and equipment, investments, debt and equity accounts, and information about items such as acquisitions, divestitures, pension and stock option plans, leases, legal proceedings, income taxes, contingencies, commitments, and segments,

1.7 A qualified report is issued when the overall financial statements are fairly presented "except for" items which the auditor discloses; an adverse opinion is issued when the financial statements have departures from GAAP so numerous that the statements are not presented fairly. A disclaimer of opinion is caused by a

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scope limitation resulting in the auditor being unable to evaluate and express an opinion on the fairness of the statements. An unqualified opinion with explanatory language is caused by a consistency departure due to a change in accounting principle, uncertainty caused by future events such as contract disputes and lawsuits, events which the auditor believes may present business risk and going concern problems.

1.8 The Management Discussion and Analysis section is of potential interest to the analyst because it contains information that cannot be found in the financial data. The content of this section includes coverage of any favorable or unfavorable trends and significant events or uncertainties in the areas of liquidity, capital resources, and results of operations. In particular, the analyst can expect to find a discussion of the following:

1. The internal and external sources of liquidity
2. Any material deficiencies in liquidity and how they will be remedied
3. Commitments for capital expenditures, the purpose of such commitments, and expected sources of funding
4. Anticipated changes in the mix and cost of financing resources
5. Unusual or infrequent transactions that affect income from continuing operations
6. Events that cause material changes in the relationship between costs and revenues (such as future labor or materials price increases or inventory adjustments)
7. A breakdown of sales increases into price and volume components

1.9 The proxy statement is a document required by the SEC to solicit shareholder votes, since many shareholders do not attend shareholder meetings. The analyst can find important information in the proxy statement such as background information on the company's nominated directors, director and executive compensation, any proposed changes to those compensation plans and the audit and non-audit fees paid to the auditing firm.

1.10 Employee relations with management, employee morale and efficiency, the reputation of the firm with its customers and in its operating environment, the quality and effectiveness of management, provisions for management succession, potential exposure to regulatory changes, "bad publicity" in the media.

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1.11

Memorandum

Date: Current Date
To: B.R. Neal, Director of Marketing
From: Student's Name
Subject: Contents of an Annual Report

The company's annual report presents financial information about the firm. This information package is published primarily for shareholders and the general public. The major components of an annual report are briefly described in this memo.

1) An annual report contains four financial statements: The **balance sheet** shows the financial condition (assets, liabilities, stockholders' equity) at end of year; the **income** or **earnings statement** presents the results of operations including revenues, expenses, net profit or loss, and net profit or loss per share for the year; the **statement of stockholders' equity** reconciles beginning and ending balances of accounts in the equity section of the balance sheet; and the **statement of cash flows** shows inflows and outflows of cash from operating, financing, and investing activities for the year.

2) Notes to the financial statements provide additional detail about particular items in the financial statements. 3) The auditor's report is prepared by an independent accounting firm and attests to the fairness of the information presented. 4) The five year summary shows key financial data including net sales, income/loss from continuing operations on a dollar and per share basis, assets, long term debt, and dividends per common share. 5) Quarterly stock prices record how the company's stock shares have performed over the past two years. 6) Management's Discussion and Analysis provides management's perspective on how the company is doing including favorable or unfavorable trends, and significant events or uncertainties.

The remaining material in the annual report is included primarily to provide background information about the company and its management, and to make the document attractive and interesting to read.

If staff members would like to learn more about any of the material in the company's annual report, the following book is highly recommended: Understanding Financial Statements by Fraser and Ormiston (Prentice Hall, 20??).

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1.12 There is no solution presented as the information will be changing over time.

1.13 The SEC website contains information useful to the financial analyst including the following sections:*

"About the SEC" explains the role of the SEC, outlines the laws, regulations, and rules of practice of the SEC, includes biographies of the SEC commissioners, lists upcoming events, offers a listing of all the forms available at the SEC, and includes the strategic plan, annual reports, budgets, and directories of the SEC.

"Divisions" has links to each SEC division and office and includes an organization chart of the SEC. Each of the division links offers significant information related to each division's duties.

"Enforcement" provides information on SEC enforcement actions, opinions issued by the Commission, briefs filed by SEC staff, trading suspensions, and notices concerning the creation of investors' claims funds in specific cases.

"Regulation" provides links to releases concerning SEC rulemaking activity.

"Education" allows the analyst to search for information, ask questions, file complaints, access research tools and calculators, and includes warnings and updates the SEC may desire to share with the public.

"Filings" includes the EDGAR database which allows analysts to access the SEC forms filed by publicly-held companies. A quick EDGAR tutorial is offered in this section as well as a description of SEC forms and how to request paper documents.

"News" includes SEC press releases, speeches and testimony by senior SEC officials, special studies and reports and a list of topics of current interest at the SEC.

Other links provided on the SEC homepage include information for specific groups such as accountants, broker dealers, EDGAR filers and small business to name a few.

*Information was obtained in March, 2014. Changes may have been made since that date.

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Case 1.1

(a) Intel designs and manufactures advanced integrated digital technology platforms. A platform consists of a microprocessor and chipset, and may be enhanced by additional hardware, software, and services. Platforms are used in a wide range of computing applications, such as notebooks, desktops, servers, tablets, smartphones, automobile infotainment systems, automated factory systems, and medical devices. Intel also develops and sells software and services primarily focused on security and technology integration. (pg. 1 of Form 10-K)

(b) The analyst could learn the following by reading the letters from the CEO and the chairman:

- Intel delivered revenue of $52.7 billion, net income of $9.6 billion, $1.89 of earnings per share and $21 billion of cash from operations in 2013,
- Intel's datacenter business is growing due to increased demand for cloud services, high-performance computing, storage and networking,
- Intel is the only semiconductor manufacturer offering Tri-gate transistors and 22 nanometer technology-based products,
- in 2013, the fourth generation of Intel Core processors were introduced and a new family of low power Intel Atom chips for mobile devices,
- in 2013, Intel sold 10 million microprocessors for tablets and has a goal to sell 40 million in 2014,
- Intel continues to pursue Moore's Law by developing computing devices that are smaller, lower cost, and higher performing, and can also be more mobile,
- Quark technology was introduced in 2013 as Intel continues to innovate in markets for wearables and "Internet of Things" where priorities are small size, low power consumption chips,
- Intel returned $6.6 billion in value to shareholders in the form of $4.5 billion in dividends and $2.1 billion of repurchased common stock,
- corporate responsibility initiatives include expanding education opportunities for millions of students around the world, being the largest voluntary purchaser of green power in the U.S., and donating over a million employee hours to communities
- Intel accomplished goal to manufacture DRC conflict-free microprocessors in 2013, i.e. products are free of minerals that benefit armed groups in the Democratic Republic of the Congo

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- Andy Bryant, chairman of Intel's Board acknowledged Intel's failure to recognize the potential of the tablet market in a timely manner and discussed that when choosing the new CEO the board looked for a person who would look at markets from a fresh perspective, help make Intel a leaner, more agile company attuned and reacting to the world around it, and with a focus on accountability and results.

(c) Intel received an unqualified audit opinion. The audit report states that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board and the financial statements are in conformity with generally accepted accounting principles. Intel also received an unqualified opinion on the effectiveness of their internal controls over financial reporting. (pgs. 107-108 of Form 10-K)

(d) The Management Discussion and Analysis for Intel discusses the following items: (Note: the numbers refer to the checklist found in Figure 1.3.)

1. The company expects the key source of liquidity to be cash from operating activities. In 2013, Intel generated $20.776 billion of cash from operations. Cash is generated externally from the sale of stock through employee plans and the firm raised $1.6 billion in proceeds in 2013. The company has the potential to borrow $3.0 billion under its commercial paper program. Intel borrowed $300 million in 2013 but this was repaid before year-end. In addition, Intel has the ability to offer an unspecified amount of debt, equity and other securities because it has an automatic shelf registration on file with the SEC. (pgs. 40-43 of Form 10-K)

2. No material deficiencies of liquidity currently exist. (pgs. 40-43 of Form 10-K)

3. Intel does not share the projections for capital expenditures or the purpose of any capital expenditures for the 2014 fiscal year. The Business Outlook section which lists current expectations for revenue, gross margin percentage, R&D spending and capital expenditures in 2014 is available on the Investors Relations web site www.intc.com. (pg. 29 of Form 10-K)

Note: the Business Outlook section on Intel's website is often updated so that information found at on a certain date may change at a later date. As of April 2014, the capital expenditures were projected to be approximately $11 billion for 2014.

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4. No anticipated changes in the mix and cost of financing resources are discussed. (pgs. 41-43 of Form 10-K)

5. No unusual or infrequent transactions were found in 2013.

6. Intel reduced their workforce, certain businesses, and facilities in 2013 as a result of the business environment. (pg. 38 of Form 10-K) The firm has projected that revenues and gross margins will be flat in 2014. (pg. 29 of Form 10-K) Savings from the cost cuts mentioned above combined with an upward trend in operating expenses as a percentage of revenue may result in flat net income for the upcoming year.

7. Sales decreased 1% overall due to lower platform unit sales partially offset by higher average selling prices. The PC Client Group revenues decreased 4% primarily due to less demand for traditional PC products. Lower notebook and desktop platform unit sales were down 4% and 2%, respectively. The Data Center Group revenues increased 7% due to both volume and higher average selling prices. Revenues decreased 7% in the Other Intel Architecture segment due to lower unit sales and, to a lesser extent, lower average selling prices. (pgs. 34-37 of Form 10-K)

(e) Intel is focusing on new growth opportunities which are positive. The firm has the financial resources to pursue their strategy. Some concerns may be potential competition and the current downward trend in sales and profits. It appears Intel has not transitioned away from traditional PC products quickly enough.

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Case 1.2

(a)

Clear

The 'Analysis ToolPak' add-in must be installed and active.

Enter data on this sheet before other financial statement information.

Company Name:	Applied Materials		
Stock Ticker Symbol:	AMAT		
U.S. Stock Exchange:	NASDAQ		
Statement Year-end Dates:	10/27/2013	10/28/2012	10/30/2011
Financial Reports Rounded to :	Millions		

Supplemental Ratio Requirements:	2013	2012	2011
Rent expense (in millions):	$ 36	$ 38	$ 44
Dividends per share:	$ 0.39	$ 0.35	$ 0.31
End of year stock price (***adjusted for splits***):	$ 17.71	$ 10.65	$ 12.62
Marketwatch.com URL for stock prices:	http://marketwatch.com/tools/quotes/historical.asp?date=10%2F25%2F2013&symb=AMAT&siteid=mktw	http://marketwatch.com/tools/quotes/historical.asp?date=10%2F26%2F2012&symb=AMAT&siteid=mktw	http://marketwatch.com/tools/quotes/historical.asp?date=10%2F28%2F2011&symb=AMAT&siteid=mktw

Check Figures:

Balance Sheet	Current Assets:	$ 5,642	$ 5,102	
	Total Assets:	$ 12,043	$ 12,102	
	Current Liabilities:	$ 2,443	$ 2,265	
	Total Stockholders' Equity:	$ 7,088	$ 7,235	
Income Statement	Gross Profit:	$ 2,991	$ 3,313	$ 4,360
	Operating Profit:	$ 432	$ 411	$ 2,398
	Net Profit:	$ 256	$ 109	$ 1,926
Cash Flow	Net Flows from Operations:	$ 623	$ 1,851	$ 2,429
	Net Flows from Investing Activity:	$ 215	$ (4,660)	$ 707
	Net Flows from Financing Activity:	$ (519)	$ (1,754)	$ 960

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(b) Each student's response will differ depending on the news sources used and the date on which the student completes the assignment. Below is a sample of the type of article a student could find about Applied Materials in 2013:

Source: Daisuke Wakabayashi, "Applied Materials to Acquire Tokyo Electron; Merged Firm to Have $29 Billion Market Capitalization," Wall Street Journal Online, September 24. 2013.

If Applied Materials makes it through the antitrust screening and is allowed to acquire Tokyo Electron, the merger would be one of the largest foreign takeovers of a Japanese company. If merged, the combined firm will be incorporated in the Netherlands. The merger has been compared to combining Google and Microsoft. Applied Materials is No. 1 in sales of chip manufacturing gear and Tokyo Electron ranks third.

(c) Item 1 in the Applied Materials Form 10-K for 2013 describes the business in which Applied Materials operates. The organizational structure of the firm is detailed including information about Applied Materials' four operating groups, the economic regions in which the firm operates, and the products and solutions that the firm provides to their customers. A discussion of the competitive environment for each segment is outlined and short biographies of the company's executive officers are also included.

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Case 1.3

1. Mattel, Inc. designs, manufactures, and markets a broad variety of toy products worldwide.

2. a. Balance sheet - pg. 57
   b. Income statement - pg. 58 (59 is comprehensive income statement)
   c. Statement of cash flows - pg. 60
   d. Statement of stockholders' equity - pg. 61
   e. Notes to the financial statements - pgs. 62-102
   f. Management's discussion and analysis - pgs. 27-51
   g. Summary of selected financial data - pg.26
   h. Auditor's report - pg. 56

3. PricewaterhouseCoopers LLP

4. a. Assets - $6,439,626
   b. Liabilities - $3,188,067 ($1,047,440+$2,140,627)
   c. Stockholders' equity – $3,251,559
   d. Net sales - $6,484,892
   e. Net income - $903,944
   f. Cash decreased $296,495
   g. Retained earnings - $3,918,122

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Case 1.4

a. The Management Discussion and Analysis section provides important information that cannot be found anywhere else in the annual report. The section covers trends, events, and uncertainties in the areas of liquidity, capital resources, and operations. Information should include a discussion of:

1. Internal and external sources of liquidity;
2. Any material deficiencies in liquidity and how they will be remedied;
3. Commitments for capital expenditures and expected sources of funding;
4. anticipated changes in the mix and cost of financing resources;
5. Unusual or infrequent transactions which affect income from continuing operations;
6. Events which cause material changes in the relationship between costs and revenues; and
7. A breakdown of sales increases into price and volume components.

b. The MD&A includes the following discussion of the seven items outlined in (a) above:

1. The principal sources of liquidity for Biolase are cash and cash equivalents on hand of $1.4 million, $11.1 million of net accounts receivable (internal sources) and available borrowings under two revolving credit lines totaling approximately $3.4 million (external sources). It should be noted that the credit lines will expire in May, 2014 and the firm will need to find alternative sources of funding. In addition, Biolase has registered equity securities with the SEC up to a total offering price of $12.5 million and in February, 2014, received proceeds of $4.8 million from the private placement of common stock (external source).
2. While Biolase explains in the MD&A that the financial statements have been prepared under the assumption that the firm is a going concern, there is substantial doubt that the firm will be able to continue as a going concern as evidenced by the explanatory language in the audit opinion referring to this issue. Biolase has discussed the material deficiencies in liquidity and, also, remedies being employed to prevent bankruptcy. The company has used cash in operations three years in a row due to net losses. Remedies include obtaining new patents for cutting edge products, restructuring their sales and marketing team to improve revenues, implementing cost cuts, and

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hiring an investment banking firm to explore merger and acquisition opportunities.

3. Biolase plans to spend approximately $750,000 for capital expenditures. There is no explanation in the MD&A to explain how the funds will be used or how they will fund these expenditures.
4. Based on the information related to the going concern issue it appears likely that Biolase may take on more debt in the future, assuming they can find lenders willing to offer credit. The firm has been successful in private placements of common stock so equity could also increase if investors can be located.
5. The going concern issue would be unusual and infrequent.
6. It is difficult to determine if there will be any material changes in the relationship between costs and revenues. It seems likely that any increases in revenues will be offset by higher costs. For example, Biolase may be able to increase sales due to a better organized sales force and demand for newer products; however, those products have higher costs than the laser systems so the increased revenue dollars may be offset by the increase in cost of goods sold. Based on the expectations Biolase discusses in the MD&A, engineering expenses may increase in the future while payroll, marketing and advertising expenses decrease. Other costs, though not specified by Biolase, that may increase would include interest expense, if more debt is needed, legal costs for the defense of class action lawsuits and other general and administrative expenses. Overall, it is doubtful that Biolase will be able to improve results. In fact, it is possible that the firm may not be able to increase sales enough to avoid bankruptcy.
7. Net sales decreased 2% in 2013 due to volume decreases in domestic laser system revenue, offset by volume increases in imaging systems, consumable products, services, license fees and royalty revenue. Domestic laser system sales have higher profit margins than imaging system sales and international laser system sales.

c. Biolase explained changes in numbers and offered reasons for these changes. Some forward-looking information was offered in the discussion of expenses and capital expenditures; however, more detail about capital expenditures is warranted. The firm was honest in discussing the financial issues faced by the firm and offered quality information to explain how they planned to remedy the deficiencies in liquidity.

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d. Answers will vary based on individual students' reactions to the MD&A. An example of a possible response follows:

The prospects for Biolase are poor. There is substantial doubt about whether Biolase can continue as a going concern. Net losses and negative cash flows from operations are resulting in the firm needing substantial infusions of cash to avoid bankruptcy. Their credit lines expire in May, 2014, forcing the firm to obtain financing elsewhere. It is not clear if creditors or investors will be willing to loan money or invest in the equity of Biolase.

On a positive note, the firm is investing in development of new and innovative products, has reorganized their sales and marketing area to improve revenues, has cut costs, and is selling products both domestically and internationally.

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