Financial & Managerial Accounting for Decision Makers 4th edition Hanlon Solutions Manual

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Chapter 1

Introducing Financial Accounting

Learning Objectives – coverage by question				
	Mini-Exercises	**Exercises**	**Problems**	**Cases and Projects**
LO1 – Identify the users of accounting information and discuss the costs and benefits of disclosure.	25	28, 34		49, 50
LO2 – Describe a company's business activities and explain how these activities are represented by the accounting equation.	19, 20, 21	27, 29, 32, 33	36, 37, 38, 43	47
LO3 – Introduce the four key financial statements including the balance sheet, income statement, statement of stockholders' equity and statement of cash flows.	22, 23, 24	30, 31	37, 38, 39, 40, 41, 42, 43, 44, 45	46, 47, 49
LO4 – Describe the institutions that regulate financial accounting and their role in establishing generally accepted accounting principles.	26	34		50
LO5 – Compute two key ratios that are commonly used to assess profitability and risk – return on equity and the debt-to-equity ratio.		32, 33	36, 43, 44, 45	46, 47, 48, 49
LO6 – Appendix 1A: Explain the conceptual framework for financial reporting.		35		

QUESTIONS

Q1-1. Organizations undertake planning activities that subsequently shape three major activities: financing, investing, and operating. Financing is the means used to pay for resources. Investing refers to the buying and selling of resources necessary to carry out the organization's plans. Operating activities are the actual carrying out of these plans. (Planning is the glue that connects these activities, including the organization's ideas, goals and strategies.)

Q1-2. An organization's financing activities (liabilities and equity = sources of funds) pay for investing activities (assets = uses of funds). An organization cannot have more or less assets than its liabilities and equity combined and, similarly, it cannot have more or less liabilities and equity than its total assets. This means: assets = liabilities + equity. This relation is called the accounting equation (sometimes called the *balance sheet equation*, or BSE), and it applies to all organizations at all times.

Q1-3. The four main financial statements are: income statement, balance sheet, statement of stockholders' equity, and statement of cash flows. The income statement provides information relating to the company's revenues, expenses and profitability over a period of time. The balance sheet lists the company's assets (what it owns), liabilities (what it owes), and stockholders' equity (the residual claims of its owners) as of a point in time. The statement of stockholders' equity reports on the changes to each stockholders' equity account during the year. Some changes to stockholders' equity, such as those resulting from the payment of dividends and unrealized gains (losses) on marketable securities, can only be found in this statement as they are not included in the computation of net income. The statement of cash flows identifies the sources (inflows) and uses (outflows) of cash, that is, from what sources the company has derived its cash and how that cash has been used. All four statements are necessary in order to provide a complete picture of the financial condition of the company.

Q1-4. The balance sheet provides information that helps users understand a company's resources (assets) and claims to those resources (liabilities and stockholders' equity) as of a given *point in time*.

An income statement reports whether the business has earned a net income (also called profit or earnings) or a net loss. Importantly, the income statement lists the types and amounts of revenues and expenses making up net income or net loss. The income statement covers a *period of time*.

Q1-5. Your authors would agree with Mr. Buffett. A recent study of top financial officers suggests they find earnings and the year-to-year changes in earnings as the most important items to report. We would add cash flows particularly from operations, and the year-to-year changes.

Q1-6. The statement of cash flows reports on the cash inflows and outflows relating to a company's operating, investing, and financing activities over a *period of time*. The sum of these three activities yields the net change in cash for the period. This statement is a useful complement to the income statement which reports on revenues and expenses, but conveys relatively little information about cash flows.

Q1-7. Articulation refers to the updating of the balance sheet by information contained in the income statement or the statement of cash flows. For example, retained earnings is increased each period by any profit earned during the period (as reported in the income statement) and decreased each period by the payment of dividends (as reported in the statement of cash flows and the statement of stockholders' equity). It is by the process of articulation that the financial statements are linked.

Q1-8. Return refers to income, and risk is the uncertainty about the return we expect to earn. The lower the risk, the lower the expected return. For example, savings accounts pay a low return because of the low risk of a bank not returning the principal with interest. Higher returns are to be expected for common stocks as there is a greater uncertainty about the realized return compared with the expected return. Higher expected return offsets this higher risk.

Q1-9. Companies often report more information than is required by GAAP because the benefits of doing so outweigh the costs. These benefits often include lower interest rates and better terms from lenders, higher stock prices and greater access to equity investors, improved relationships with suppliers and customers, and increased ability to attract the best employees. All of these benefits arise because the increased disclosure reduces uncertainty about the company's future prospects.

Q1-10. External users and their uses of accounting information include: (a) lenders for measuring the risk and return of loans; (b) shareholders for assessing the return and risk in acquiring shares; and (c) analysts for assessing investment potential. Other users are auditors, consultants, officers, directors for overseeing management, employees for judging employment opportunities, regulators, unions, suppliers, and appraisers.

Q1-11. Managers deal with a variety of information about their employers and customers that is not generally available to the public. Ethical issues arise concerning the possibility that managers might personally benefit by using confidential information. There is also the possibility that their employers and/or customers might be harmed if certain information is not kept confidential.

Q1-12. Return on equity (ROE) is computed as net income divided by average stockholders' equity (an average of stockholders' equity for the current and previous year is commonly used, but the ratio is sometimes computed only with beginning or ending stockholders' equity). The return on equity is a popular measure for analysis because it compares the level of return earned with the amount of equity invested to generate the return. Furthermore, it combines both the income statement and the balance sheet and, thereby, highlights the fact that companies must manage *both* well to achieve high performance.

Q1-13. While businesses acknowledge the increasing need for more complete disclosure of financial and nonfinancial information, they have resisted these demands to protect their competitive position. These companies must weigh the benefits they receive from the market as a result of more transparent and revealing financial reporting against the costs of divulging proprietary information.

Q1-14. Generally Accepted Accounting Principles (GAAP) are the various methods, rules, practices, and other procedures that have evolved over time in response to the need to regulate the preparation of financial statements. They are primarily set by the Financial Accounting Standards Board (FASB), an entity of the private sector with representatives from companies that issue financial statements, accounting firms that audit those statements, and users of financial information.

Q1-15. International Financial Reporting Standards (IFRS) are the accounting methods, rules and principles established by the International Accounting Standards Board (IASB). The need for IFRS stems from the wide variety of accounting principles adopted in various countries and the lack of comparability that this variety creates. IFRS are intended to create a common set of accounting guidelines that will make the financial statements of companies from different countries more comparable.

The IASB has no enforcement authority. As a consequence, the strict enforcement of IFRS is left to the accounting profession and/or securities market regulators in each country. Many countries have reserved the right to make exceptions to IFRS by applying their own (local) accounting rules in selected areas. Some accountants and investors argue that a little diversity is a good thing – variations in accounting practice reflect differences in cultures and business practices of various countries. However, one concern is that IFRS may create the false impression that everyone is following the same rules, even though some variation will continue to permeate international financial reporting.

Q1-16. The auditor's primary function is to express an opinion on whether the financial statements fairly present the financial condition of the company and are free from material misstatements. Auditors do not prepare the financial statements; they only audit them and issue their opinion on them.

Q1-17.[A] The objectives of financial accounting are to provide information:

- That is useful to investors, creditors, and other decision makers who possess a reasonable knowledge of business activities and accounting
- To help investors and creditors assess the amount, timing and uncertainty of cash flows. This includes the information presented in the cash flow statement as well as other information that might help investors and creditors assess future dividend and debt payments
- About economic resources and financial claims on those resources. This includes the information in the balance sheet and any supporting information that might help the user assess the value of the company's assets and future obligations
- About a company's financial performance, including net income and its components (i.e., revenues and expenses)
- That allows decision makers to monitor company management to evaluate their effective, efficient, and ethical stewardship of company resources

Q1-18.[A] The four enhancing qualitative characteristics of accounting information are comparability, verifiability, timeliness, and understandability.

Comparability refers to the use of similar accounting methods across companies. Comparability improves the users' ability to interpret the information by making comparisons to other companies. *Verifiability* means that consensus among independent observers could be reached that reported information is a faithful representation. Verifiable financial information improves the quality of the information because auditing and interpretation of the reported data will be easier and more trusted.

Timeliness means that the financial reporting information must be available to decision makers in time for the financial statement users to make decisions. *Understandability* means that the financial statements should be presented in such a way that users who have reasonable knowledge of business activities can understand the statements. This is difficult because organizations and transactions have become more complex over time (more global, expanding into new industries, etc.) and thus the reporting of such complexities is difficult. The more understandable the statements can be the better for users of the statements.

MINI EXERCISES

M1-19. (10 minutes)
LO 2

($ millions)

Assets	=	Liabilities	+	Equity
$19,381		$13,720		$5,661

Macy's receives more of its financing from creditors ($13,720 million) versus owners ($5,661 million). Its owner financing comprises 29.2%% of its total financing ($5,661 mil / $19,381 mil.).

M1-20. (10 minutes)
LO 2

($ millions)

Assets	=	Liabilities	+	Equity
$87,896		$68,919		$18,977

Coca-Cola receives more of its financing from creditors ($68,919 million) than from owners ($18,977 million). Its owner financing comprises 21.6% of its total financing ($18,977 mil./ $87,896 mil.).

M1-21. (15 minutes)
LO 2

($ millions)

	Assets	=	Liabilities	+	Equity
Hewlett-Packard Enterprises Co	$ 55,493		$ 34,219		(a) $ 21,274
General Mills	$30,624.0		(b) $24,482.9		$6,141.1
Harley-Davidson	(c) $ 9,972.7		$ 8,128.4		$1,844.3

The percent of owner financing for each company follows:

Hewlett-Packard Ent. Co:	38.3% ($21,274 mil./ $55,493 mil.);
General Mills:	20.1% ($6,141.1 mil./ $30,624 mil.);
Harley-Davidson:	18.5% ($1,844.3 mil./ $9,972.7 mil.).

continued next page

The creditor percent of financing is computed as 100% minus the owner percent. Therefore, Hewlett Packard Enterprises Co is more owner-financed (38.3%) than the other two firms, while Harley-Davidson has the highest percentage of creditor (non-owner) financing (81.5% = 100% - 18.5%).

M1-22. (15 minutes)
LO 3

For its annual report dated September 29, 2018, Apple reports the following amounts (in $ millions):

Assets	=	Liabilities	+	Equity
$365,725	=	$258,578	+	$107,147

As shown, the accounting equation holds for Apple. Also, we can see that Apple's creditor financing is 70.7% of its total financing ($258,578 mil./$365,725 mil).

M1-23. (20 minutes)
LO 3

Nike, Inc.
Statement of Shareholders' Equity
For Year Ended May 31, 2017

	Contributed Capital	Retained Earnings	Other Stockholders' Equity	Total Stockholders' Equity
Balance, May 31, 2016	$ 7,789	$ 4,151	$ 318	$ 12,258
Stock Issuance	121			121
Net Income		4,240		4,240
Dividends		(1,159)		(1,159)
Other changes	731	(3,253)	(531)	(3,053)
Balance, May 31, 2017	$ 8,641	$ 3,979	$ (213)	$ 12,407

Nike was more profitable in the fiscal year ending May 2017 versus in the fiscal year ending May 2018. Net income was $4,240 million in the fiscal year ending May 2017 compared to $1,933 in the fiscal year ending May 2018. Note: As reported in the text, ROE was 17.4% in the fiscal year ending May 2018 compared to 34.4% in the fiscal year ending May 2017.

M1-24. (20 minutes)
LO 3

a. BS	d. BS and SE	g. SCF and SE
b. IS	e. SCF	h. SCF and SE
c. BS	f. BS and SE	i. IS and SE

M1-25. (10 minutes)
LO 1

There are many stakeholders affected by this business decision, including the following (along with a description of how):

- You/Manager—your reputation, self-esteem, and potentially your livelihood can be affected.
- Creditors/Bondholders– credit decisions based on inaccurate information can occur.
- Shareholders—buying or selling shares based on inaccurate information can occur.
- Management/Employees of your company—repercussions of your decision extend to them; also, your decision may suggest an environment condoning dishonesty

Indeed, our decisions can affect many more parties than we might initially realize.

M1-26. (10 minutes)
LO 4

Internal controls are rules and procedures that involve monitoring an organization's activities, transactions, and interactions with customers, employees and other stakeholders to promote efficiency and to prevent wrongful use of its resources. They help prevent fraud, ensure the validity and credibility of accounting reports, and are often crucial to effective and efficient operations.

The absence or failure of internal controls can adversely affect the effectiveness of both domestic and global financial markets. Enron (along with other accounting scandals) provided a case in point. Because the failure of internal controls can have significant economic consequences, Congress is interested in making sure that publicly- traded companies have adequate internal controls and that any concerns about internal controls are properly reported.

EXERCISES

E1-27. (15 minutes)
LO 2

($ millions)	Assets	=	Liabilities	+	Equity
Motorola Solutions, Inc	$ 8,208		$ 9,950		$ (1,742)
Kraft Heinz Company.......	$ 119,992		$53,958		$ 66,034
Merck & Co Inc.	$87,872		$53,303		$34,569

The percent of creditor financing for each company follows:
Motorola Solutions: 121.2% ($9,950 mil./ $8,208 mil.);
Kraft Heinz: 45.0% ($53,958 mil./ $119,992 mil.);
Merck & Co: 60.7% ($53,303 mil./ $87,872 mil.).

The owner percent of financing is computed as 100% minus the owner percent. Merck is more creditor-financed than Kraft Heinz. Motorola has negative equity so their liabilities are larger than their recorded assets.

E1-28. (15 minutes)
LO 1

External users and some questions they seek to answer with accounting information from financial statements include:

1. Shareholders (investors), who seek answers to questions such as:
   a. Are resources owned by a business adequate to carry out plans?
   b. Are the debts owed excessive in amount?
   c. What is the current level of income (and its components)?

2. Creditors, who seek answers for questions such as:
   a. Does the business have the ability to repay its debts?
   b. Can the business take on additional debt?
   c. Are resources sufficient to cover current amounts owed?

3. Employees (and potential employees), who seek answers to questions such as:
   a. Is the business financially stable?
   b. Can the business afford to pay higher salaries?
   c. What are growth prospects for the organization?

E1-29. (20 minutes)
LO 2, 3

($ millions)

a. Using the accounting equation:

($ millions)	Assets	=	Liabilities	+	Equity
Intel	$123,249		$54,230		<u>$69,019</u>

b. Starting with the accounting equation at the *beginning* of the year:

($ millions)	Assets	=	Liabilities	+	Equity
JetBlue Airways............	$9,323		<u>$5,310</u>		$4,013

Using the accounting equation at the *end* of the year:

($ millions)	Assets	=	Liabilities	+	Equity
JetBlue Airways.........	$9,781		$4,947		<u>$4,834</u>
	($9,323+$458)		($5,310- $363)		

Alternative approach to solving part (b):

ΔAssets($458) = ΔLiabilities($-363) + ΔEquity(?)

where "Δ" refers to "change in."

Thus: Δ *Ending* Equity = $458 + $363 = $821 and

Ending equity = $4,013 + $821 = <u>$4,834</u>

c. Starting with the accounting equation at the *end* of the year:

($ millions)	Assets	=	Liabilities	+	Equity
Walt Disney	$98,598		$44,693		<u>$53,905</u>
			($49,637-$4,944)		

Using the accounting equation at the *beginning* of the year:

($ millions)	Assets	=	Liabilities	+	Equity
Walt Disney	$95,789		$49,637		<u>$46,152</u>
	($98,598-$2,809)				

E1-30. (10 minutes)
LO 3

Computation of dividends

	Retained earnings, 2016	$19,922
+	Net income	2,024
–	Cash dividends	(?)
=	Retained earnings, 2017	$20,531

Thus, dividends were $1,415 million for 2017. This dividends amount comprises 70% ($1,415/ $2,024) of its 2017 net income.

E1-31. (20 minutes)
LO 3

COLGATE-PALMOLIVE COMPANY Income Statement For the year ended December 31, 2017 ($millions)	
Revenues	$15,454
Cost of goods sold	6,099
Gross profit	9,355
Other expenses, including income taxes	7,331
Net income (or loss)	$ 2,024

E1-32. (15 minutes)
LO 2, 5

a. Return on equity (ROE) = Net income / Average stockholders' equity
= $12,662 / [($152,502 + $139,036)/2]
= 8.69%

b. Debt-to-equity = Total liabilities / Stockholders' equity
= $44,793* / $152,502
= 29.4

*$44,793 = $197,295 - $152,502

E1-33. (150 minutes)
LO 2, 5

a. Return on equity (ROE)	=	Net income / Average stockholders' equity
	=	€10,525 / [(€64,023 + €57,950)/2]
	=	17.3%
b. Debt-to-equity	=	Total liabilities / Stockholders' equity
	=	€191,582* / €64,023
	=	2.99

*€191,582 = €255,605 - €64,023

E1-34. (20 minutes)
LO 1, 4

a. Financial information provides users with information that is useful in assessing the financial performance of companies and, therefore, in setting securities prices. To the extent that securities prices are accurate, the costs of the funds that companies raise will accurately reflect their relative efficiency and risk of operations. Those companies that can effectively utilize capital better will be able to obtain that capital at a reasonable cost, and society's financial resources will be effectively allocated.

b. First, the preparation of financial statements involves and understanding of complex accounting rules and a significant amount of assumptions and estimation. Second, GAAP allows for differing accounting treatments for the same transaction. And third, auditors are at a relative information disadvantage vis-à-vis company accountants. As the capital markets place increasing pressures on companies to perform, accountants are often placed in a difficult ethical position to use the flexibility given to them under GAAP in order to bias the financial results.

E1-35.[A] (15 minutes)
LO 6

1.	e	6.	g
2.	f	7.	j
3.	i	8.	c
4.	a	9.	d
5.	h	10.	b

PROBLEMS

P1-36. (40 minutes)
LO 2, 5

a.

Year	Assets	Liabilities	Equity	Net Income
2016	$127,136	$69,153	$57,983	$10,508
2017	$118,806	$64,628	$54,178	$15,326
2018	$118,310	$66,984	$51,326	$9,750

b. 2017 ROE = $15,326 / [($57,983+$54,178)/2] = 27.3%

2018 ROE = $9,750 / [($51,326+$54,178)/2] = 18.5%

P&G's ROE decreased in 2018, however, it was above the median for Fortune 500 companies in both years.

c. 2017 debt-to-equity = $64,628 / $54,178 = 1.19

2018 debt-to-equity = $66,984 / $51,326 = 1.31

P&G's debt-to-equity ratio increased in 2018 and it is below the median for Fortune 500 companies in both years.

P1-37. (30 minutes)
LO 2, 3

a.

GENERAL MILLS, INC. Income Statement For Year Ended May 27,2018 ($ millions)	
Sales	$15,740.4
Cost of goods sold	10,312.9
Gross profit	5,427.5
Other expenses, including income taxes	3,264.5
Net income	$ 2,163

GENERAL MILLS, INC. Balance Sheet May 27, 2018 ($ millions)			
Cash & cash equivalents	$ 399	Total liabilities	$24,131.6
Noncash assets	30,225	Stockholders' equity	6,492.4
Total assets	$30,624	Total liabilities and equity	$30,624

GENERAL MILLS, INC. Statement of Cash Flows For Year Ended May 27, 2018 ($ millions)	
Net cash flows from operations	$ 2,841
Net cash flows from investing	(8,685.4)
Net cash flows from financing	5,445.5
Effect of exchange rates on cash	31.8
Net change in cash	(367.1)
Cash, beginning year	766.1
Cash, ending year	$ 399

b. $6,492.4 /$30,624 = 21.2% contributed by owners

P1-38. (30 minutes)
LO 2, 3

a.

ABERCROMBIE & FITCH Income Statement For Year Ended February 3, 2018 ($ millions)	
Sales	$ 3,492.7
Cost of goods sold	1,408.8
Gross profit	2,083.9
Other expenses including income taxes	2,073.4
Net income	$ 10.5

ABERCROMBIE & FITCH Balance Sheet February 3, 2018 ($ millions)			
Cash asset	$ 675.6	Total liabilities	$ 1,073.2
Noncash assets	1,650.1	Stockholders' equity	1,252.5
Total assets	$ 2,325.7	Total liabilities and equity	$ 2,325.7

ABERCROMBIE & FITCH Statement of Cash Flows For Year Ended February 1, 2014 ($ millions)	
Net cash flows from operations	$ 285.7
Net cash flows from investing	(106.8)
Net cash flows from financing	(74.8)
Effect of exchange rate changes on cash	24.3
Net change in cash	128.4
Cash, beginning year	547.2
Cash, ending year	$ 675.6

b. $1,252.5 / $2,325.7 = 53.9% contributed by owners
$1,073.2 / $2,325.7 = 46.1% contributed by creditors

P1-39. (30 minutes)
LO 3

TILLY'S, INC. Income Statements For years ended February 3, 2018 and January 28, 2017 ($ thousands)		
Fiscal year ending	**2018**	**2017**
Sales	$576,899	$568,952
Cost of goods sold	401,529	400,493
Gross profit	175,370	168,459
Other expenses, including income taxes	160,670	157,049
Net income	$ 14,700	$ 11,410

TILLY'S, INC. Balance Sheets February 3, 2018 and January 28, 2017 ($ thousands)		
	2018	**2017**
Cash asset	$ 53,202	$ 78,994
Noncash assets	236,909	211,512
Total assets	$290,111	$290,506
Total liabilities	$ 129,686	$ 101,286
Stockholders' equity	160,425	189,220
Total liabilities and stockholders' equity	$290,111	$290,506

TILLY'S, INC. Cash Flow Statements For years ended February 3, 2018 and January 28, 2017 ($ thousands)		
	2018	**2017**
Cash flow from operating activities	$32,708	$48,509
Cash flow from investing activities	(40,878)	(21,658)
Cash flow from financing activities	(17,622)	1,123
Change in cash	(25,792)	27,974
Cash balance, beginning of the year	78,994	51,020
Cash balance, end of the year	$53,202	$78,994

P1-40. (30 minutes)
LO 3

TESLA , INC. Income Statements For years ended December 31, 2017 and 2016 ($ millions)		
	2017	**2016**
Sales	$11,758.8	$ 7,000.1
Cost of goods sold	9,536.3	5,400.9
Gross profit	2,222.5	1,599.2
Other expenses, including income taxes	4,183.9	2,274.2
Net income (loss)	$ (1,961.4)	$ (675.0)

TESLA, INC. Balance Sheets December 31, 2017 and 2016 ($ millions)		
	2018	**2017**
Cash asset	$ 3,367.9	$ 3,393.2
Noncash assets	25,287.5	19,270.9
Total assets	$28,655.4	$22,664.1
Total liabilities	$23,420.8	$ 17,126
Stockholders' equity	5,234.6	5,538.1
Total liabilities and stockholders' equity	$28,655.4	$22,664.1

TESLA, INC. Cash Flow Statements For years ended December 31, 2017 and 2016 ($ millions)		
	2017	**2016**
Cash flow from operating activities	$(60.7)	$(123,8)
Cash flow from investing activities	(4,419)	(1,416.4)
Cash flow from financing activities	4,414.9	3,744.0
Effect of exchange rate changes on cash	39.5	(7.4)
Change in cash	(25.3)	2,196.3
Cash balance, beginning of the year	3,393.2	1,196.9
Cash balance, end of the year	$3,367.9	$3,393.2

P1-41. (15 minutes)
LO 3

CROCKER CORPORATION
Statement of Stockholders' Equity
For Year Ended December 31, 2019

	Contributed Capital	Retained Earnings	Stockholders' Equity
December 31, 2018	$ 70,000	$ 30,000	$100,000
Issuance of common stock	30,000		30,000
Net income		50,000	50,000
Cash dividends		(25,000)	(25,000)
December 31, 2019	$100,000	$ 55,000	$155,000

P1-42. (15 minutes)
LO 3

DP SYSTEMS, INC.
Statement of Stockholders' Equity
For Year Ended December 31, 2019

	Common Stock	Retained Earnings	Stockholders' Equity
December 31, 2018	$ 550	$2,437	$2,987
Net income		859	859
Cash dividends		(281)	(281)
December 31, 2019	$ 550	$3,015	$3,565

P1-43. (15 minutes)
LO 2, 3, 5

a. Return on equity is net income divided by average stockholders' equity.

Nokia's ROE: €-1,458 / [(€16,218 + €20,975)/2] = -0.078 or -7.8%.

b. Debt-to-equity is total liabilities divided by stockholders' equity.

Nokia's debt-to-equity: (€41,024 − €16,218) / €16,218 = 1.53.

c. Revenues less expenses equal net income. Taking the revenues and net income numbers for Nokia, yields:

€23,147 million − Expenses = €-1,458 million.

Therefore, expenses must equal €24,605 million.

P1-44. (20 minutes)
LO 3, 5

a.

BEST BUY CO., INC. **Income Statement** **For the year ended February 3, 2018** **($ millions)**	
Sales revenue	$42,151
Cost of goods sold	32,275
Gross profit	9,876
Other expenses, including income taxes	8,876
Net income (or loss)	$ 1,000

b. Best Buy's ROE = $1,000 mil. / [($4,709 mil. + $3,612 mil.)/2] = 24.0%.

c. Best Buy's debt-to-equity = ($13,049 - $3,612) / $3,612 = 2.61

P1-45. (20 minutes)
LO 3, 5

a.

FACEBOOK, INC. Income Statement For the years ended December 31, 2017 and 2016 ($ millions)		
	2017	**2016**
Revenue	$ 40,653	$ 27,638
Operating expenses	20,450	15,211
Gross profit from operations	20,203	12,427
Other expenses, including income taxes	4,269	2,210
Net income	$ 15,934	$ 10,217

b. Stockholders' equity: 2017 -- $84,524 mil. - $10,177 mil. = $74,347 mil.
2016 -- $64,961 mil. - $5,767 mil. = $59,194 mil.

2017 ROE = $15,934 mil. / [($74,347 mil. + $59,194 mil.)/2] = 23.9.0%.
2016 ROE = $10,217 mil. / [($59,194 mil. + $44,218 mil.)/2] = 19.8%.

c. 2017 debt-to-equity = $10,177 / $74,347 = 0.14.
2016 debt-to-equity = $5,767 / $59,194 = 0.10.

CASES and PROJECTS

C1-46. (40 minutes)
LO 3, 5

a.

STARBUCKS CORPORATION Income Statement For the years ended September 30,2018 and October 1, 2017 ($ millions)		
	2018	**2017**
Sales revenue	$ 24,719.5	$ 22,386.8
Cost of goods sold	10,174.5	9,034.3
Gross profit on sales	14,545.0	13,352.5
Other expenses, including income taxes	10,027	10,467.6
Net income	$4,518.0	$ 2,884.9

b. 2018 stockholders' equity: $24,256.4 mil. – $22,980.6 mil. = $1,275.8 mil.
2017 stockholders' equity: $14,365.6 mil. -- $8,908.6 mil. = $5,457 mil.

2018 ROE: $4,518 / [($1,275.8 + $5,457)/2] = 134.2%
2017 ROE: $2,884.9 / [($5,457 + $5,890.7)/2] = 50.8%

c. 2018 debt-to-equity: $22,980.6 / $1,275.8 = 18.01
2017 debt-to-equity: $8,908.6 / 5,457 = 1.63

d. 2018 ROE restated: ($4,518.0 - $3,700) / [($1,275.8- $3,700 + 5,457)/2] = 53.9%

The unrecorded potential litigation cost of $3,700 is subtracted from the net income number and from the 2018 stockholders' equity amount to arrive at this number. This does not take into account the effect of income taxes.

e. The primary cost to Starbucks of disclosing information about the pending litigation is that the disclosure may cause potential investors and creditors to hold a less favorable view of the company. A concern about the disclosure is that such disclosure may actually affect the outcome of the litigation.

The primary benefit to disclosure is that by disclosing information about the lawsuit before its completion, the company cannot be accused of withholding relevant information from stakeholders. This prevents potential lawsuits from investors or creditors and contributes to the company's reputation for reliable financial reporting.

C1-47. (40 minutes)
LO 2, 3, 5

a. The Gap, Inc.: ROE = $848 / [($3,144 + $2,904)/2] = 28.00%
Nordstrom, Inc.: ROE = $437 / [($977 + $870)/2] = 47.3%

Nordstrom had the higher ROE.

b. The Gap, Inc.: Debt-to-equity = ($7,989 - $3,144) / $3,144 = 1.54
Nordstrom, Inc.: Debt-to-equity = ($8,115 - $977) / $977 = 7.31

Nordstrom relies more on debt than The Gap.

c.

THE GAP, INC. 2018 Income Statement ($millions)	
Revenues	$15,855
Cost of goods sold	9,789
Gross profit	6,066
Other expenses, including income taxes	5,218
Net income (or loss)	$ 848

NORDSTROM, INC. 2013 Income Statement ($millions)	
Revenues	$15,478
Cost of goods sold	9,890
Gross profit	5,588
Other expenses, including income taxes	5,151
Net income (or loss)	$ 437

The Gap: $6,066 / $15,855 = 38.3%

Nordstrom: $5,588 / $15,478 = 36.1%

d. Nordstrom earned a higher ROE than The Gap (47.3% vs. 28%). Nordstrom's debt-to-equity ratio is 7.31 vs. about 1.54 for The Gap. The Gap reported a slightly higher gross profit per dollar of sales revenue (38.3% vs. 36.1% for Nordstrom). These two percentages are very close, reflecting the similarity of their retail operations. One important difference (not provided or apparent in the information supplied) is that Nordstrom has a larger consumer credit business than The Gap.

C1-48. (30 minutes)
LO 5

a. JetBlue: ROE = $1,147 / {[($9,781-$1,108) + ($9,323 - $1,444)] /2} = <u>13.9%</u>

Southwest: ROE = $3,488 / {[($25,110-$13,973) + ($23,286-$14,845)] /2} = <u>35.6%</u>

b. JetBlue: Debt-to-equity = $1,108 / ($9,781 - $1,108) = <u>0.13</u>

Southwest: Debt-to-equity = $13,973 / ($25,110 - $13,973) = <u>1.25</u>

c. JetBlue: $1,147 / $7,015 = 16.4%

Southwest: $3,488 / $21,171 = 16.5%

d. JetBlue's ROE was 13.9% for the year. In comparison, Southwest earned an ROE of 35.6% in 2017. Both of these ROE numbers are at or above the average for *Fortune* 500 companies. Currently, Southwest uses more creditor financing. This has changed over time, JetBlue carried more debt just 5 years ago. Southwest's debt-to-equity ratio is 1.25 compared to a debt-to-equity ratio of 0.13 for JetBlue. In terms of income per dollar of sales, both companies look very similar. JetBlue's reported net income equaled 16.4% of revenues, while Southwest reported net income equal to 16.5% of revenues. The numbers for both airlines have improved significantly in recent years.

C1-49. (20 minutes)
LO 1, 3, 5

a. $285,000 Assets - $45,000 Liabilities = $240,000 Net Assets. $72,000 Average Annual Income / $240,000 Investment = 30% return. Seale's return would be 24% ($72,000 Average Annual Income / $300,000 Investment), assuming no adjustment is made for Meg's salary. (See part b.)

b. No. Withdrawals do not affect net income, because they are not part of the firm's operating activities. However, in calculating Krey's return in part a, Seale might wish to "impute" an amount for Krey's half-time work in computing Krey's return on investment. Thus, if Seale believes that Krey's services are worth $18,000 (half of the $36,000 salary she expects to pay a full-time manager), annual income should be calculated at $54,000 instead of $72,000. If Seale hires a full-time manager at $36,000, her return will be only 12% [($72,000 - $36,000)/$300,000].

c. Yes, the difference between net income shown in the financial statements and net income shown on the tax return can be legitimate, because income tax rules for determining revenues and deductions from revenues differ from Generally Accepted Accounting Principles. Seale may obtain additional assurance about the propriety of the financial statements by engaging a licensed professional accountant to audit the financial statements and render a report on them.

C1-50. (15 minutes)
LO 1, 4

a. It is important for a CPA to be independent when performing audit services because third parties will be relying on the audited financial statements in making decisions. The financial statements are the representations of the corporation's management. The audit by a CPA adds credibility to the financial statements. Only if third parties believe that the CPA is independent will a CPA be able to add credibility to financial statements.

b. Jackie is not independent for two reasons: (1) her brother is president and chair of the board of directors of the company to be audited and (2) Jackie is on the board of directors of the company to be audited. The auditing profession takes the position that Jackie's other activities for the company—consulting and tax work—do not impair a CPA's independence. This last point may generate some discussion, particularly in this case when the potential auditor is the same person (Jackie) who is doing the consulting work. Usually, when the same CPA firm does both auditing and consulting work, those tasks are assigned to different persons to ensure auditor independence.