Understanding Financial Statements 12th 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 SEC requires regular filing of Annual reports (10-K), quarterly reports (10-Q) and other reports dependent on particular circumstances, such as a change in auditor, bankruptcy, financial restatements, or other important events (all filed as 8-K reports).

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.

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.

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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 *statement of comprehensive income* 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 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 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, or any other events which the auditor believes may present business risk and going concern problems.

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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 Form 10-K 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 **statement of comprehensive income** 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) 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.

Sometimes material in the 10-K 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, 2024).

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