Chapter 5
Communicating and Interpreting Accounting Information

ANSWERS TO QUESTIONS

1. The primary responsibility for the accuracy of the financial records and conformance with Generally Accepted Accounting Principles (GAAP) of the information in the financial statements rests with management, normally the CEO and CFO. Independent auditors or CPAs are responsible for conducting an examination of the statements in accordance with Generally Accepted Auditing Standards (for private companies) and PCAOB Auditing Standards (for public companies), and based on that examination, attesting to the fairness of the financial presentations in accordance with GAAP. Both management and the auditors assume a financial responsibility to users of the statements.

2. Financial analysts, who normally work for brokerage and investment banking houses, mutual funds, and investment advisory services, gather extensive financial and nonfinancial information about a company, on which they base forecasts and stock purchase and sale recommendations. Private investors include individuals who purchase shares in companies, often on the basis of recommendations from financial analysts. Institutional investors are managers of pension, mutual, endowment, and other funds that invest on behalf of others.

3. Information services provide a wide variety of financial and nonfinancial information to analysts and investors, often on-line or on CD-ROM. These services are normally the first source where important financial information such as quarterly earnings announcements are available.

4. Material amounts are amounts that are large enough to influence a user’s decision.

5. a. Income statement--Accrual basis required by GAAP.
   b. Balance sheet--Accrual basis required by GAAP.
   c. Statement of cash flows--Cash basis required by GAAP.

6. Private companies normally issue quarterly and annual reports, both of which are normally simple photocopied reports. The quarterly reports normally present unaudited summary income statement and balance sheet information. The annual reports include the four basic financial statements, related notes, and the auditor's opinion if the statements are audited.
7. Public companies issue quarterly press releases, quarterly reports, and annual reports to shareholders and Forms 10-Q (quarterly reports), 10-K (annual reports), and 8-K (special events) reports to the SEC. Press releases include a summary of the quarterly report information and are the first announcement of quarterly financial information. The quarterly reports normally present unaudited summary income statement, cash flow statement, and balance sheet information along with abbreviated management discussion and analysis and notes. Annual reports are often elaborate reports including extensive discussions. The financial section includes: (1) summarized financial data for a 5-year period; (2) management’s discussion and analysis of financial condition and results of operations and disclosures about market risk; (3) the four basic financial statements; (4) notes (footnotes); (5) report of independent registered public accounting firm (auditor’s opinion) and the management certification; (6) recent stock price information; (7) summaries of the unaudited quarterly financial data; and (8) listings of directors and officers of the company and relevant addresses. The Form 10-Q and 10-K provide more detailed information than the quarterly and annual reports of private companies including additional disclosures not included in those reports. The 8-K is issued irregularly when special events, such as a change in auditors, occur.

8. The four major subtotals or totals on the income statement are: (a) gross profit, (b) income from operations, (c) income before income taxes, and (d) net income.

9. The six major classifications on the balance sheet are: (a) current assets, (b) noncurrent assets, (c) current liabilities, (d) long-term liabilities, (e) contributed capital and (f) retained earnings.

10. Property, plant, and equipment are reported on the balance sheet. Property, plant, and equipment are those assets held by the business not for resale but for use in operating the business, such as a delivery truck. (a) Property, plant, and equipment are reported at their acquisition cost which represents the amount of resources expended in acquiring them. (b) Over their period of use, they are "depreciated" because of being worn out (used up) or becoming obsolete in carrying out the function for which they were acquired. A portion of the cost of this effect is known as depreciation expense. A certain amount of depreciation is reported each period as an expense on the income statement and the total amount of depreciation on the asset from the date it was acquired up to the date of the financial statement is known as accumulated depreciation. (c) Cost minus accumulated depreciation equals net book value, as reported on the balance sheet. Net book value (sometimes also called book value or carrying value) does not represent the current market value of the asset but rather the original cost of it less the amount of that cost that has been measured as depreciation expense for all of the periods since the asset was acquired.

11. The major classifications of stockholders’ equity are: (1) contributed capital, which represents the stockholders’ investments and (2) retained earnings, which represent the earnings of the company to date less any dividends paid to the owners.
Contributed capital is often split between the account common stock (which consists of a nominal legal amount called par value) and additional paid-in capital.

12. The three major classifications on the Statement of Cash Flows are (a) cash from operating activities, (b) cash from investing activities, and (c) cash from financing activities.

13. The three major categories of notes to the financial statements are: (1) descriptions of accounting rules applied to the company's statements, often called significant accounting policies (e.g., the depreciation method applied to property, plant, and equipment), (2) additional details about financial statement numbers (e.g., sales by geographic region), and (3) relevant financial information not listed on the statements (e.g., the existence of a bank line of credit).

14. Return on assets (ROA) is a ratio measure defined as net income divided by average total assets. It measures how much the firm earned for each dollar of assets available to management, regardless of the source of financing. A return on assets analysis provides an overall framework for evaluating company performance by breaking down ROA into its two determinants: net profit margin and total asset turnover. Together, these indicate why ROA differs from prior levels or that of competitors, and provide insights into strategies to improve ROA in future periods.

ANSWERS TO MULTIPLE CHOICE

1. b) 2. b) 3. c) 4. a) 5. b) 6. d) 7. b) 8. c) 9. c) 10. a)