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 prospective (potential) 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. Equity (stock) and credit (debt) 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 these 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 to shareholders. Financial accounting information is used by managers to assess the profitability and health of individual business units and the company as a whole. 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 covenant compliance is measured by 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 Moody’s 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 customers of the company. 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 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.

Customers demand financial accounting information to help determine if the company will be able to deliver the product
on a timely basis and provide product support after delivery.

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 may charge a higher rate of interest for the added informational risk, 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:**
Student responses will vary, but here are some examples:

- Competitive forces from within the industry (i.e., other firms in the industry are voluntarily disclosing information about order backlogs, customer turnover, or other key performance indicators).

- 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 releasing such information in press releases is that the news 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.

P1-5. Generally accepted accounting principles (GAAP)

Requirement 1:
What are generally accepted accounting principles (GAAP)?
GAAP refers to the network of conventions, rules, guidelines and procedures that shape the financial reporting practices of businesses and non-profit organizations. GAAP comes from two main sources: (1) written pronouncements by designated standards-setting organizations such as the FASB, IASB and SEC; and (2) accounting practices that have evolved over time as preparers and auditors dealt with new business transactions and circumstances not yet described in written pronouncements. The FASB’s Accounting Standards Codification is now the sole authoritative source for written GAAP, although suggested implementation guidelines are provided by industry trade groups and the AICPA through its various industry guides.

Requirement 2:
Why is GAAP important to independent auditors and to external users? Independent auditors provide reasonable assurance that the financial statements of the companies they audit “present fairly, in all material respects” the financial position, results of operations, and cash flows “in conformity with U.S. generally accepted accounting principles.” It is therefore essential that independent auditors possess a thorough understanding of GAAP and how it applies to each specific client.

The goal of GAAP in the United States and most other developed countries is to ensure that a company’s financial
statements represent faithfully its economic condition and performance. GAAP achieves this goal by providing a framework for determining when to record a business transaction or event (recognition), what dollar amount to record (measurement), how summary information is to be displayed in financial statements (presentation), and what additional information to provide in the notes (disclosure). External users benefit when the GAAP framework ensures that the resulting statements and notes accurately convey information about a company’s true economic condition and performance.

Requirement 3:
Describe the FASB organization and how it establishes new accounting standards. Although the Securities and Exchange Commission (SEC) has ultimate legal authority to determine accounting principles in the United States, it has looked to private-sector organizations to establish these principles. Today, the private sector standards setting organization is the FASB. It exists as an independent group with seven full-time members and a large staff. Board members are appointed for five-year terms and are required to sever all ties with the companies and institutions they served prior to joining the board.

The FASB follows a “due process” procedure in developing accounting standards and updates that involves three steps: (1) Discussion-memorandum stage; (2) Exposure-draft stage; and (3) Voting stage. Public comments on discussion memoranda and exposure drafts are invited, and public hearings are sometimes held.

Requirement 4:
Describe the IASB organization and its role in establishing new accounting standards. The International Accounting Standards Board, formed in 1973, works to formulate accounting standards, promote their worldwide acceptance, and achieve greater convergence of financial reporting regulations, standards, and procedures across countries. Members are drawn from professional accounting organizations and businesses around the world.
Requirement 5:
How does the Securities and Exchange Commission (SEC) influence the financial reporting practices of U.S. companies? The SEC retains statutory power over the financial accounting and reporting practices of registrant companies. This power includes the ability to issue financial accounting and reporting rules as well as to enforce compliance with the rules it issues or those issued by standards-setting organizations (e.g., FASB) as designated by the SEC.

P1-6. Relevant versus faithful representation

Requirement 1:
The Blue Book average price is more relevant to the car buying decision than is the list (or “sticker”) price shown on the manufacturer’s web site. Why? Because it better represents the price you can expect to pay for the automobile.

The Blue Book price describes the average price actually paid by recent buyers for comparably equipped automobiles. Actual prices are the result of arms-length negotiations between willing buyers and sellers, and thus reflect what you can expect to pay (on average) when you negotiate your automobile purchase. The list (“sticker”) price is just a suggested retail price—the actual negotiated price is often considerably less (but sometimes can be more) than the manufacturer’s list price.

Requirement 2:
The Blue Book price of $19,500 is less representationally faithful than the manufacturer’s list price. To understand why, notice that recent selling prices have ranged from $18,000 to $22,000. This means that while you can expect to pay $19,500 on average for the automobile, it may cost you as little as $18,000 or as much as $22,000. On the other hand, there is little (if any) variation in the manufacturer’s list price—comparably equipped cars have essentially the same list price.
In this setting, reliability refers to price variation and there is more variation (less reliability) in the underlying Blue Book prices than there is in the manufacturer’s list price.

P1-8. Accounting Conservatism

Requirement 1: Accounting conservatism requires that the land now be shown on the balance sheet at the lower amount $3 million, its estimated fair market value, rather than at the $5 million you paid two months ago. Conservatism is the practice of recording possible losses—in this case, the decline in value of the land—as soon as they become probable and measurable.

Requirement 2: Accounting conservatism requires that the land continue to be shown on the balance sheet at the price paid two months ago ($3 million) rather than the higher estimated fair value ($5 million). Conservatism records losses as soon as they are probable and measurable, but additional requirements must be met to record gains (as you will soon discover in Chapter 2).

P1-9. Your position on the issues

1) 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).

2) 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 self-serving and 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.

3) 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.

Examples illustrating the politics of accounting standards are interspersed throughout this book.

4) 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.

5) This is true. If the information is value-relevant—meaning, important for investors to know—there is no obvious reason not to disclose the information except when doing so places the company at a competitive disadvantage.

6) 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.

7) 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.

P1-10. Economic Consequences of Accounting Standards

Requirement 1:
There are several economic consequences that could arise when companies are forced to alter their past accounting methods—in this case, by recording a new liability and corresponding expense.

Mandatory changes in accounting methods of this sort can disrupt contracts that are defined in terms of accounting ratios. One example is a loan agreement that restricts the firm from exceeding some maximum debt-to-equity ratio. The accounting change will add additional dollars to debt and
simultaneously subtract dollars from equity, and thus may cause the firm to violate its lending agreement. The costs associated with violating the agreement represent an economic consequence of the accounting change.

In response to the possibility of violating the loan agreement, management may decide to sell some otherwise productive assets. The cash raised could then be used to pay down debt, and the accounting gain would increase reported equity. This would soften the adverse effect of the accounting change on the company’s debt-to-equity ratio. But notice that the asset sale is occurring only in response to the accounting change—and thus it too represents an economic consequence of the change.

And, as described in requirement 2, management may decide to reduce or curtail employee healthcare benefits so that the recorded liability (and expense) is as small as possible. This benefit reduction becomes an economic consequence borne by employees of the company.

**Requirement 2:**
There are widely divergent views on whether the FASB should consider the economic consequences of its actions when formulating accounting standards.

On the one hand, *SFAC No. 2* states that “neutrality” is a desired characteristic of financial statement information. Neutrality means that the information cannot be selected to favor one set of interested parties over another. So, real liabilities cannot remain unrecorded just because recording them may cause some firms to violate their lending agreements. When applied to the standard setting process, neutrality means that the FASB should ignore the economic consequences of alternative accounting practices.

A more practical problem is that it is exceedingly difficult to quantify those consequences in any meaningful way. How can the FASB determine which firms will likely violate their lending agreements or what it will cost them if they do so? And what
about the economic consequences of likely changes in management’s actions (e.g., asset sale, reduced employee benefits, etc.)? Even if the FASB was able to quantify all of the potential consequences associated with a particular proposed accounting change, it would still face the gargantuan task of deciding whether the total benefits outweighed the total costs to the various parties involved. For example, should lenders be favored and employees harmed by requiring health care liabilities to be shown on the balance sheet? Or, should lenders be harmed and employees favored by keeping health care liabilities off the balance sheet?

Of course, the interested parties themselves fervently believe the FASB should consider the economic consequences of alternative accounting practices when formulating standards. To do otherwise, they argue, is to ignore a simple fact that mandatory accounting changes sometimes have real consequences.