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chapter **5** Page 224

Communicating and Interpreting Accounting Information

It is the rare person today who has not been affected by Apple products and services. From the first commercially viable personal computer, the Apple II introduced in 1977, to the raft of mobile communication and media devices, personal computers, software, and iStore content that we all use today, Apple has fundamentally changed the way we work, play, and interact. Apple Inc. the company is a far cry from the startup incorporated by Steve Jobs, Steve Wozniak, and a group of venture capitalists in 1977. Its 1977 sales of \$1 million rose to \$1 billion by 1982 and exceeded \$100 billion in 2011. To accomplish this feat, Apple didn't just invent new products, it created whole new product categories such as the personal music player, the smartphone, and the tablet. And its laserlike focus on superior ease-of-use, seamless integration of hardware, software, and content, innovative design, and frequent updating make it very difficult for others to compete.

Apple's financial statements reflect its phenomenal sales and profit growth and convey this information to the stock market. Apple's stock price increased five-fold over the last five years in response to news of its success.

Financial statement information will only affect a company's stock price if the market believes in the integrity of the financial communication process. As a publicly traded company, Apple Inc. is required to provide detailed information in regular filings with the Securities and Exchange Commission. As the certifying officers of the company, current President and CEO Timothy Cook and Peter Oppenheimer, Senior Vice President and Chief Financial Officer, are responsible for the accuracy of the filings. The board of directors and auditors monitor the integrity of the system that produces the disclosures. Integrity in communication with investors and other users of financial statements is a key to maintaining relationships with suppliers of capital.

Learning Objectives

After studying this chapter, you should be able to:

5-1

Recognize the people involved in the accounting communication process (regulators, managers, directors, auditors, information intermediaries, and users), their roles in the process, and the guidance they receive from legal and professional standards. p. 227

- 5-2** Identify the steps in the accounting communication process, including the issuance of press releases, annual reports, quarterly reports, and SEC filings, as well as the role of electronic information services in this process. p. 232
- 5-3** Recognize and apply the different financial statement and disclosure formats used by companies in practice and analyze the gross profit percentage. p. 234
- 5-4** Analyze a company's performance based on return on assets and its components and the effects of transactions on financial ratios. p. 244

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FOCUS COMPANY:

Apple Inc.

COMMUNICATING FINANCIAL
INFORMATION AND CORPORATE
STRATEGY

www.apple.com

UNDERSTANDING THE BUSINESS

Apple Inc.'s best-known products and services are the iPhone[®], iPad[®], Mac[®], iPod[®], and the iTunes Store[®]. The company sells its products and services worldwide through its own Apple Store retail and online stores, as well as through third-party cellphone companies such as AT&T and Verizon and

retailers such as Best Buy. Components for its products are produced by outsourcing partners in the United States, Asia, and Europe. Final assembly of the company's products is currently performed in the company's manufacturing facility in Ireland and by outsourcing partners, primarily located in Asia. Apple invests considerable sums in research and development, marketing, and advertising and is known for introducing new and innovative products long before the end of existing products' life cycles.

CORPORATE GOVERNANCE

refers to the procedures designed to ensure that the company is managed in the interests of the shareholders.

Apple also invests in **corporate governance**: procedures designed to ensure that the company is managed in the interests of the shareholders. Much of its corporate governance system is aimed at ensuring integrity in the financial reporting process. Good corporate governance eases the company's access to capital, lowering both the costs of borrowing (interest rates) and the perceived riskiness of Apple's stock.

Apple knows that when investors lose faith in the truthfulness of a firm's accounting numbers, they also normally punish the company's stock. Disclosure of an accounting fraud causes, on average, a 20 percent drop in the price of a company's stock.

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The **SARBANES-OXLEY ACT** is a law which strengthens U.S. financial reporting and corporate governance regulations.

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The extreme accounting scandals at Le-Nature's (discussed in Chapter 1), Enron, and WorldCom caused their stock to become worthless. In an attempt to restore investor confidence, Congress passed the Public Accounting Reform and Investor Protection Act (the **Sarbanes-Oxley Act**), which strengthens financial reporting and corporate governance for public companies.

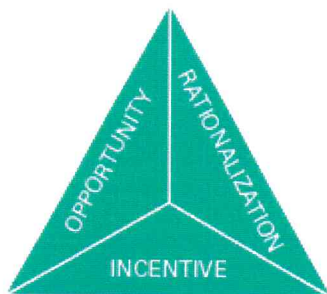
A QUESTION OF ETHICS



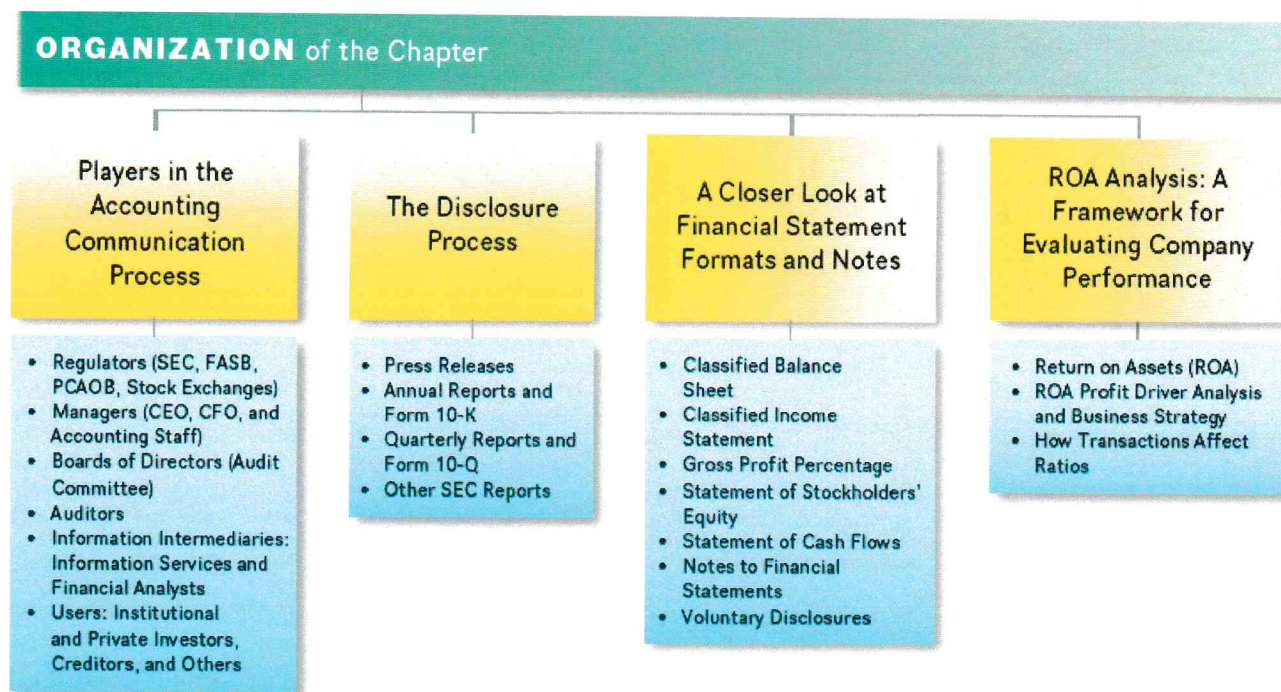
The Fraud Triangle

Three conditions are necessary for financial statement fraud to occur. There must be: (1) an incentive to commit fraud, (2) the opportunity to commit fraud, and (3) the ability to rationalize the misdeed. These conditions make up what antifraud experts call the fraud triangle. A good system of corporate governance is designed to address these conditions. Clear lines of responsibility and sure and severe punishment counteract incentives to commit fraud. Strong internal controls and oversight by directors and auditors reduce opportunity to commit fraud. A strong code of ethics, ethical actions by those at the top of the organization, fair dealings with employees, and rewards for whistle-blowing make it more difficult for individuals to rationalize fraud. Financial statement users also have a role to play in preventing fraud. While even the savviest user can still be surprised by fraudulent reports in some cases, accounting knowledge and healthy skepticism are the best protection from such surprises.

THE FRAUD TRIANGLE



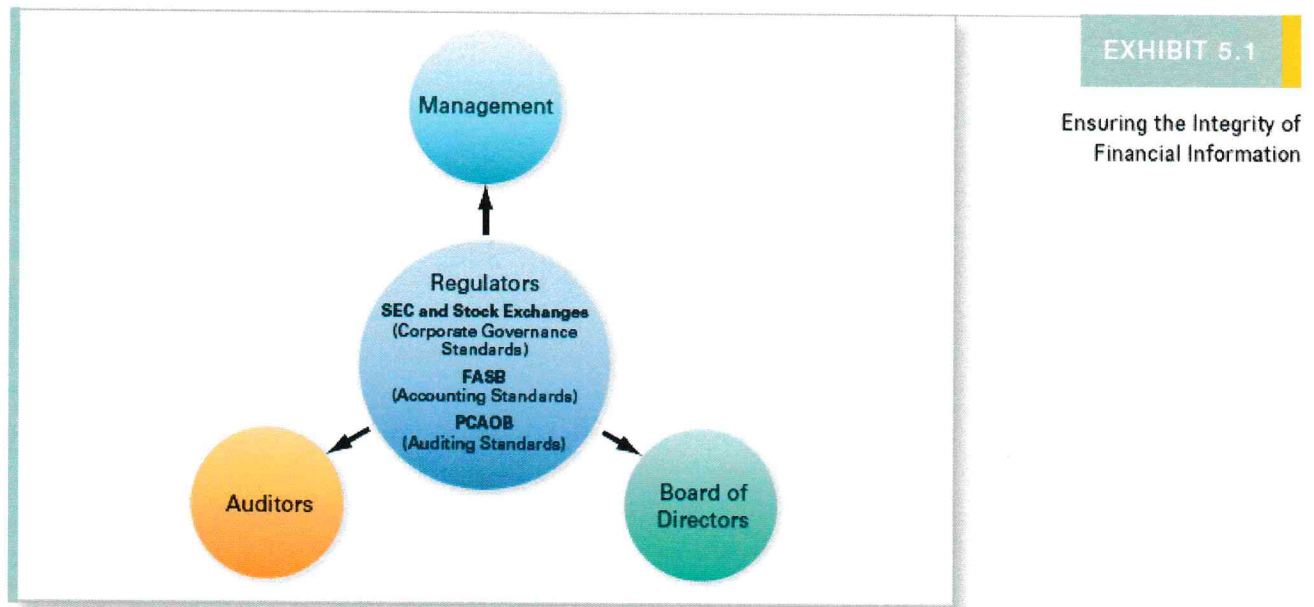
Chapters 2 through 4 focused on the mechanics of preparing the income statement, balance sheet, statement of stockholders' equity, and cash flow statement. Based on your better understanding of financial statements, we will next take a closer look at the people involved and the regulations that govern the process that conveys accounting information to statement users in the Internet age. We will also take a more detailed look at statement formats and additional disclosures provided in financial reports to help you learn how to find relevant information. Finally, we will examine a general framework for assessing a company's business strategy and performance based on these reports.



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PLAYERS IN THE ACCOUNTING COMMUNICATION PROCESS

LEARNING OBJECTIVE 5-1

Recognize the people involved in the accounting communication process (regulators, managers, directors, auditors, information intermediaries, and users), their roles in the process, and the guidance they receive from legal and professional standards.

Exhibit 5.1 summarizes the major actors involved in ensuring the integrity of the financial reporting process.

Regulators (SEC, FASB, PCAOB, Stock Exchanges)

The **SECURITIES AND EXCHANGE COMMISSION (SEC)** is the U.S. government agency that determines the financial statements

that public companies must provide to stockholders and the measurement rules that they must use in producing those statements.

The **FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)** is the private sector body given the primary responsibility to work out the detailed rules that become generally accepted accounting principles.

The **PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB)** is the private sector body given the primary responsibility to issue detailed auditing standards.

The mission of the U.S. **Securities and Exchange Commission (SEC)** is to protect investors and maintain the integrity of the securities markets. As part of this mission, the SEC oversees the work of the **Financial Accounting Standards Board (FASB)**, which sets generally accepted accounting principles (GAAP), and the **Public Company Accounting Oversight Board (PCAOB)**, which sets auditing standards for independent auditors (CPAs) of public companies.

The SEC staff also reviews the reports filed with it for compliance with its standards, investigates irregularities, and punishes violators. During 2007 through 2012, the SEC brought 830 enforcement actions related to financial fraud and issuer financial reporting.¹ As a consequence, a number of high profile company officers have recently been fined and sentenced to jail. Consequences to the company can include enormous financial penalties as well as bankruptcy, as in the cases of Le-Nature's, Enron, and WorldCom. You can read about recent SEC enforcement actions at

www.sec.gov/divisions/enforce/friactions.shtml

Managers (CEO, CFO, and Accounting Staff)

The primary responsibility for the information in Apple's financial statements and related disclosures lies with management, specifically the highest officer in the company, often called the **chief executive officer** (CEO), and the highest officer associated with the financial and accounting side of the business, often called the **chief financial officer** (CFO). At Apple and all public companies, these two officers must personally certify that:

- Each report filed with the Securities and Exchange Commission does not contain any untrue material statement or omit a material fact and fairly presents in all material respects the financial condition, results of operations, and cash flows of the company.

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There are no significant deficiencies and material weaknesses in the internal controls over financial reporting.

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- They have disclosed to the auditors and audit committee of the board any weaknesses in internal controls or any fraud involving management or other employees who have a significant role in financial reporting.

Executives who knowingly certify false financial reports are subject to a fine of \$5 million and a 20-year prison term. The members of the **accounting staff**, who actually prepare the details of the reports, also bear professional responsibility for the accuracy of this information, although their legal responsibility is smaller. Their future professional success depends heavily on their reputation for honesty and competence. Accounting managers responsible for financial statements with material errors are routinely fired and often have difficulty finding other employment.

Board of Directors (Audit Committee)

The **BOARD OF DIRECTORS** is elected by the stockholders to represent their interests; its audit committee is responsible for maintaining the integrity of the company's financial reports.

As Apple's statement on corporate governance indicates, the **board of directors** (elected by the stockholders) oversees the Chief Executive Officer and other senior management in the competent and ethical operation of Apple on a day-to-day basis and assures that the long-term interests of shareholders are being served. The **audit committee** of the board, which must be composed of nonmanagement (independent) directors with financial knowledge, is responsible for ensuring that processes are in place for maintaining the integrity of the company's accounting, financial statement preparation, and financial reporting. It is responsible for hiring the company's independent auditors. They meet separately with the auditors to discuss management's compliance with their financial reporting responsibilities.

Auditors

An **UNQUALIFIED (CLEAN) AUDIT OPINION** is an auditor's statement that the financial statements are fair presentations in all material respects in conformity with GAAP.



The SEC requires publicly traded companies to have their statements and their control systems over the financial reporting process audited by an independent registered public accounting firm (independent auditor) following auditing standards established by the PCAOB. Many privately owned companies also have their statements audited. By signing an **unqualified (clean) audit opinion**, a CPA firm assumes part of the financial responsibility for the fairness of the financial statements and related presentations. This opinion, which adds credibility to the statements, is also often required by agreements with lenders and private investors. Subjecting the company's statements to independent verification reduces the risk that the company's financial condition is misrepresented in the statements. As a result, rational investors and lenders should lower the rate of return (interest) they charge for providing capital. Examples of an unqualified audit opinion are presented on pages B10 and C2 of this text.

Ernst & Young is currently Apple's auditor. Ernst & Young, Deloitte, KPMG, and PricewaterhouseCoopers make up what are referred to as the "Big 4" CPA firms. Each of these firms employs thousands of CPAs in offices scattered throughout the world. They audit the great majority of publicly traded companies as well as many that are privately held. Some public companies and most private companies are audited by smaller CPA firms. A list of the auditors for selected focus companies follows.

Focus Company	Industry	Auditor
Starbucks	Coffee	Deloitte & Touche
Deckers Outdoor	Footwear	KPMG
Washington Post	Education & Media	PricewaterhouseCoopers

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Information Intermediaries: Information Services and Financial Analysts

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Students often view the communication process between companies and financial statement users as a simple process of mailing the report to individual shareholders who read the report and then make investment decisions based on what they have learned. This simple picture is far from today's reality. Now most investors rely on company websites, information services, and financial analysts to gather and analyze information.

Companies actually file their SEC forms electronically through the EDGAR (Electronic Data Gathering and Retrieval) Service, which is sponsored by the SEC. Each fact in the report is now tagged to identify its source and meaning using a language called **XBRL**. Users can retrieve information from EDGAR within 24 hours of its submission, long before it is available through the mail. EDGAR is a free service available on the Web under "Filings & Forms" at

www.sec.gov

Most companies also provide direct access to their financial statements and other information over the Web. You can contact Apple at

investor.apple.com

Information services allow investors to gather their own information about the company and monitor the recommendations of a variety of analysts. Financial analysts and other sophisticated users obtain much of the information they use from the wide variety of commercial online information services. Fee-based services such as Compustat and ThomsonReuters provide broad access to financial statements and news information. A growing number of other resources offering a mixture of free and fee-based information exist on the Web. These include:

www.google.com/finance

www.bloomberg.com

finance.yahoo.com

www.smartmoney.com

www.marketwatch.com

Exhibit 5.2 suggests the wide range of information about Apple available on the Google Finance website. It includes stock price and financial statement information, news accounts, and important future events related to Apple. Note that the financial information at the bottom of the exhibit matches the income statement information and ratio calculations for Apple and its two largest competitors presented later in this chapter. To see what has happened to Apple since this chapter was written, go to www.google.com/finance?q=NASDAQ:AAPL. Look at the "Related companies" section to see how Apple has fared compared to its competitors. Click on "Financials" on the top left menu to review the most recent financial statements.

EARNINGS FORECASTS are predictions of earnings for future accounting periods, prepared by financial analysts.

Financial analysts receive accounting reports and other information about the company from electronic information services. They also gather information through conversations with company executives and visits to company facilities and competitors. The results of their analyses are combined into analysts' reports. Analysts' reports normally include forecasts of future quarterly and annual earnings per share and share price; a buy, hold, or sell recommendation for the company's shares; and explanations for these judgments. In making their **earnings forecasts**, the analysts rely heavily on their knowledge of the way the accounting system translates business events into the numbers on a company's financial statements, which is the subject matter of this text. Individual analysts often specialize in particular industries (such as sporting goods or energy companies). Analysts are regularly evaluated based on the accuracy of their forecasts, as well as the profitability of their stock picks. A sample of these forecasts and stock recommendations for Apple at the time this chapter was written follow:

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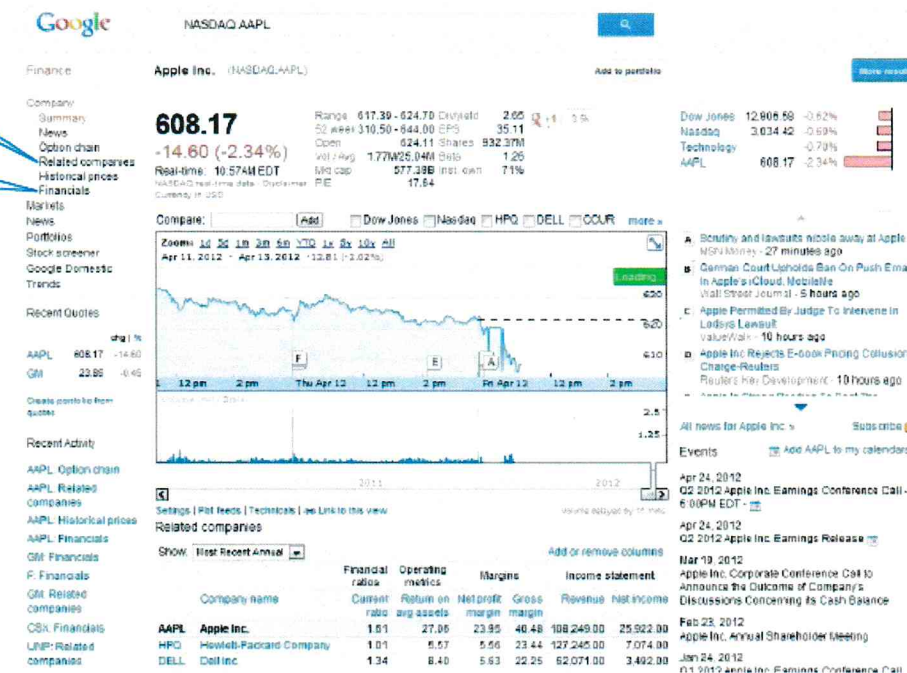
EXHIBIT 5.2 Google Finance Information on Apple

REAL WORLD EXCERPT

Google Finance

Competitors

Financial Statements



News Articles

Upcoming Events

Financial Ratios

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Firm	Stock Recommendation	Earnings per Share Forecast for 2012	Earnings per Share Forecast for 2013
Bernstein Research	Overweight	44.19	51.29
Credit Suisse	Overweight	46.40	51.91
Gabelli & Company	Buy	45.00	49.00
Wedbush Securities	Buy	41.95	46.02
Consensus of 49 analysts	Buy	42.92	47.91

Analysts often work in the research departments of brokerage and investment banking houses such as Credit Suisse, mutual fund companies such as Fidelity Investments, and investment advisory services such as Value Line that sell their advice to others. Through their reports and recommendations, analysts are transferring their knowledge of accounting, the company, and the industry to customers who lack this expertise.

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Search

Information services have become the primary tool for professional analysts who use them to analyze competing firms. Information services are also an important source of information for job seekers. Potential employers expect job applicants to demonstrate knowledge of their companies during an interview, and electronic information services are an excellent source of company information. The best place to begin learning about potential employers is to visit their websites. Be sure to read the material in the employment section and the investor relations section of the site. To learn more about electronic information services, contact the business or reference librarian at your college or university or explore the websites discussed in this section.

Users: Institutional and Private Investors, Creditors, and Others

INSTITUTIONAL INVESTORS are managers of pension, mutual, endowment, and other funds that invest on the behalf of others.

Institutional investors include pension funds (associated with companies, unions, or government agencies); mutual funds; and endowment, charitable foundation, and trust funds (such as the endowment of your college or university). These institutional stockholders usually employ their own analysts who also rely on the information intermediaries just discussed. Institutional shareholders control the majority of publicly traded shares of U.S. companies. For example, at the time this chapter is being written, institutional investors owned 70 percent of Apple stock. Apple's three largest institutional investors follow:

Institution	Approximate Ownership
FMR LLC	5.43%
Vanguard Group Inc.	3.99%
State Street Corp.	3.73%

Most small investors own stock in companies such as Apple indirectly through mutual and pension funds.

PRIVATE INVESTORS include individuals who purchase shares in companies.

Private investors include large individual investors such as the venture capitalists who originally invested directly in Apple, as well as small retail investors who buy shares of publicly traded companies through brokers such as Fidelity. Retail investors normally lack the expertise to understand financial statements and the resources to gather data efficiently. They often rely on the

advice of information intermediaries or turn their money over to the management of mutual and pension funds (institutional investors).

LENDERS (CREDITORS) include suppliers and financial institutions that lend money to companies.

Lenders, or **creditors**, include suppliers, banks, commercial credit companies, and other financial institutions that lend money to companies. Lending officers and financial analysts in these organizations use the same public sources of information. They also use additional financial information (e.g., monthly statements) that companies often agree to provide as part of the lending contract. Lenders are the primary external user group for financial statements of private companies. Institutional and private investors also become creditors when they buy a company's publicly traded bonds.

COST EFFECTIVENESS requires that the benefits of accounting for and reporting information outweigh the costs.

MATERIAL AMOUNTS are amounts that are large enough to influence a user's decisions.

Financial statements also play an important role in the relationships between suppliers and customers. Customers evaluate the financial health of suppliers to determine whether they will be reliable, up-to-date sources of supply. Suppliers evaluate their customers to estimate their future needs and ability to pay debts. Competitors also attempt to learn useful information about a company from its statements. The potential loss of competitive advantage is one of the costs of public financial disclosures. Accounting regulators consider these costs as well as the direct costs of preparation when they consider requiring new disclosures. **Cost effectiveness** requires the benefits of accounting for and reporting information to outweigh the costs. Small amounts do not have to be reported separately or accounted for precisely according to GAAP if they would not influence users' decisions. Accountants usually designate such items and amounts as **immaterial**. Determining **material amounts** is often very subjective.

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PAUSE FOR FEEDBACK

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In this section, we learned the roles of different parties in the accounting communication process and the guidance they receive from legal and professional standards. Management of the reporting company decides the appropriate format and level of detail to present in its financial reports. Independent audits increase the credibility of the information. Directors monitor managers' compliance with reporting standards and hire the auditor. The SEC staff reviews public financial reports for compliance with legal and professional standards and punishes violators. Financial statement announcements from public companies usually are first transmitted to users through electronic information services. Analysts play a major role in making financial statement and other information available to average investors through their stock recommendations and earnings forecasts. Before you move on, complete the following exercise to test your understanding of these concepts.

SELF-STUDY QUIZ

Match the key terms in the left column with their definitions in the right column.

- | | |
|-----------------------|--|
| 1. Material amount | a. Management primarily responsible for accounting information. |
| 2. CEO and CFO | b. An independent party who verifies financial statements. |
| 3. Financial analyst | c. Amount large enough to influence users' decisions. |
| 4. Auditor | d. Reporting only information that provides benefits in excess of costs. |
| 5. Cost effectiveness | e. An individual who analyzes financial information and provides advice. |

After you have completed your answers, check them with the solutions at the bottom of the page.

THE DISCLOSURE PROCESS

LEARNING OBJECTIVE 5-2

Identify the steps in the accounting communication process, including the issuance of press releases, annual reports, quarterly reports, and SEC filings, as well as the role of electronic information services in this process.

As noted in our discussion of information services and information intermediaries, the accounting communication process includes more steps and participants than one would envision in a world in which annual and quarterly reports are simply mailed to shareholders. SEC regulation FD, for "Fair

Disclosure,” requires that companies provide all investors equal access to all important company news. Managers and other insiders are also prohibited from trading their company's shares based on nonpublic (insider) information so that no party benefits from early access.

Press Releases

A **PRESS RELEASE** is a written public news announcement normally distributed to major news services.

To provide timely information to external users and to limit the possibility of selective leakage of information, Apple and other public companies announce quarterly and annual earnings through a **press release** as soon as the verified figures (audited for annual and reviewed for quarterly earnings) are available. Apple normally issues its earnings press releases within four weeks of the end of the accounting period. The announcements are sent electronically to the major print and electronic news services, including *DowJones*, *Thomson/Reuters*, and *Bloomberg*, which make them immediately available to subscribers. Exhibit 5.3 shows an excerpt from a typical earnings press release for Apple that includes key financial figures. This excerpt is followed by management's discussion of the results and condensed income statements and balance sheets, which will be included in the formal report to shareholders, distributed after the press release.

Many companies, including Apple, follow these press releases with a **conference call** during which senior managers answer analysts' questions about the quarterly results. These calls are open to the investing public. Listening to these recordings is a good way to learn about a company's business strategy and its expectations for the future, as well as key factors that analysts consider when they evaluate a company.

Solutions to SELF-STUDY QUIZ

1. *c*;
 2. *a*;
 3. *e*;
 4. *b*;
 5. *d*.
-

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EXHIBIT 5.3

Earnings Press Release
Excerpt for Apple Inc.

APPLE

REAL WORLD EXCERPT
Press Release

APPLE REPORTS FIRST QUARTER RESULTS

Highest Quarterly Revenue and Earnings Ever

All-Time Record iPhone, iPad and Mac Sales

CUPERTINO, California—January 24, 2012—Apple® today announced financial results for its fiscal 2012 first quarter which spanned 14 weeks and ended December 31, 2011. The Company posted record quarterly revenue of \$46.33 billion and record quarterly net profit of \$13.06 billion, or \$13.87 per diluted share. These results compare to revenue of \$26.74 billion and net quarterly profit of \$6 billion, or \$6.43 per diluted share, in the year-ago quarter. Gross margin was 44.7 percent compared to 38.5 percent in the year-ago quarter. International sales accounted for 58 percent of the quarter's revenue.

The Company sold 37.04 million iPhones in the quarter, representing 128 percent unit growth over the year-ago quarter. Apple sold 15.43 million iPads during the quarter, a 111 percent unit increase over the year-ago quarter. The Company sold 5.2 million Macs during the quarter, a 26 percent unit increase over the year-ago quarter. Apple sold 15.4 million iPods, a 21 percent unit decline from the year-ago quarter.

"We're thrilled with our outstanding results and record-breaking sales of iPhones, iPads and Macs," said Tim Cook, Apple's CEO. "Apple's momentum is incredibly strong, and we have some amazing new products in the pipeline."

FINANCIAL ANALYSIS



How Does the Stock Market React to Earnings

Announcements?

For actively traded stocks such as Apple, most of the stock market reaction (stock price increases and decreases from investor trading) to the news in the press release usually occurs quickly. Recall that a number of analysts follow Apple and regularly predict the company's earnings. When the actual earnings are published, the market reacts not to the amount of earnings, but to the difference between expected earnings and actual earnings. This amount is called **unexpected earnings**. In January, analysts expected Apple to report quarterly profit of \$10.08 per share. In its press release presented in Exhibit 5.3, Apple's actual earnings per share for the quarter ended up being \$13.87 per share. Unexpected earnings (Actual – Expected) were thus \$3.79 cents per share (\$13.87 – \$10.08), and, as a result, the share price jumped \$34 or 8 percent on that day.

Companies such as Apple also issue press releases concerning other important events such as new product announcements. Press releases related to annual earnings and quarterly earnings often precede the issuance of the quarterly or annual report by 15 to 45 days. This time is necessary to prepare the additional detail and to distribute those reports.

Annual Reports and Form 10-K

For privately held companies, **annual reports** are relatively simple documents photocopied on white bond paper. They normally include only the following:

1. Four basic financial statements: income statement, balance sheet, stockholders' equity or retained earnings statement, and cash flow statement.
2. Related notes (footnotes).
3. Report of Independent Accountants (Auditor's Opinion) if the statements are audited.

The **FORM 10-K** is the annual report that publicly traded companies must file with the SEC.

The annual reports of public companies filed on **Form 10-K** are significantly more elaborate mainly because of additional SEC reporting requirements. SEC reports are normally referred

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to by number (for example, the "10-K"). The principal components of the financial disclosures in the 10-K include:

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Item Business: Description of business operations and company strategy.

1.

Item Selected Financial Data: Summarized financial data for a 5-year period.

6.

Item Management's Discussion and Analysis of Financial Condition and Results

7. **of Operations:** Management's views on the causes of its successes and failures during the reporting periods and the risks it faces in the future.

Item Financial Statements and Supplemental Data: The four basic financial

8. statements and related notes, the report of management, and the auditor's report (Report of Independent Registered Public Accounting Firm).

Except for the Management's Discussion and Analysis, most of these elements have been covered in earlier chapters. This element includes an explanation of key figures on the financial statements and the risks the company faces in the future. The Form 10-K also provides a more detailed description of the business including its products, product development, sales and marketing, manufacturing, and competitors. It also lists properties owned or leased, any legal proceedings it is involved in, and significant contracts it has signed.

Quarterly Reports and Form 10-Q

The **FORM 10-Q** is the quarterly report that publicly traded companies must file with the SEC.

Quarterly reports for private companies include condensed financial statements providing fewer details than annual statements and only key notes to the statements. They are not audited and so are marked **unaudited**. Often the cash flow statement, statement of stockholders' equity, and some notes to the financial statements are omitted. Private companies normally prepare quarterly reports for their lenders. Public companies file their quarterly reports on **Form 10-Q** with the SEC. The Form 10-Q contains most of the information items provided in the financial section (PART II) of the 10-K and some additional items.

Other SEC Reports

The **FORM 8-K** is used by publicly traded companies to disclose any material event not previously reported that is important to investors (e.g., auditor changes, mergers).

Public companies must file other reports with the SEC. These include the current event reports **Form 8-K**, which is used to disclose any material event not previously reported that is important to

investors (e.g., auditor changes, mergers). Other filing requirements for public companies are described on the SEC website.

A CLOSER LOOK AT FINANCIAL STATEMENT FORMATS AND NOTES

LEARNING OBJECTIVE 5-3

Recognize and apply the different financial statement and disclosure formats used by companies in practice and analyze the gross profit percentage.

The financial statements shown in previous chapters provide a good introduction to their content and structure. In this section, we will discuss three additional characteristics of financial statements and the related disclosures that are designed to make them more useful to investors, creditors, and analysts:

- **Comparative financial statements.** To allow users to compare performance from period to period, companies report financial statement values for the current period and one or more prior periods. Apple and most U.S. companies present two years' balance sheets and three years' income statements, cash flow statements, and statements of stockholders' equity.
- **Additional subtotals and classifications in financial statements.** You should not be confused when you notice slightly different statement formats used by different companies. In this section, we will focus on similarities and differences in the classifications and line items presented on Apple's and Chipotle's balance sheet, income statement, and cash flow statement.
- **Additional disclosures.** Most companies present voluminous notes that are necessary to understand a company's performance and financial condition. In addition, certain complex transactions require additional statement disclosures. We take a closer look at some of Apple's note disclosures to prepare you for more detailed discussions in the remaining chapters in this text.

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Classified Balance Sheet

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Exhibit 5.4 shows the September 24, 2011, balance sheet for Apple. This balance sheet looks very similar in structure to the balance sheet for Chipotle presented in Chapter 4, but it is presented for two years to ease comparisons over time. The statement classifications (current vs. noncurrent assets and current vs. noncurrent liabilities) play a major role in our discussions of ratio analysis (e.g., the current ratio in Chapter 2).

Apple's balance sheet contains an item, not included in Chipotle's, that is worthy of additional discussion. **Intangible assets** (discussed in Chapter 8) have no physical existence and a long life. Examples are patents, trademarks, copyrights, franchises, and goodwill from purchasing other companies. Most intangibles (except goodwill, trademarks, and other intangibles with indefinite lives) are amortized as they are used in a manner similar to the depreciation of tangible assets (Amortization Expense is debited and the contra-asset Accumulated Amortization is credited). Just as tangible fixed assets are reported net of accumulated depreciation, **intangible assets are reported net of accumulated amortization** on the balance sheet. **Goodwill** is a more general intangible asset representing the excess of the price paid for another company over the value of its identifiable assets. It is discussed in more detail in Chapter 8.

APPLE INC.		
Consolidated Balance Sheets*		
(in millions except number of shares which are in thousands)		
	September 24, 2011	September 25, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 9,815	\$11,261
Short-term marketable securities	16,137	14,359
Accounts receivable, less allowances of \$53 and \$55, respectively	5,369	5,510
Inventories	776	1,051
Deferred tax assets	2,014	1,636
Vendor non-trade receivables	6,348	4,414
Other current assets	<u>4,529</u>	<u>3,447</u>
Total current assets	44,988	41,678
Long-term marketable securities	55,618	25,391
Property, plant, and equipment, net	7,777	4,768
Goodwill	896	741
Acquired intangible assets, net	3,536	342
Other assets	<u>3,556</u>	<u>2,263</u>
Total assets	<u>\$116,371</u>	<u>\$75,183</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 14,632	\$12,015
Accrued expenses	9,247	5,723
Deferred revenue	<u>4,091</u>	<u>2,984</u>
Total current liabilities	27,970	20,722
Deferred revenue - noncurrent	1,686	1,139
Other noncurrent liabilities	<u>10,100</u>	<u>5,531</u>
Total liabilities	39,756	27,392
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value; 1,800,000 shares authorized; 929,277 and 915,970 shares issued and outstanding, respectively	13,774	10,942
Retained earnings	<u>62,841</u>	<u>36,849</u>
Total shareholders' equity	76,615	47,791
Total liabilities and shareholders' equity	<u>\$116,371</u>	<u>\$75,183</u>

*Apple's statements have been simplified for purposes of our discussion.

EXHIBIT 5.4

Balance Sheet of Apple Inc.

APPLE

REAL WORLD EXCERPT
Annual Report

Assets that will be used or turned into cash within one year

Assets that will be used or turned into cash beyond one year

Obligations that will be paid or settled within one year

Obligations that will be paid or settled after one year

Capital contributed by shareholders

Earnings reinvested in the company

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Also recall our discussion of deferred revenues from Chapter 4. These are liabilities created when customers pay for goods or services before the company delivers them. In Page 236 Apple's balance sheet, **deferred revenues show up in two places: current liabilities and noncurrent liabilities**. They both relate primarily to product warranties that Apple includes with its products. The deferred revenues related to repairs Apple expects to provide during the next year are classified as current. Those that relate to repairs to be provided in later years are classified as noncurrent.

When you first look at a new set of financial statements, try not to be confused by differences in terminology. When interpreting line items you have never seen before, be sure to consider their description **and their classification**.

Classified Income Statement

GROSS PROFIT (GROSS MARGIN) is net sales less cost of goods sold.

OPERATING INCOME (INCOME FROM OPERATIONS) equals net sales less cost of goods sold and other operating expenses.

Apple's 2011 consolidated income statement is reprinted for you in Exhibit 5.5. It presents the income statement followed by earnings per share for three years as required by the SEC. Apple's income statement includes one subtotal not included in Chipotle's. Like many manufacturing and merchandising (retail and wholesale) companies that sell goods, Apple reports the subtotal **Gross Profit** (gross margin), which is the difference between net sales and cost of goods sold. **It is important to note that regardless of whether a company reports a gross profit subtotal, the income statement presents the same information.** Another subtotal—**Operating Income** (also called Income from Operations)—is computed by subtracting operating expenses from gross profit.

INCOME BEFORE INCOME TAXES (PRETAX EARNINGS) is revenues minus all expenses except income tax expense.

Nonoperating (other) Items are revenues, expenses, gains, and losses that do not relate to the company's primary operations. Examples include interest income, interest expense, and gains and losses on the sale of fixed assets and investments. These nonoperating items are added to or subtracted from income from operations to obtain **Income before Income Taxes**, also called Pretax Earnings. At this point, Provision for Income Taxes (Income Tax Expense) is subtracted to obtain Net Income. Some companies show fewer subtotals on their income statements. No difference exists in the revenue, expense, gain, and loss items reported using the different formats. Only the categories and subtotals differ.

Nonrecurring Items that companies may also report on their income statements are:

1. Discontinued operations
2. Extraordinary items

If one or both of these items exists, an additional subtotal is presented for Income from Continuing Operations (or Income before Nonrecurring Items), after which the nonrecurring items are presented. These two items are presented separately because they are not useful in predicting the future income of the company given their nonrecurring nature.

When a major component of a business is sold or abandoned, income or loss from that component earned before the disposal, as well as any gain or loss on disposal, are included as discontinued operations. Extraordinary Items are gains or losses incurred that are both unusual and infrequent in occurrence. **Companies report extraordinary items very rarely.** For example, only 3 of the 500 companies followed by Accounting Trends and Techniques reported extraordinary items. Apple does not report either item.

Finally, **earnings per share** is reported. Simple computations of earnings per share (EPS) are as follows:

$$\text{Earnings per Share} = \frac{\text{Net Income}^*}{\text{Average Number of Shares of Common Stock Outstanding during the Period}}$$

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APPLE INC.				EXHIBIT 5.5
Consolidated Statements of Operations*				
(in millions except number of shares which are in thousands and per share amounts)				
Three years ended September 24, 2011	2011	2010	2009	Income Statement of Apple Inc.
Net sales	\$108,249	\$ 65,225	\$ 42,905	} APPLE
Cost of sales	64,431	39,541	25,683	
Gross profit	43,818	25,684	17,222	} REAL WORLD EXCERPT Annual Report
Operating expenses:				
Research and development	2,429	1,782	1,333	} <i>Operating activities (central focus of the business)</i>
Selling, general, and administrative	7,599	5,517	4,149	
Total operating expenses	10,028	7,299	5,482	} <i>Peripheral activities (not the main focus of the business)</i>
Operating income	33,790	18,385	11,740	
Other income and expense	415	155	326	} <i>Income tax expense</i>
Income before provision for income taxes	34,205	18,540	12,066	
Provision for income taxes	8,283	4,527	3,831	} = <i>Net Income/Average Number of Shares Outstanding</i>
Net income	\$ 25,922	\$ 14,013	\$ 8,235	
Earnings per common share:				
Basic	\$ 28.05	\$ 15.41	\$ 9.22	
Shares used in computing earnings per share:				
Basic	924,258	909,461	893,016	

*Apple's statements have been simplified for purposes of our discussion.

FINANCIAL ANALYSIS



Statement of Comprehensive Income

Both the FASB and IASB require an additional statement entitled the Statement of Comprehensive Income which can be presented separately or in combination with the income statement. When presented separately, the statement starts with Net Income, the bottom line of the income statement. Following this total would be the components of other comprehensive income. The Net Income and other comprehensive income items are then combined to create a total called Comprehensive Income (the bottom line for this statement). Apple's competitor Lenovo Group Ltd., maker of ThinkPad computers, presented the following in a recent quarterly report. Other comprehensive income items include fair value changes on certain investment securities, which are discussed in Appendix A, as well as other items discussed in more advanced accounting classes

Lenovo Group Ltd.	
Consolidated Statement of Comprehensive Income	
3 months ended September 30, 2011 (in thousands)	
Net income	\$144,671
Other comprehensive (loss)/income	
Fair value change on available-for-sale investments	(35,000)
Fair value change on cash flow hedge	38,882
Actuarial loss from defined benefit pension plans	(318)
Currency translation differences	<u>(31,224)</u>
Comprehensive income	<u>\$117,011</u>

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PAUSE FOR FEEDBACK

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As Apple's statements suggest, most statements are classified and include subtotals that are relevant to analysis. On the balance sheet, the most important distinctions are between current and noncurrent assets and liabilities. On the income statement, the subtotals gross profit and income from operations are most important. So the next step in preparing to analyze financial statements is to see if you understand the effects of transactions you have already studied on these subtotals. The following questions will test your ability to do so.

SELF-STUDY QUIZ

1. Complete the following tabulation, indicating the **direction** (+ for increase, – for decrease, and NE for no effect) **and amount** of the effect of each transaction. Consider each item independently. (Hint: Prepare journal entries for each transaction. Then consider the balance sheet or income statement classification of each account affected to come up with your answers.)
 - a. Recorded and paid rent expense of \$200.
 - b. Recorded the sale of services on account for \$400.

Transaction	Current Assets	Gross Profit	Income from Operations
a.			
b.			

After you have completed your answers, check them with the solutions at the bottom of the page.

GUIDED HELP



www.mhhe.com/libby8e

For additional step-by-step video instruction on preparing the balance sheet and income statement from a trial balance, go to the URL or scan the QR code in the margin with your smartphone or iPad.

KEY RATIO ANALYSIS



Gross Profit Percentage

The key subtotals on the income statement we just discussed also play a major role in financial ratio analysis. As we noted above, net sales less cost of goods sold equals the subtotal **gross profit** or **gross margin**. Analysts often examine gross profit as a percentage of sales (the gross profit or gross margin percentage).

? ANALYTICAL QUESTION

How effective is management in selling goods and services for more than the costs to purchase or produce them?

% RATIO AND COMPARISONS

The gross profit percentage ratio is computed as follows:

$$\text{Gross Profit Percentage} = \frac{\text{Gross Profit}^*}{\text{Net Sales}}$$

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The ratio for 2011 for Apple is:

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$$\frac{\$43,818}{\$108,249} = 0.405 \text{ (40.5\%)}$$

COMPARISONS OVER TIME		
Apple		
2009	2010	2011
40.1%	39.4%	40.5%

COMPARISONS WITH COMPETITORS	
Dell	HP
2011	2011
22.3%	23.4%

INTERPRETATIONS

In General The gross profit percentage measures a company's ability to charge premium prices and produce goods and services at low cost. All other things equal, a higher gross profit results in higher net income.

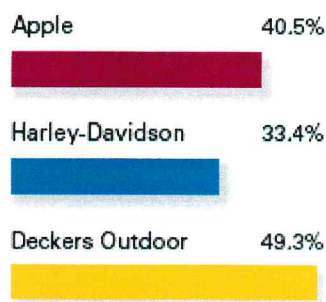
Business strategy, as well as competition, affects the gross profit percentage. Companies pursuing a product-differentiation strategy use research and development and product promotion activities to convince customers of the superiority or distinctiveness of the company's products. This allows them to charge premium prices, producing a higher gross profit percentage. Companies following a low-cost strategy rely on more efficient management of production to reduce costs and increase the gross profit percentage. Managers, analysts, and creditors use this ratio to assess the effectiveness of the company's product development, marketing, and production strategy.

Focus Company Analysis Apple's gross profit percentage has remained steady over the past three years and remains well above all of its competitors, including Dell and HP. At the beginning of the chapter, we discussed key elements of Apple's business strategy that focused on introducing new integrated technologies, product lines, and styles, as well as managing production and inventory costs. Each of these elements can have a large effect on gross profit. Its Form 10-K indicates that its various product lines have different gross profit percentages, and that a large increase in iPhone sales increased the overall gross profit percentage. Introducing new products with higher initial cost structures such as the iPad can decrease gross profit percentage.

A Few Cautions To assess the company's ability to sustain its gross profits, you must understand the sources of any change in the gross profit percentage. For example, an increase in margin resulting from increased sales of high-margin new products can be eroded by actions of competitors or increases in component costs for popular products. Also, higher prices must often be sustained with higher R&D and advertising costs, which reduce net income and can offset any increase in gross profit. This has not been the case for Apple in recent years as we will see later in the chapter. Apple's astonishing gross profit results in an industry-leading net profit margin and return on assets.

*Gross Profit = Net Sales – Cost of Sales

**Selected Focus
Companies' Gross Profit
Percentage Ratios**



Solutions to SELF-STUDY QUIZ

1. a. Rent expense (+E, -SE)	200	b. Accounts receivable (+A)	400
Cash (-A)	200	Sales revenue (+R, +SE)	400
-200, NE, -200		+400, +400, +400	

Statement of Stockholders' Equity

The statement of stockholders' (shareholders') equity reports the changes in each of the company's stockholders' equity accounts during the accounting period. Exhibit 5.6 presents Apple's 2011 consolidated statement of stockholders' equity. The statement has a column for each stockholders' equity account and one for the effect on total stockholders' equity. (Apple does not have an additional paid-in capital account; if it did, this account would have its own column.) The first row of the statement starts with the beginning balances in each account, which correspond to the prior year's ending balances on the balance sheet. Each row that follows lists each event that occurred during the period that affected any stockholders' equity accounts. Apple reported net income of \$25,992 for the year, which increases retained earnings. Apple declared no dividends. Had it done so, the amount would have been subtracted from retained earnings. Apple issued 13,307 shares of common stock during the year and received \$2,832 million for the issuance. **Note that the number of shares and the dollar amount are both listed. It is important not to confuse them.** If Apple had repurchased and retired shares, the number of shares and dollar amount would have been subtracted from common stock. The final row lists the ending balances in the accounts, which correspond to the ending balances on the balance sheet. Public companies must present information for the prior three years in their statements of stockholders' equity. So Apple's 2009 and 2010 statements would be presented above the information shown in Exhibit 5.6.

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EXHIBIT 5.6

Statement of Stockholders' Equity

APPLE INC.				
Consolidated Statements of Shareholders' Equity (partial)*				
(In millions, except number of shares which are reflected in thousands)				
	Common Stock		Retained Earnings	Total Stockholders' Equity
	Shares	Amount		
Balances as of September 25, 2010	915,970	\$10,942	\$36,849	\$47,791
Net income			25,992	25,992
Dividends declared			-	-
Stock issued	13,307	2,832		2,832
Stock repurchased		-		-
Balances as of September 24, 2011	<u>929,277</u>	<u>\$13,774</u>	<u>\$62,841</u>	<u>\$76,615</u>

**Apple's statements have been simplified for purposes of our discussion.*

Statement of Cash Flows

We introduced the three cash flow statement classifications in prior chapters:

Cash Flows from Operating Activities. This section reports cash flows associated with earning income.

Cash Flows from Investing Activities. Cash flows in this section are associated with the purchase and sale of (1) productive assets (other than inventory) and (2) investments in other companies.

Cash Flows from Financing Activities. These cash flows are related to financing the business through borrowing and repaying loans from financial institutions, stock (equity) issuances and repurchases, and dividend payments.

Exhibit 5.7 presents Apple's 2011 consolidated statement of cash flows. The first section (Cash Flows from Operating Activities) can be reported using either the **direct** or **indirect** method. For Apple, this first section is reported using the indirect method, which presents a reconciliation of net income on an accrual basis to cash flows from operations.

The Operating Activities section prepared using the indirect method helps the analyst understand the **causes of differences** between a company's net income and its cash flows. Net income and cash flows from operating activities can be quite different. Remember that the income statement is prepared under the accrual concept. Revenues are recorded when earned without regard to when the related cash flows occur. Likewise, expenses are matched with revenues and recorded in the same period without regard to when the related cash flows occur.

In the indirect method, the operating activities section starts with net income computed under the accrual concept and then eliminates noncash items, leaving cash flow from operating activities:

Net income
+/- Adjustments for noncash items
<hr style="width: 50%; margin: 0 auto;"/>
Cash provided by operating activities

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APPLE INC.			
Consolidated Statements of Cash Flows*			
(in millions)			
Three years ended September 24, 2011	2011	2010	2009
Cash and cash equivalents, beginning of the year	\$ 11,261	\$ 5,263	\$ 11,875
Operating activities:			
Net income	25,922	14,013	8,235
Adjustments to reconcile net income to cash generated by operating activities:			
Depreciation	1,814	1,027	734
Other noncash items	4,036	2,319	1,750
Changes in operating assets and liabilities:	5,757	1,236	(560)
Cash generated by operating activities	<u>37,529</u>	<u>18,595</u>	<u>10,159</u>
Investing activities:			
Purchases of marketable securities	(102,317)	(57,793)	(46,724)
Proceeds from sales/maturities of marketable securities	69,853	46,718	30,678
Payments for acquisition of property, plant, and equipment	(4,504)	(2,643)	(1,144)
Payments for acquisition of intangible assets	(3,192)	(116)	(69)
Other investing activities	(259)	(20)	(175)
Cash used in investing activities	<u>(40,419)</u>	<u>(13,854)</u>	<u>(17,434)</u>
Financing activities:			
Proceeds from issuance of common stock	831	912	475
Other financing activities	613	345	188
Cash generated by financing activities	<u>1,444</u>	<u>1,257</u>	<u>663</u>
(Decrease)/increase in cash and cash equivalents	<u>(1,446)</u>	<u>5,998</u>	<u>(6,612)</u>
Cash and cash equivalents, end of the year	<u>\$ 9,815</u>	<u>\$ 11,261</u>	<u>\$ 5,263</u>
Supplemental cash flow disclosure:			
Cash paid for income taxes, net	\$ 3,338	\$ 2,697	\$ 2,997

* Apple's statements have been simplified for purposes of our discussion.

EXHIBIT 5.7

Cash Flow Statement of Apple

APPLE

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Annual Report

Cash flows associated with earning income computed by eliminating noncash items from net income

Cash flows associated with purchase and sale of productive assets and investments

Cash flows associated with borrowing and repaying loans, issuing and repurchasing stock, and dividends

} Total change in cash

} End of year cash on balance sheet

The items listed between these two amounts explain the reasons they differ. For example, since no cash is paid during the current period for Apple's depreciation expense reported on the income statement, this amount is added back to net income to eliminate its effect. Similarly, increases and decreases in certain current assets and liabilities also account for some of the difference between net income and cash flow from operations. For example, sales on account increase net income as well as the current asset accounts receivable, but sales on account do not increase cash. As we cover different portions of the income statement and balance sheet in more detail in Chapters 6 through 11, we will also discuss the relevant sections of the cash flow statement. Then we discuss the complete cash flow statement in detail in Chapter 12.

Notes to Financial Statements

While the numbers reported on the various financial statements provide important information, users require additional details to facilitate their analysis. All financial reports include additional

information in notes that follow the statements. Apple's 2011 notes include three types of information:

1. Descriptions of the key accounting rules applied to the company's statements.
2. Additional detail supporting reported numbers.
3. Relevant financial information not disclosed on the statements.

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Accounting Rules Applied in the Company's Statements

One of the first notes is typically a summary of significant accounting policies. As you will see in your study of subsequent chapters, generally accepted accounting principles (GAAP) permit companies to select from alternative methods for measuring the effects of transactions. The summary of significant accounting policies tells the user which accounting methods the company has adopted. Apple's accounting policy for property, plant, and equipment is as follows:

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NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Property, Plant, and Equipment

Property, plant, and equipment are stated at cost. Depreciation is computed by use of the straight-line method over the estimated useful lives of the assets, which for buildings is the lesser of 30 years or the remaining life of the underlying building, up to five years for equipment, and the shorter of lease terms or ten years for leasehold improvements.

We will discuss alternative depreciation methods in Chapter 8. Without an understanding of the various accounting methods used, it is impossible to analyze a company's financial results effectively.

Additional Detail Supporting Reported Numbers

The second category of notes provides supplemental information concerning the data shown on the financial statements. Among other information, these notes may show revenues broken out by geographic region or business segment, describe unusual transactions, and/or offer expanded detail on a specific classification. For example, in Note 3, Apple indicates the makeup of property, plant, and equipment presented on the balance sheet.

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NOTE 3 – CONSOLIDATED FINANCIAL STATEMENT DETAILS

Property, Plant, and Equipment

	2011	2010
Land and buildings	\$ 2,059	\$ 1,471
Machinery, equipment, and internal-use software	6,926	3,589
Office furniture and equipment	184	144
Leasehold improvements	2,599	2,030
Gross property, plant, and equipment	11,768	7,234
Accumulated depreciation and amortization	(3,991)	(2,466)
Net property, plant, and equipment	<u>\$ 7,777</u>	<u>\$ 4,768</u>

Relevant Financial Information Not Disclosed on the Statements

The final category includes information that impacts the company financially but is not shown on the statements. Examples include information on legal matters and contractual agreements that do not result in an asset or liability on the balance sheet. In Note 7, Apple disclosed the details of its commitments under supply agreements, which total over \$15 billion and are not shown as a liability on the balance sheet.

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NOTE 7 – COMMITMENTS AND CONTINGENCIES

Other Commitments

As of September 24, 2011, the Company had outstanding off-balance sheet commitments for outsourced manufacturing and component purchases of \$13.9 billion.

Additionally, other outstanding obligations were \$2.4 billion as of September 24, 2011, and were comprised mainly of commitments under long-term supply agreements to make additional inventory component prepayments and to acquire capital equipment, commitments to acquire product tooling and manufacturing process equipment, and commitments related to advertising, research and development, Internet and telecommunications services and other obligations.

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Voluntary Disclosures

GAAP and SEC regulations set only the minimum level of required financial disclosures. Many companies provide important disclosures beyond those required. For example, in its annual report, 10-K, and recent earnings press release, Apple discloses sales by major product category, which helps investors track the success of new products.

	2011	Change	2010	Change	2009
Net Sales by Product:					
Desktops (a)	\$ 6,439	4%	\$ 6,201	43%	\$ 4,324
Portables (b)	15,344	36%	11,278	18%	9,535
Total Mac net sales	21,783	25%	17,479	26%	13,859
iPod	7,453	(10)%	8,274	2%	8,091
Other music related products and services (c) . . .	6,314	28%	4,948	23%	4,036
iPhone and related products and services (d) . . .	47,057	87%	25,179	93%	13,033
iPad and related products and services (e) . . .	20,358	311%	4,958	NM	0
Peripherals and other hardware (f)	2,330	28%	1,814	23%	1,475
Software, service and other sales (g)	2,954	15%	2,573	7%	2,411
Total net sales	<u>\$108,249</u>	66%	<u>\$65,225</u>	52%	<u>\$42,905</u>

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**under IFRS and U.S. GAAP**

Financial accounting standards and disclosure requirements are adopted by national regulatory agencies. Many countries, including the members of the European Union, have adopted international financial reporting standards (IFRS) issued by the International Accounting Standards Board (IASB). IFRS are similar to U.S. GAAP, but there are several important differences. A partial list of the differences at the time this chapter is being written is presented below, along with the chapter in which these issues will be addressed:

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Difference	U.S. GAAP	IFRS	Chapter
Extraordinary items	Permitted	Prohibited	5
Last-in first-out (LIFO) method for inventory	Permitted	Prohibited	7
Reversal of inventory write-downs	Prohibited	Required	7
Basis for property, plant, and equipment	Historical cost	Fair value or historical cost	8
Development costs	Expensed	Capitalized	8
Debt to be refinanced	Current	Noncurrent	9
Recognition of contingent liabilities	Probable	More likely than not	9
Stockholders' equity accounts	Capital stock	Share capital	11
	Paid-in capital	Share premium	
Interest received on cash flow statement	Operating	Operating or investing	12
Interest paid on cash flow statement	Operating	Operating or financing	12

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The FASB and IASB are working together to eliminate these and other differences.

RETURN ON ASSETS ANALYSIS: A FRAMEWORK FOR EVALUATING COMPANY PERFORMANCE

LEARNING OBJECTIVE 5-4

Analyze a company's performance based on return on assets and its components and the effects of transactions on financial ratios.

Evaluating company performance is the primary goal of financial statement analysis. Company managers, as well as competitors, use financial statements to better understand and evaluate a company's business strategy. Analysts, investors, and creditors use these same statements to judge company performance when they estimate the value of the company's stock and its creditworthiness. Our discussion of the financial data contained in accounting reports has now reached the point where we can develop an overall framework for using that data to evaluate company performance. The most general framework for evaluating company performance is called return on assets (ROA) analysis.

KEY RATIO ANALYSIS



Return on Assets (ROA)

? ANALYTICAL QUESTION

During the period, how well has management used the company's total investment in assets financed by both debt holders and stockholders?

% RATIO AND COMPARISONS

$$\text{Return on Assets} = \frac{\text{Net Income}^*}{\text{Average Total Assets}^\dagger}$$

The 2011 ratio for Apple:

$$\frac{\$25,922}{(\$75,183 + \$116,371) \div 2} = 0.271 \text{ (27.1\%)}$$

COMPARISONS OVER TIME		
Apple		
2009	2010	2011
19.7%	22.8%	27.1%

COMPARISONS WITH COMPETITORS	
Dell	HP
2011	2011
8.4%	5.6%

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💡 INTERPRETATIONS

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In General ROA measures how much the firm earned for each dollar of investment in assets. It is the broadest measure of profitability and management effectiveness, independent of financing strategy. Firms with higher ROA are doing a better job of selecting and managing investments, all other things equal. Since it is independent of the source of financing (debt vs. equity), it can be used to evaluate performance at any level within the organization. It is often computed on a division-by-division or product line basis and used to evaluate division or product line managers' relative performance.

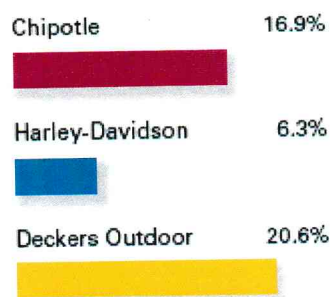
Focus Company Analysis The increase in return on assets between 2009 and 2011 was mainly due to an increase in overall sales and a change in product mix to products with higher gross profit percentages. For example, as disclosed in the voluntary disclosure of product line sales presented above, iPhone sales have nearly doubled each of the last two years. They have a higher gross profit percentage than most other Apple products, and this carries over to higher net income. The company is doing much better than its more traditional rivals Dell and HP.

A Few Cautions Like all ratios, the key to interpreting change is to dig deeper to understand the reason for each change. Our next topic, ROA Profit Driver Analysis and Business Strategy, is aimed at just that.

*In more complex return on assets analyses, interest expense (net of tax) and minority interest are added back to net income in the numerator of the ratio, since the measure assesses return on capital independent of its source.

†Average Total Assets = (Beginning Total Assets + Ending Total Assets) ÷ 2.

Selected Focus Companies' Return on Assets Ratios

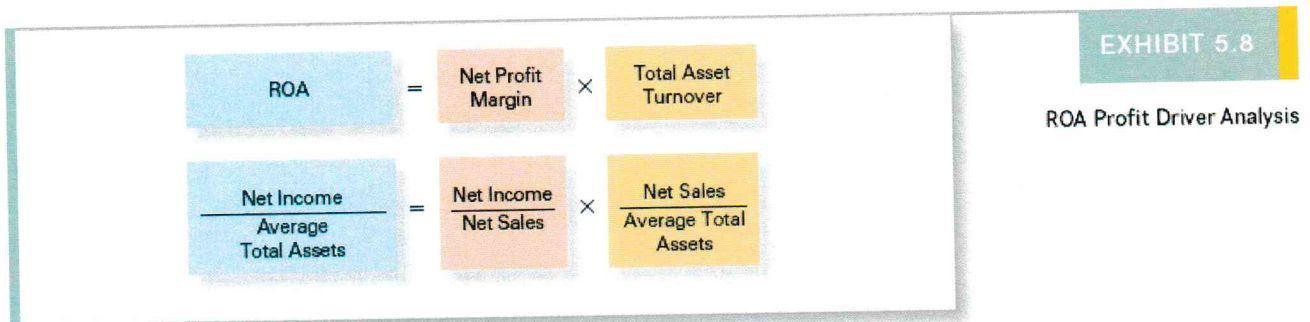


ROA Profit Driver Analysis and Business Strategy

Effective analysis of Apple's performance also requires understanding **why** its ROA differs both from prior levels and from those of its competitors. ROA profit driver analysis (also called **ROA decomposition** or **DuPont analysis**) breaks down ROA into the two factors shown in Exhibit 5.8. These factors are often called **profit drivers** or **profit levers** because they describe the two ways that

management can improve ROA. They are measured by the key ratios you learned in Chapters 3 and 4.

1. **Net profit margin** = $\text{Net Income} \div \text{Net Sales}$. It measures how much of every sales dollar is profit. It can be increased by
 - a. Increasing sales volume.
 - b. Increasing sales price.
 - c. Decreasing cost of goods sold and operating expenses.
2. **Total asset turnover** = $\text{Net Sales} \div \text{Average Total Assets}$. It measures how many sales dollars the company generates with each dollar of assets (efficiency of use of assets). It can be increased by
 - a. Centralizing distribution to reduce inventory kept on hand.
 - b. Consolidating production facilities in fewer factories to reduce the amount of assets necessary to generate each dollar of sales.



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These two ratios report on the effectiveness of the company's operating and investing activities, respectively.

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Successful manufacturers often follow one of two business strategies. The first is a **high-value** or **product-differentiation** strategy. Companies following this strategy rely on research and development and product promotion to convince customers of the superiority or distinctiveness of their products. This allows the company to charge higher prices and earn a higher net profit margin. The second is a **low-cost strategy**, which relies on efficient management of accounts receivable, inventory, and productive assets to produce high asset turnover.

The ROA profit driver analysis presented in Exhibit 5.9 indicates the sources of Apple's ROA and compares them to the same figures for Dell. **Apple** follows a classic **high-value strategy**, developing a reputation for the most innovative products in its markets. The success of this strategy is evident in its market leading **net profit margin** of .239 or **23.9%**. This means that 23.9 cents of every sales dollar is net profit. This compares with Dell's 5.6% net profit margin, which matches other competitors such as HP.

Dell primarily follows a **low-cost strategy** by offering excellent products and service at competitive prices. The efficiency of Dell's operations is evident in its higher **total asset turnover** of **1.49** compared to Apple's 1.13. Apple has produced a much higher ROA than Dell because its phenomenal net profit margin more than offsets its lower total asset turnover, and its stock price has responded accordingly.

If Apple follows the same strategy it has in the past, the secret to maintaining its ROA must be continued product development to support premium selling prices. In 2011, Apple made major strides in new product development and the success of its new product introductions bodes well for a high ROA in the longer term. As the preceding discussion indicates, a company can take many different actions to try to affect its profit drivers. To understand the impact of these actions, financial analysts disaggregate each of the profit drivers into more detailed ratios. For example, the total asset turnover ratio is further disaggregated into turnover ratios for specific assets such as accounts receivable, inventory, and fixed assets. We will develop our understanding of these more specific ratios in the next seven chapters of the book. Then, in Chapter 13, we will combine the ratios in a comprehensive review.

How Transactions Affect Ratios

Apple and other companies know that investors and creditors follow their key financial ratios closely. Changes in ROA and its components can have a major effect on a company's stock price and interest rates that lenders charge. As a consequence, company managers closely follow the effects of their actual and planned transactions on these same key financial ratios. We have already learned how to determine the effects of transactions on key subtotals on the income statement and balance sheet (gross profit, current assets, etc.). So we are only one step away from being able to compute the effects of transactions on ratios. The following three-step process will help you do so:

1. **Journalize the transaction to determine its effects on various accounts**, just as we did in Chapters 2 through 4.
2. **Determine which accounts belong to the financial statement subtotals or totals in the numerator (top) and denominator (bottom) of the ratio and the direction of their effects.**

3. Evaluate the combined effects from step 2 on the ratio.

EXHIBIT 5.9

Apple vs. Dell ROA Profit
Driver Analysis

ROA Profit Drivers	Formulas	Apple	Dell
Net Profit Margin	Net Income/Net Sales	0.239	0.056
× Total Asset Turnover	× Net Sales/Average Total Assets	1.13	1.49
= Return on Assets	= Net Income/Average Total Assets	0.271	0.084

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Let's try a few examples to get a feel for the process. What would be the effect of the following transactions on the following ratios (ignoring taxes)? The examples we will consider illustrate that the effect depends on what part of the ratio, numerator (top) and/or denominator (bottom), is affected. We need to consider three cases.

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What if only the numerator or denominator is affected?

Example 1: Apple incurred an additional \$1,000 in research and development expense paid for in cash (all numbers in millions). What would be the effect on the **net profit margin** ratio? The entry would be:

Research and development expense (+E, -SE)	1,000
Cash (-A)	1,000

Note that the transaction would decrease the numerator Net Income, and have no effect on the denominator Net Sales. The ratio was .239. It would decrease to .230 as follows.

	Net Income	÷	Net Sales	=	Net Profit Margin
As reported:	\$25,922	÷	\$108,249	=	.239
Transaction effect:	<u>-1,000</u>		<u>-</u>		
After transaction:	\$24,922	÷	\$108,249	=	.230

This example illustrates a general point about the effect of transactions on ratios. If a transaction **only** affects the numerator **or** denominator of the ratio, it will have the following effects on the ratio:

Ratio Changes Given Changes in Numerator <u>or</u> Denominator	
Numerator	Ratio
Increases	Increases
Decreases	Decreases
Denominator	
Increases	Decreases
Decreases	Increases

What if both the numerator and denominator are affected but by different amounts?

Example 2: Consider the same transaction in Example 1. What would be the effect on the **return on assets** ratio? Note that the transaction would decrease the numerator Net Income by \$1,000. It would also **decrease the ending** total assets by \$1,000, but have **no effect on beginning** total assets. So the denominator, **average** total assets, would only decrease by \$500:

$$\text{Avg. Total Assets} = (\$75,183 + \$116,371 - \$1,000) \div 2 = \$95,277$$

The ratio was .271 in Exhibit 5.9. It would decrease as follows:

	Net Income	÷	Avg. Total Assets	=	Return on Assets
As reported:	\$25,922	÷	\$95,777	=	.271
Transaction effect:	<u>-1,000</u>		<u>-500</u>		
After transaction:	\$24,922	÷	\$95,277	=	.262

This example illustrates a second general point about the effect of transactions on ratios. If a transaction affects the numerator by more than it affects the denominator, or if it affects the denominator by more than it affects the numerator, **focus only on the larger effect and the effects in the table above still hold.**