

Solutions to Study Questions, Problems, and Cases

Chapter 1

1.1 The types of questions that can be answered include the following:

- Would an investment generate attractive returns?
- What is the degree of risk inherent in the investment?
- Should existing investment holdings be liquidated?
- Will cash flows be sufficient to service interest and principal payments to support the firm's borrowing needs?
- Does the company provide a good opportunity for employment, future advancement, and employee benefits?
- How well does this company compete in its operating environment?
- Is this firm a good prospect as a customer?

1.2 The annual report is published primarily for shareholders, while the 10-K report is filed with the Securities and Exchange Commission and is used by regulators, analysts, and researchers. The financial statements and much of the financial data are identical in the two documents; but the 10-K report contains more detail (such as schedules showing management remuneration and transactions, a description of material litigation and governmental actions, and elaborations of many financial statement accounts) than the annual report; and the annual report presents additional public relations type material such as colored pictures, charts, graphs, and promotional information about the company.

1.3 The analyst should use the financial statements: the balance sheet, the income statement, the statement of stockholders' equity, and the statement of cash flows; the notes to the financial statements; supplementary information such as financial reporting by segments; the auditor's report; management's discussion and analysis of operating performance and financial condition; and the five-year summary of financial data.

Use the public relations "fluff," such as colored pictures and descriptive material with caution.

1.4 The SEC has the legal authority to write accounting rules in the United States; however, they choose to delegate writing rules, for the most part, to the FASB. The SEC plays a supportive role and at times will encourage FASB to write particular rules or make changes to policies.

1.5 The annual report or Form 10-K includes the following four financial statements:

1. The *balance sheet or statement of financial position* shows the financial position—assets, liabilities, and stockholders' equity—of the firm on a particular date, such as the end of a quarter or a year.
2. The *income or earnings statement* presents the results of operations—revenues, expenses, net profit or loss, and net profit or loss per share—for the accounting period.
3. The *statement of stockholders' equity* reconciles the beginning and ending balances of all accounts that appear in the stockholders' equity section of the balance sheet. Some firms prepare a statement of retained earnings, frequently combined with the income statement, which reconciles the beginning and ending balances of the retained earnings account. Companies choosing the latter format will generally present the statement of stockholders' equity in a footnote disclosure.
4. The *statement of cash flows* provides information about the cash inflows and outflows from operating, financing, and investing activities during an accounting period.

1.6 The notes are, in fact, an integral part of the statements and must be read in order to understand the presentation on the face of each financial statement. The notes to the financial statements provide a summary of the firm's accounting policies, any changes in accounting policies during the reporting period, details about particular accounts, such as inventory, property, plant, and equipment, investments, debt and equity accounts, and information about items such as acquisitions, divestitures, pension and stock option plans, leases, legal proceedings, income taxes, contingencies, commitments, and segments,

1.7 A qualified report is issued when the overall financial statements are fairly presented "except for" items which the auditor discloses; an adverse opinion is issued when the financial statements have departures from GAAP so numerous that the statements are not presented fairly. A disclaimer of opinion is caused by a scope limitation resulting in the auditor being unable to evaluate and express an opinion on the fairness of the statements. An unqualified opinion with explanatory

language is caused by a consistency departure due to a change in accounting principle, uncertainty caused by future events such as contract disputes and lawsuits, events which the auditor believes may present business risk and going concern problems.

1.8 The Management Discussion and Analysis section is of potential interest to the analyst because it contains information that cannot be found in the financial data. The content of this section includes coverage of any favorable or unfavorable trends and significant events or uncertainties in the areas of liquidity, capital resources, and results of operations. In particular, the analyst can expect to find a discussion of the following:

1. The internal and external sources of liquidity
2. Any material deficiencies in liquidity and how they will be remedied
3. Commitments for capital expenditures, the purpose of such commitments, and expected sources of funding
4. Anticipated changes in the mix and cost of financing resources
5. Unusual or infrequent transactions that affect income from continuing operations
6. Events that cause material changes in the relationship between costs and revenues (such as future labor or materials price increases or inventory adjustments)
7. A breakdown of sales increases into price and volume components

1.9 The proxy statement is a document required by the SEC to solicit shareholder votes, since many shareholders do not attend shareholder meetings. The analyst can find important information in the proxy statement such as background information on the company's nominated directors, director and executive compensation, any proposed changes to those compensation plans and the audit and non-audit fees paid to the auditing firm.

1.10 Employee relations with management, employee morale and efficiency, the reputation of the firm with its customers and in its operating environment, the quality and effectiveness of management, provisions for management succession, potential exposure to regulatory changes, "bad publicity" in the media.

1.11

Memorandum

Date: Current Date
To: B.R. Neal, Director of Marketing
From: Student's Name
Subject: Contents of an Annual Report

The company's annual report presents financial information about the firm. This information package is published primarily for shareholders and the general public. The major components of an annual report are briefly described in this memo.

1) An annual report contains four financial statements: The **balance sheet** shows the financial condition (assets, liabilities, stockholders' equity) at end of year; the **income or earnings statement** presents the results of operations including revenues, expenses, net profit or loss, and net profit or loss per share for the year; the **statement of stockholders' equity** reconciles beginning and ending balances of accounts in the equity section of the balance sheet; and the **statement of cash flows** shows inflows and outflows of cash from operating, financing, and investing activities for the year.

2) Notes to the financial statements provide additional detail about particular items in the financial statements. 3) The auditor's report is prepared by an independent accounting firm and attests to the fairness of the information presented. 4) The five year summary shows key financial data including net sales, income/loss from continuing operations on a dollar and per share basis, assets, long term debt, and dividends per common share. 5) Quarterly stock prices record how the company's stock shares have performed over the past two years. 6) Management's Discussion and Analysis provides management's perspective on how the company is doing including favorable or unfavorable trends, and significant events or uncertainties.

The remaining material in the annual report is included primarily to provide background information about the company and its management, and to make the document attractive and interesting to read.

If staff members would like to learn more about any of the material in the company's annual report, the following book is highly recommended: Understanding Financial Statements by Fraser and Ormiston (Prentice Hall, 20??).

1.12 There is no solution presented as the information will be changing over time.

1.13 The SEC website contains information useful to the financial analyst including the following sections:*

"About the SEC" explains the role of the SEC, outlines the laws, regulations, and rules of practice of the SEC, includes biographies of the SEC commissioners, lists upcoming events, offers a listing of all the forms available at the SEC, and includes the strategic plan, annual reports, budgets, and directories of the SEC.

"Filings and Forms" includes the EDGAR database which allows analysts to access the SEC forms filed by publicly-held companies. A quick EDGAR tutorial is offered in this section as well as a description of SEC forms and how to request paper documents.

"Regulatory Actions" provides links to releases concerning SEC rulemaking activity.

"Staff Interpretations" provides guidance of the SEC staff members on various accounting and legal matters.

"Investor Information" allows the analyst to search for information, ask questions, file complaints, access research tools and calculators, and includes warnings and updates the SEC may desire to share with the public.

"SEC Newsroom" includes SEC press releases, speeches and testimony by senior SEC officials, special studies and reports and a daily summary of significant SEC actions.

"Litigation" provides information on SEC enforcement actions.

"Divisions & Offices" has links to each SEC division and office and includes an organization chart of the SEC. Each of the division links offers significant information related to each division's duties.

Other links provided on the SEC homepage include information for specific groups such as accountants, broker dealers, EDGAR filers and small business to name a few.

*Information was obtained in May, 2011. Changes may have been made since that date.

Case 1.1

(a) In 2010 Intel is the world's largest semiconductor chip maker based on revenue. The company also develops integrated digital technology, primarily integrated circuits, for industries such as computing and communications and hardware and software computing platforms. Other products include microprocessors, chipsets, motherboards, and wireless and wired connectivity products. (pg. 1 of Form 10-K)

(b) The analyst could learn the following by reading the letters from the CEO and the chairman:

- Intel reported the best financial results ever in 2010,
- Xeon and Itanium processors were introduced in 2010 that delivered higher performance for servers as well as better reliability and security features,
- the Intel Atom processor family of products is allowing Intel to expand into new markets of computing devices,
- new second generation “core” processors represent the largest increase in computing performance and capabilities over any previous generation,
- since 2009 Intel has been shipping 32-nanometer process technology while the competition had not shipped any,
- production of 22 nanometer process technology is scheduled to begin in 2011,
- Intel acquired Infineon’s Wireless Solutions business and Texas Instruments’ cable modem product line to take advantage of connectivity growth opportunities,
- in 2010 Intel announced plans to acquire McAfee, the world’s largest dedicated security technology company, in order to work toward better security in connected devices,
- for the third consecutive year Intel was the largest purchaser of green power and earned certification and awards for sustainable construction as well as a philanthropy award for contributions to education,
- dividends paid out continue to increase and the firm repurchases stock to increase stockholder value,
- new factories are being built in Oregon and Arizona,
- a new committee has been formed to monitor and ensure that Intel is in compliance with legal requirements globally and is operating at the highest level of integrity, and

- Intel is promoting education and access programs for women and underserved minorities, as well as increasing diversity in its own workforce.

(c) Intel received an unqualified audit opinion. The audit report states that the audit was conducted according to generally accepted auditing standards and the financial statements are in conformity with generally accepted accounting principles. Intel also received an unqualified opinion on the effectiveness of their internal controls over financial reporting. (pgs. 105-106 of Form 10-K)

(d) The Management Discussion and Analysis for Intel discusses the following items:

1. The company expects the key source of liquidity to be cash from operating activities. In 2010, Intel generated over \$16 billion of cash from operations. Cash is generated externally from the sale of stock through employee plans and the firm raised \$587 million in proceeds in 2010. The company has the potential to borrow \$3.0 billion under its commercial paper program. Intel borrowed \$150 million in 2010 but this was repaid before year-end. In addition, Intel has the ability to offer an unspecified amount of debt, equity and other securities because it has an automatic shelf registration on file with the SEC. (pgs. 40-42 of Form 10-K)
2. No material deficiencies of liquidity currently exist. (pgs. 40-42 of Form 10-K)
3. Intel plans to spend approximately \$9 billion plus or minus \$300 million in 2011 for capital expenditures. The funds will be used for investments in 22 nanometer process technology. (pg. 39 of Form 10-K) It is implied that funding will come from cash from operations. (pg. 42 of Form 10-K)
4. No anticipated changes in the mix and cost of financing resources are discussed. (pgs. 39-42 of Form 10-K)
5. No unusual or infrequent transactions were found in 2010; however the Intel paid a large fine to the European Commission and settled a lawsuit with AMD in 2009. (pg. 34 of Form 10-K)
6. Intel's restructuring program to promote efficiency and reduce costs is expected to continue to positively impact the firm in 2011. (pg. 35 of Form 10-K) Intel is projecting higher revenues in 2011, but will also experience lower gross margins and higher expenses in most categories. On a percentage basis it appears that Intel may just maintain its current net profit margin. (pg. 39 of Form 10-K)

7. Sales increased 24% overall due to higher microprocessor and chipset unit sales, as well as higher microprocessor average selling prices. The PC Client Group revenues increased 21% primarily due to higher volume of notebook unit sales and, to a lesser extent, higher average selling prices for notebooks. One area that had significantly lower sales was the wireless connectivity product lines. The Data Center Group revenues increased 35% due primarily to volume, and, to a lesser extent, higher average selling prices. Revenues increased 27% in the Other Intel Architecture segment due to volume increases. (pgs. 31-33 of Form 10-K)

(e) Intel appears to have a good strategy and is focusing on new growth opportunities. The firm has the financial resources to pursue their strategy. Some concerns may be potential competition and continued litigation.

Case 1.2

(a)

Clear

The 'Analysis ToolPak' add-in must be installed and active.

Enter data on this sheet before other financial statement information.

Company Name:	Avnet		
Stock Ticker Symbol:	AVT		
U.S. Stock Exchange:	NYSE	Variable	
Statement Year-end Dates:	7/3/2010	6/27/2009	6/28/2008
Financial Reports Rounded to :	Thousands		

Supplemental Ratio Requirements:

	2010	2009	2008
Rent expense (in thousands):	\$ 64,487	\$ 64,382	\$ 59,176
Dividends per share:			
End of year stock price (<i>adjusted for splits</i>):	\$ 23.98	\$ 21.52	\$ 29.55

Marketwatch.com URL for stock prices: <http://marketwatch.com/tools/quotes/historical.asp?date=07%2F02%2F2010&synd=AVT&siteid=mktw> <http://marketwatch.com/tools/quotes/historical.asp?date=06%2F26%2F2009&synd=AVT&siteid=mktw> <http://marketwatch.com/tools/quotes/historical.asp?date=06%2F27%2F2008&synd=AVT&siteid=mktw>

Check Figures:

Balance Sheet	Current Assets:	\$ 6,630,168	\$ 5,144,252	
	Total Assets:	\$ 7,782,382	\$ 6,273,516	
	Current Liabilities:	\$ 3,439,615	\$ 2,455,860	
	Total Stockholders' Equity:	\$ 3,009,117	\$ 2,760,857	
Income Statement	Gross Profit:	\$ 2,280,217	\$ 2,022,993	\$ 2,313,716
	Operating Profit:	\$ 635,600	\$ (1,018,998)	\$ 710,771
	Net Profit:	\$ 410,370	\$ (1,129,712)	\$ 489,578
Cash Flow	Net Flows from Operations:	\$ (30,415)	\$ 1,118,035	\$ 453,617
	Net Flows from Investing Activity:	\$ (112,421)	\$ (397,685)	\$ (378,380)
	Net Flows from Financing Activity:	\$ 296,772	\$ (405,241)	\$ (33,047)

(b) Each student's response will differ depending on the news sources used and the date on which the student completes the assignment. Below is a sampling of news from articles in 2010-2011:

Source: Online Product News, August 2010
"Avnet Express Launches Asia-Wide Ecommerce Site"

Avnet is launching its first distributor website in Asia to offer a China payment capacity and rapid access to inventory held across Asia.

Source: Electronics Weekly, September 8, 2010
"Zammit: 'No Major Risks'"

Avnet's European President, Patrick Zammit, discusses the German industrial economy which is showing good growth. He predicts a 30% growth rate in 2010. Further he states that there is no inventory build-up at this time.

Source: Zacks Equity Research, May 19, 2011
"Avnet Flexes Distribution Muscle"

Avnet will acquire IT distributor, Amosdec, headquartered in Paris. Avnet's strategy has been to acquire smaller targets in markets where they want to expand their business. Avnet's recent acquisitions of Bell Micro and Tallard have firmly established Avnet as a leading distributor in Latin America.

(c) Item 1 in the Avnet Form 10-K for 2010 describes the business in which Avnet operates. The organizational structure of the firm is detailed including information about Avnet's two operating groups, the economic regions in which the firm operates, and the products and solutions that Avnet provides to their customers. The firm's strategy with regard to acquisitions is explained as well as the competition Avnet faces and the advantages they believe they have with regard to the competition.

Item 3 of the Form 10-K informs the reader of the legal proceedings in which Avnet is a party. Avnet has incurred liabilities related to environmental issues with regard to disposal of hazardous substances. The firm believes it has accrued its share of the costs for any environmental clean up in its financial statements.

The auditor's report indicates that KPMG LLP has given Avnet unqualified opinions on their financial statements as well as their effectiveness in maintaining internal controls. *

*The auditor's report is usually in Item 8; however, Avnet has moved this item to Item 15 and noted this under Item 8.

Case 1.3

1. Mattel, Inc. designs, manufactures, and markets a broad variety of toy products worldwide.

2. a. Balance sheet - pg. 54

b. Income statement - pg. 55

c. Statement of cash flows - pg. 56

d. Statement of stockholders' equity - pg. 57

e. Notes to the financial statements - pgs. 58-102

f. Management's discussion and analysis - pgs. 25-47

g. Summary of selected financial data - pg.24

h. Auditor's report - pg. 53

3. PricewaterhouseCoopers LLP

4. a. Assets - \$5,417,733

b. Liabilities - \$2,789,149

c. Stockholders' equity – \$2,628,584

d. Net sales - \$5,856,195

e. Net income - \$684,863

f. Cash increased \$164,126

g. Retained earnings - \$2,720,645

Case 1.4

1. The Management Discussion and Analysis section provides important information that cannot be found anywhere else in the annual report. The section covers trends, events, and uncertainties in the areas of liquidity, capital resources, and operations. Information should include a discussion of:
 - a. internal and external sources of liquidity;
 - b. any material deficiencies in liquidity and how they will be remedied;
 - c. commitments for capital expenditures and expected sources of funding;
 - d. anticipated changes in the mix and cost of financing resources;
 - e. unusual or infrequent transactions which affect income from continuing operations;
 - f. events which cause material changes in the relationship between costs and revenues; and
 - g. a breakdown of sales increases into price and volume components.

2. The MD&A includes the following discussion of the seven items outlined in (1) above:
 - a. The principal source of liquidity for Apple is internal, cash generated by operating activities, as well as the current balances in cash, cash equivalents, and marketable securities. There is no mention in the MD&A of external sources of liquidity in the form of equity financing and Apple currently has no debt financing.
 - b. No material deficiencies of liquidity currently exist.
 - c. Apple plans to spend approximately \$4 billion for capital expenditures, including product tooling and manufacturing process equipment, corporate facilities, and infrastructure. Apple has sufficient cash on hand (\$51 billion) to cover these expenditures and has generated between \$9 and \$18 billion of cash from operating activities in each of the past three years.
 - d. No changes to the current mix and cost of financing resources were discussed. This is not surprising given the large amounts of cash Apple generates.
 - e. No unusual or infrequent transactions were discussed in the MD&A.
 - f. If Apple continues to be successful in innovating new products that create high demand such as their iPhone and iPad products, the relationship between costs and revenues should be stable or could possibly result in higher revenues relative to costs. Competition or saturation of markets could result in higher costs relative to revenues,

but at this point seems unlikely. Apple projects lower gross margin percentages in the future, but has been able to increase revenues faster than operating expenses other than cost of goods sold, therefore, it appears that Apple should be able to maintain the current relationship between costs and revenues.

- g. Net sales increased 52% in 2010 after a 14% increase in 2009. The increase in sales was driven by an increase in the volume of sales of the iPhone and related products and services in both 2009 and 2010. In addition the iPad was released in 2010. Mac unit sales increased in 2009 and 2010, however, selling prices declined. Sales volume increased for music related products and services both years as a result of growth of the iTunes App Store. Unit sales of iPods decreased in 2010 while net sales(\$) of iPods increased due to a shift in product mix toward iPod touch. In 2009, iPod net sales and unit sales decreased due to price reductions taken with the introduction of new iPods and a stronger U.S. dollar, offset partially by a higher mix of iPod touch sales.
- 3. Apple explained changes in numbers and offered reasons for these changes. Some forward-looking information was offered in the discussion of expenses and capital expenditures, however, forward-looking information related to future revenues would be helpful. The overall quality of the MD&A is good.
- 4. Answers will vary based on individual students' reactions to the MD&A. An example of a possible response follows.

The prospects are excellent for Apple. The company focuses on innovation as evidenced by the increased spending on research and development. In addition, Apple is expanding its retail operations overseas to capture more markets. Demand for Apple products is currently high as evidenced by the large increase in sales in 2010. The firm generates significant amounts of cash and has no debt which has resulted in a solid financial structure.

