CHAPTER 10 Corporate Governance, Notes to the Financial Statements, and Other Disclosures

CHAPTER OUTLINE:

I. Corporate Governance
  A. General background and perspective
    1. Impact of stock market and corporate failures
    2. Variety of reform measures
  B. Sarbanes-Oxley Act (SOX) of 2002
    1. Public Company Accounting Oversight Board (PCAOB)
    2. Prohibited non-audit services for audit clients
    3. Management's Report on Internal Control over Financial Reporting
  C. Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act)
    1. Regulation of executive compensation
    2. Enhanced shareholder rights
  D. Financial Reporting Misstatements
    1. Trends in SEC filings for financial misstatements in recent years
    2. Thirteen Types of Financial Shenanigans identified by Schilit and Perler
      a. Earnings Manipulation Shenanigans
      b. Cash Flow Shenanigans
      c. Key Metrics Shenanigans

II. General Organization of Notes to the Financial Statements
  A. Significant Accounting Policies
    1. Depreciation method
    2. Inventory valuation method
    3. Basis of consolidation
    4. Income taxes
    5. Employee benefits
    6. Goodwill and other acquisition-related intangibles
    7. Earnings per share of common stock
    8. Stock option and stock purchase plans
  B. Details of Other Financial Statement Amounts
    1. Reporting to the Securities and Exchange Commission
  C. Other Disclosures
    1. Accounting changes
    2. Business combinations

3. Contingencies and commitments
4. Events subsequent to the balance sheet date
5. Impact of inflation
6. Segment information

D. Management's Statement of Responsibility

1. Financial statements are the responsibility of management—not the auditors

III. Management's Discussion and Analysis (MD&A)

A. Enhance public disclosure of information about the corporation

B. Non-GAAP Financial Measures—reconciled to comparable GAAP measures

IV. Five-Year (or Longer) Summary of Financial Data

A. Adjustment of per share data for stock dividends and stock splits

B. Supplemental disclosures—not part of the financial statements themselves

V. Independent Auditors' Report

A. Structure of the standard audit report

1. Introductory paragraph
2. Scope paragraph
3. Opinion paragraph
4. Reference to the audit of the effectiveness of internal control over financial reporting
5. Alternative presentation—combining the financial statements audit opinion and the internal controls audit opinion

B. Departures from the standard audit report,

C. Qualified opinions

D. Adverse opinions

VI. Financial Statement Compilations

TEACHING/LEARNING OBJECTIVES:

Principal:

1. To have students obtain a sense of the current regulatory environment and the issues of corporate governance.

2. To have students integrate the context of the notes to the financial statements with their understanding of financial reporting learned in previous chapters.

3. To have students understand that the notes to the financial statements must be reviewed if the numbers in the financial statements are to be understood.

4. To have students understand the significance and meaning of the independent auditors' report, and that it is not a guarantee of company profitability or absolute accuracy of the financial statements.

Supporting:

5. To explain the general types of financial reporting misstatements that frequently occur, and how they impact the reporting entity's financial statements.

6. To explain the general content of the notes to the financial statements, so that the notes will become less formidable to students than they seem to be at first glance.

7. To review and clarify the student's understanding of some of the more challenging facets of financial reporting by discussing accounting issues in the context of note disclosures, rather than in a transaction context.

8. To emphasize to the student that the financial statements reflect management's assertions, and that management—not the independent auditor—is responsible for the financial statements.

9. To have the student understand the process of adjusting per share data for stock dividends and stock splits.

TEACHING OBSERVATIONS/ASSIGNMENT SUGGESTIONS:

1. This chapter, like Chapters 9 and 11, helps students to build on their understanding of many of the accounting issues that were introduced in the study of the balance sheet. Students should understand that the notes to the financial statements do not introduce new concepts—they describe the application of concepts already learned.

2. Use the notes to the financial statements in the annual reports that students have obtained to illustrate the summary of significant accounting policies and other disclosures.

3. Emphasize the nature of management's responsibilities, and clearly separate them from the auditors' responsibilities.

4. If time permits, introduce some recent examples of lawsuits involving public accounting firms.

5. Review the significance of trends in financial ratios, and illustrate how the summary financial data are used to identify trends.

ASSIGNMENT OVERVIEW:

NO.	LEARNING OBJECTIVES	DIFFICULTY & TIME ESTIMATE	OTHER COMMENTS
M10.1.	9	Easy, 2-3 min.	Basic EPS restatement demo.
M10.2.	9	Easy, 2-3 min.	Basic EPS restatement demo, working backwards.
E10.3.	1, 2	Easy, 5-10 min.	Comment on what is and is not included in Campbell's corporate governance disclosures. Ask students whether this information is consistent with their expectations and useful to them as investors.
E10.4.	2, 3	Easy, 5-10 min.	Give students a guided tour of Campbell's 2017 Annual Report.
E10.5.	10	Easy, 3-5 min.	Use as a discussion starter: "What is the role of the auditor?"
E10.6.	10	Easy, 3-5 min.	An alternative to E10.5.
E10.7.	9	Med., 7-10 min.	Good in-class demonstration of the EPS restatement process.
E10.8.	9	Med., 7-10 min.	See E10.7. Good homework assignment.
E10.9.	9	Med., 7-10 min.	Some students may get hung up on the math. Remind them that they are working backwards to find the originally reported EPS.
E10.10.	9	Med., 7-10 min.	See E10.9. Good homework assignment.
P10.11.	2, 4, 9	Med., 15-20 min.	Straight-forward problem using Campbell's financial statement data. Have students verify the answers provided.
P10.12.	2, 4, 9	Med., 15-20 min.	Straight-forward. Good homework assignment.
C10.13.	4	Med., 20-30 min.	Focus company case, provided for instructors wishing to follow up on E1.1.
C10.14.	5	Med.-Hard, 20-25 min.	**Group learning case.** Provides an opportunity to explain how to read and interpret segment data. Students appreciate the importance of note disclosures as they see their "value added" beyond the financial statements. Consider giving a guided tour through the solutions to save class time.

SOLUTIONS:

M10.1.

Originally reported EPS for 2019 .... $5.80
Divided by 4 to reflect 4-for-1 stock split = EPS for 2019 as restated in 2020 .... **$1.45**

M10.2.

EPS for 2019, as restated in 2020 annual report $1.05
Multiply by 3 to reflect 3-for-1 stock split = originally reported EPS for 2019 ...... **$3.15**

Proof: Originally reported EPS for 2019 .... $3.15
Divided by 3 to reflect 3-for-1 stock split = EPS for 2019 as restated in 2020 .... $1.05

E10.3.

Information related to the Board and executive officers:
Campbell's provides biographical information about members of the Board of Directors, details about Board committees, information about how to communicate concerns to the Board, SEC filings regarding insider transactions, and the full text of the "Code of Ethics for the CEO and Senior Financial Officers."

Policies, Guidelines, Standards, Codes, etc.:
Campbell's provides the full text of its "Corporate Governance Standards" and "Code of Business Conduct and Ethics,", as well as the company's "Environmental Sustainability Policy," "Human Rights Principles," "Insider Trading Policy," "Political Accountability Guidelines," "Water Policy," "Guidelines for Responsible Advertising to Children," and "Commitment Concerning Advertising to Children," all of which emphasize the company's commitment to ethical and legal business practices on a worldwide basis.

Other disclosures that would be appropriate? No, the corporate governance disclosures provided by Campbell Soup Company are quite extensive, and other somewhat related information is contained under the "Corporate Responsibility" tab.

E10.4.

Class discussion can focus on the importance of these items to a reader's full understanding of the company's financial statements (financial position, results of operations, and cash flows). Campbell's financial disclosures certainly appear to be adequate.

E10.5.

The auditors' opinion is that the identified financial statements *present fairly, in all material respects* (emphasis added), the financial position, results of operations, and cash flows in conformity with U.S. generally accepted accounting principles. Thus, the auditor does not guarantee that the statements are free of *immaterial* errors (only that they are free of material errors) or that the statements present the financial position, results of operations, and cash flows *perfectly* (only that they present the statements fairly).

E10.6.

The standard four-paragraph independent auditors' report is not at all an indicator of a company's future financial success or future cash dividends. However, if the auditor has substantial doubt about an entity's ability to continue as a going concern, there will be an explanatory paragraph to that effect.

E10.7.

a. Original earnings per share is $1.56. To reflect a 3 for 1 stock split, divide by 3.
Adjusted EPS = **$0.52**

b. For 2020, 2018 earnings per share as adjusted in 2019 will have to be adjusted again by dividing by 2. Adjusted EPS for 2018, to be reported in 2020 = $0.52 / 2 = **$0.26**

c. To reflect a 10% stock dividend, divide unadjusted earnings per share by 1.10.
Adjusted EPS = $1.56 / 1.10 = **$1.42**

E10.8.

a. Net income for 2019 (as reported in the 2020 annual report) = **$442,890.** Stock dividends and stock splits that occur subsequently do not cause changes to reported earnings amounts of prior years.

b. Earnings per share for 2019 (as reported in the 2019 annual report) = Net income / Weighted-average number of shares outstanding = $442,890 / 155,400 = **$2.85**

c. For the calculation of earnings per share for 2019 (as reported in the 2020 annual report), the weighted-average number of shares outstanding in 2019 is adjusted retroactively to reflect the 3-for-1 stock split in 2020. EPS for 2019 (as reported in 2020) = Net income / Weighted-average number of shares outstanding = $442,890 / (155,400 * 3) = $442,890 / 466,200 = **$0.95**

E10.9.

Earnings per share, as restated	$1.20
Multiply by 2 to reflect 2 for 1 stock split	$2.40
Multiply by 1.05 to reflect 5% stock dividend	**$2.52**

Proof: Original earnings per share	$2.52
Adjust for stock split (divide by 2)	$1.26
Adjust for 5% stock dividend (divide by 1.05)	$1.20

E10.10.

a. ***Earnings per share for 2018:***

As reported in 2020	$2.70
As reported in 2019 ($2.70 * 1.1)	$2.97
As reported in 2018 ($2.97 * 1.1)	**$3.27**

The key here is to see that the $2.70 EPS figure has already been restated, so the task is to work backwards to determine the originally reported per share amount.

E10.10. ***(continued)***

b. ***Dividends per share for 2018:***

As reported in 2018	$0.45
As reported in 2019 ($0.45 / 1.1)	$0.41
As reported in 2020 ($0.41 / 1.1)	**$0.37**

In this case, the originally reported amount per share is known, so the task is to make the restatements going forward.

P10.11.

a. Net sales in 2014 = **$8,268 million** *(table, p. 13)*

b. Operating income (earnings before interest and taxes) in 2013 = **$1,474 million** *(table, p. 13)*

c. Difference between operating income (earnings before interest and taxes) and net income (net earnings) in 2015 = $1,054 − $666 = **$388 million** *(table, p. 13)*

d. Year(s) in which net income (net earnings) decreased as compared to the previous year = **2015 and 2016** *(table, p. 13)*

e. Amount of interest paid in 2017 = **$110 million** *(table, p. 71)*

f. Number of stock options exercisable at July 30, 2017 = **194 thousand** *(table, p. 66)*

g. Net sales to customers outside of the United States in 2017 = **$1,533 million** *(table, p. 46, Total net sales for all geographic areas $7,890 less U.S. $6,357, or the addition of net sales made in Australia $610 and "Other countries" $923)*

h. Cost of products sold for the third quarter of 2017 = $1,853 − $678 = **$1,175 million** *(table, p.72)*

P10.12.

a. Dividends per share declared in 2017 = **$1.40** *(table, p. 13)*

b. Capital expenditures in 2016 = **$341 million** *(table, p. 13)*

c. Year in which total equity grew by the greatest amount over the previous year = **2014, increased by $410 million** ($1,602 − $1,192). *(table, p. 13)*

d. Change in total debt from 2013 to 2017 = $4,438 beginning amount - $3,536 ending amount = **$902 million decrease** *(table, p. 13)*

P10.12. ***(continued)***

e. Amount of finished products inventory in 2017 = **$525 million** *(table, p. 69)*

f. The company's effective income tax rate in 2017 = **31.4%** *(table, p. 56)*

g. Net sales of the Global Biscuits and Snacks segment in 2017 = **$2,598 million** *(table, p. 45)*

h. Market price range of common stock for the fourth quarter of 2017
= High **$59.14** - Low **$50.62** = **$8.52 range** *(table, p. 72)*

C10.13.

a.- h. Answers will vary based on the annual report of the focus company selected.

C10.14.

a. Significant trends in consolidated totals and specific business segments:
With the exception of an increase in revenues in 2017 (relative to 2016) for the International Lead Markets segment, revenues decreased in 2017 (relative to 2016) and in 2016 (relative to 2015) within each of the three separately identifiable segments and for the company in total. Although these results are somewhat distressing at first glance, the dollar amount and percentage differences from year to year were relatively small. Overall, McDonald's appears to be experiencing a slow but steady negative growth pattern in revenues, which is not a good sign.

Conversely, operating income showed a steady growth pattern within the US and International Lead Markets segments, and a rapid growth pattern in the High Growth Markets with a particularly pronounced growth in 2017. Overall, the company experienced steady to aggressive growth in operating income in both 2016 and 2017, which is a highly encouraging sign.

Depreciation and amortization expense was relatively stable from year to year for each of the three separately identifiable segments, with the exception of a sharp decrease in 2017 for the High Growth Markets. For the company overall, depreciation and amortization expense was slightly on the decline for the 3-year period.

The asset growth patterns vary widely from segment to segment for McDonald's. Assets increased in the U.S. segment each year, reflecting a slow but steady growth rate of new store openings in a highly saturated landscape. Yet, the High Growth Markets segment showed declines in assets each year, which seems somewhat surprising. Assets declined sharply in 2016 in the International Lead Markets but then grew quickly in 2017 for this segment. On the one hand, McDonald's is likely to still have more growth opportunities outside of the U.S where their market penetration may not yet be fully realized. On the other hand, there may be significant store closures in geographic regions that are likely to be significantly more health-minded than the U.S. In an overall sense, McDonald's retrenched its asset base substantially in 2016 from $37.9 billion in the prior year to $31.0 billion, but then grew its assets to $33.8 billion in 2017, suggesting that there are ongoing restructuring efforts. .

C10.14. ***(continued)***

b.

McDonald's Corp.
2017 ROI by Primary Geographic Segment
(Dollar amounts in millions)

	U.S.	***International Lead Markets***	***High Growth Markets***
Revenues (A)	$ 8,006.4	$ 7,340.3	$5,533.2
Operating income (B).......	4,022.4	3,166.5	2,001.4
Assets, 2016 (C)...	11,960.6	9,112.5	5,208.6
Assets, 2017(D)	12,648.6	11,844.3	4,480.7
Average assets (E) = (C+D)/2	12,304.6	10,478.4	4,844.7
Margin (F) =B/A	**50.2%**	**43.1%**	**36.2%**
Turnover (G) =A/E	**0.65**	**0.70**	**1.**14
ROI = F*G = B/E.	**32.7%**	**30.2%**	**41.3%**

c. To the extent that past performance may be indicative of future prospects, the U.S. segment appears to offer the greatest potential for high returns in the future. Margin is strongest in this segment, reflecting the fact that McDonald's has been in operation for a substantially longer period of time in the U.S. than in other geographic areas in the world. Although the fast food service industry in the U.S. is highly saturated for McDonald's and thus does not offer as many growth opportunities as can be found elsewhere, the U.S. operations are much more cost effective due to McDonald's efficient distribution system and relatively low cost of labor and capital as compared to other parts of the world.

Ironically, despite what the margin results suggest, the High Growth segment offers McDonald's even greater growth opportunities than does the U.S. market, mostly because further cost efficiencies can still be achieved as the company's corporate culture becomes further engrained, and turnover is substantially higher because the infrastructure investment is not as substantial in many emerging market countries. In fact, both of the other major segments are already outperforming the U.S. in terms of turnover, suggesting that McDonald's is doing a great job at managing its asset base and generating sales outside of the U.S.

It should be noted that the reported margins for the U.S. in particular, and the other segments as well, are actually quite strong relative to the level of performance you would expect from an average company. This may well be reflective of the relatively mature consumer markets for fast food services on a global basis, which suggests that the overseas segments will eventually catch up to the level of performance that McDonald's presently enjoys in the U.S. At its present rate of profitability, the company should certainly explore new market possibilities in all corners of the globe.

C10.14. ***(continued)***

d. The "Corporate" column shown in the segment disclosures provided by most companies is intended to display the overall level of assets and expenses that cannot be meaningfully assigned to any one particular operating segment—such as the assets and expenses associated with global corporate headquarters. The "Corporate" column does not ordinarily report any revenues, since the revenues are earned within each of the operating segments; "corporate" costs must be incurred (and thus corporate assets must be maintained) in order to provide an overall infrastructure which allows the company to operate in an efficient and consistent manner. By combining the company's overall corporate assets and expenses with the operating results of a wide variety of emerging market countries, McDonald's has obscured the information quality of the latter.

e. The most obvious improvement that McDonald's Corp. could make in their classification of segment data would be to create a separate "Corporate" column such that these amounts would not be combined with the results of any geographic segment. .

   It should be noted, however, that the classification of segment data is within the control of management, but only to a limited extent. It is not appropriate under U.S. GAAP to report separate results for small segments, the results of which may be considered to be immaterial in comparison to the company's overall results. Thus, a certain degree of aggregation of results is necessary to allow the reporting entity to appropriately define segments that are of sufficient size to meet the reporting criteria.