Solution manual for Financial Accounting The Impact on Decision Makers 7th Edition by Gary A.Porter, Curtis L.Norton

Chapter 2. Financial Statements and the Annual Report.

After studying this chapter, students should be able to:

- Describe the objectives of financial reporting (LO1).
- Describe the qualitative characteristics of accounting information (LO2).
- Explain the concept and purpose of a classified balance sheet and prepare the statement (LO3).
- Use a classified balance sheet to analyze a company's financial position (LO4).
- Explain the difference between a single-step and a multiple-step income statement and prepare each type of income statement (LO5).
- Use a multiple-step income statement to analyze a company's operations (LO6).
- Identify the components of the statement of retained earnings and prepare the statement (LO7).
- Identify the components of the statement of cash flows and prepare the statement (LO8).
- Read and use the financial statements and other elements in the annual report of a publicly held company (LO9).

Chapter Outline

LO Objectives of Financial Reporting 1

Financial reporting has one overall objective and a set of related objectives, all of them concerned with how the information may be most useful to the readers.

The Primary Objectives of Financial Reporting

- Provide economic information so users (internal and external) can make informed decisions

The purpose of financial accounting is to provide information that is useful to present and potential investors and creditors to help them reach decisions in an informed manner.

The Secondary Objectives of Financial Reporting

- Reflect prospective cash receipts to investors and creditors
  - For investors, future cash flow from investment
    - Dividends
    - Receipts from sale of stock
    - Decision to hold or sell stock or buy stock in the first place
  - For creditors, interest plus repayment of loan
- Reflect prospective cash flows to company
  - Ability to pay outside parties
- Reflect company's resources and claims to its resources
  - Cash flows tied to balance sheet and income statement

LO 2 Qualitative Characteristics of Accounting Information

Qualitative (i.e., non-numerical) characteristics that make accounting information useful:

- *Understandability*: the quality of accounting information that makes it comprehensible to those willing to spend the necessary time to understand it
- *Relevance*: the capacity of information to make a difference in a decision
- *Reliability*: accounting information represents the economic conditions or events that it purports to represent
  - Three basic characteristics of reliability:
    - Verifiability – free from error.
    - Representational faithfulness - information can be validated to an actual event

- Neutrality - information is not slanted to portray a company's position in a better or worse light than the actual circumstances would dictate

- *Comparability*: the quality that allows a user to analyze two or more companies and look for similarities and differences
  - Not necessarily uniformity—alternative methods are acceptable
  - Disclosure allows reader to make adjustments for these differences
- *Consistency*: allows comparisons for the same company from one accounting period to another accounting period
  - If a company makes an accounting change, accounting standards require the impact of the change to be disclosed
- *Materiality*: the magnitude of an accounting information omission or misstatement that will affect the judgment of someone relying on the information
  - The threshold varies from one company to the next.
- *Conservatism*: is the practice of using the least optimistic estimate when two estimates of amounts are about equally likely
  - Applies when there is uncertainty about how to account for a particular item or transaction

- The International Accounting Standards Board (IASB) (www.iasb.org) is working to improve development of accounting standards around the world.
  - Agree that primary objective of accounting is to provide information useful in making economic decisions
  - Qualitative characteristic includes prudence – the use of caution in making the various estimates required in accounting

LO 3 The Classified Balance Sheet

A classified balance sheet separates both assets and liabilities into current and noncurrent.

- The operating cycle is the period of time between the purchase of inventory and the collection of the receivable from the sale of the inventory
- *Current assets*
  - Current assets will be converted to cash or sold or consumed during the operating cycle of a business or within one year, if the operating cycle is shorter than one year
    - Most businesses have an operating cycle shorter than one year
    - Cash, accounts receivable, and inventory are current assets because they are cash or will be realized in (converted to) cash within one year
    - Short-term investments or marketable securities are investments of excess cash made for the short term

- Prepaid assets represent a prepayment of expenses such as rent, office supplies and insurance

- *Noncurrent assets*
  - Noncurrent assets (also called long-term assets) are any asset not meeting the definition of a current asset. Noncurrent assets include:
    - Investments:
    - Securities not expected to be sold within one year
    - Land or buildings not currently in use
    - Funds reserved for a special purpose
    - Property, plant, and equipment: tangible, productive assets for use in the operations of a business rather than resale
      - Assets in this category are depreciated
    - Intangible assets: provide benefits to the company over the long-term
      - However, they lack physical substance
      - Include trademarks, copyrights, franchise rights, patents and goodwill
      - Amortization is the process of writing off intangibles over their useful life

- *Current liabilities*: an obligation that will be satisfied within the next operating cycle or one year, whichever is longer
  - Include accounts payable, wages payable, income taxes payable
  - Some liabilities such as a mortgage payable, is both current and long-term
  - Most liabilities are satisfied by the payment of cash
  - Some liabilities are satisfied by performing services
- *Long-term liabilities*: will not be paid within a year or the operating cycle, whichever is longer
  - Includes long-term notes payable and bonds payable
- *Stockholders' equity*: owners' claims on assets = contributed capital + retained earnings
  - contributed capital includes:
    - capital stock
      - common stock: most basic form of ownership
      - preferred stock: form of capital stock that has preference to common stock in some respects
    - paid-in capital in excess of par value
  - Retained earnings: earned capital. Represents the net income of the business since its inception less all dividends paid.

LO 4 Using a Classified Balance Sheet: Introduction to Ratios

A classified balance sheet separates assets and liabilities into those that are current and those that are noncurrent.

Working capital:

- Liquidity is the ability of a company to pay its debts as they come due
- Working capital is a measure of liquidity
- Current assets less current liabilities equals working capital at a point in time
- Bankers and other creditors are interested in a company's liquidity
- Companies strive for a balance - too little may make it difficult to pay debts; too much indicates the company is not investing enough in productive assets

Current ratio:

- Allows comparison of working capital for companies of various sizes
- Measures short-term liquidity
- Current assets ÷ current liabilities
- In general, the higher the current ratio, the more liquid the company.
- General rule of thumb 2:1 current ration is good. Also depends on industry company is in
- *Composition* of assets as well as the numerical calculation is important
  - Relative sizes of components
  - Turnover of accounts receivable, inventory
- Short-term liquidity

LO 5 The Income Statement

The **income statement** is a *summary* of the results of operations

- The income statement reports the net income of a company : excess of revenues over expenses. (net loss : excess of expenses over revenues)
- Revenue is inflow of assets resulting from sale of products and services; an expense is the outflow of assets necessary to sell products and services
- Gains and losses are special types of revenues and expenses reported on the income statement not related to primary operations

Formats of the Income Statement

- Both forms are generally accepted, although more companies use the multiple-step
- *Single- step*: all expenses are added together and deducted in a single step from the sum of all revenues

- Advantage is simplicity
- No attempt to classify revenues or expenses

- *Multiple- step*: subdivides statement into specific sections, with important subtotals
  - gross profit: sales less cost of goods sold
    - cost of goods sold is the cost of the units of inventory sold during the period
  - income from operations: gross profit less operating expenses
    - operating expenses may be further subdivided into selling and administrative
  - income before taxes: operating income adjusted by other revenue and expenses not generated or used by operations
  - income tax expense
  - net income

LO 6 Using an Income Statement to Analyze a Company’s Operations

The income statement can be used to evaluate the profitability of a business.

A company’s profit margin is the ratio of its net income to its sales or revenues

- **Profit margin**: net income ÷ sales
  - How much of each sales dollar is profit after deducting all expenses
  - Also called return on sales

- When evaluating any financial statement ratio, must consider:
  - How does this year’s ratio differ from ratios of prior years
  - How does the ratio compare with the industry norms

LO The Statement of Retained Earnings 7

Statement of stockholders’ equity shows changes in *both* components of owners’ equity during the period - capital stock and retained earnings.

- Prepare a statement of retained earnings if no changes to capital stock occurred
- Provides an important link between the income statement and balance sheet
  - Net income from the income statement is added to retained earnings

- Dividends do not appear on the income statement since they are a distribution to the owners. Direct deduction from retained earnings

LO The Statement of Cash Flows 8

The **statement of cash flows** summarizes the cash inflows/outflows resulting from operating, investing, and financing activities.

- *Operating* = cash inflow or outflow resulting from the sale or purchase of a product or sale of a service
- *Investing* = cash inflow or outflow resulting from the acquisition or sale of long-term or noncurrent assets
- *Financing* = cash inflow from issuance of long-term debt or issuance of stock, or outflow from repayment of long-term debt or repurchase of our own capital stock
- The balance of cash on the bottom of the statement of cash flows must agree with the balance for cash as shown on the balance sheet

LO 9 Looking at Financial Statements for a Real Company: General Mills, Inc.

General Mills's Balance Sheet:

- Consolidated financial statements – reflect the position and results of all operations that are controlled by a single entity
- General Mills owns other companies that are called subsidiaries
- SEC requires balance sheets as of the two most recent year- ends and income statements for each of the three most recent year-ends
- Amounts generally stated in millions of dollars

General Mills's Income Statement:

- Inclusion of data for three years allows for the analysis of certain trends
- Ratio decision model to evaluate company's ratio to another company:
  - Formulate the question
  - Gather the information from the financial statements
  - Calculate the ratio
  - Compare the ratio with others
  - Interpret the results

Although the formats of annual reports vary, certain **basic elements** have become standard in the annual reports of publicly held companies:

- *Letter from the President* or Chairman of the Board

- A section describing the companies products and markets
- Financial statements and notes
- *Auditor's report* :
  - States "in our opinion" and "presents fairly"
  - Management is responsible for the statements
  - Auditors express an opinion on the statements
  - Do not certify to the total accuracy
  - Free of material misstatement
- Ethical responsibility of management and auditors to stockholders
- Management *discussion and analysis* provides explanation for certain amounts in the statements
- *Notes* to statements satisfy the requirement for full disclosure
  - Discloses all the relevant facts to a company's results and financial position
  - Note 1 is a summary of significant accounting policies

Lecture Suggestions

LO 1

Where can external users obtain financial information about a company? Discuss the convenience, for both the user and the company, of having standard, published financial statements, instead of responding to requests for information as they come in. Also, discuss the convenience of having this information available on the company's and SEC's Web sites.

LO 2

These characteristics are fundamental to all future topics, so a brief discussion of each one is useful. The following is one approach (Dixon Sporting Goods balance sheet is illustrated in Example 2-4):

- *Understandability*: Are the Dixon Sporting Goods statements written in clear, concise language?
- *Relevance*: What information in the Dixon Sporting Goods balance sheet is of interest to a supplier who is considering selling to the company on a 30-day account?
- *Reliability*: Can a stockholder verify the information in Dixon Sporting Goods's balance sheet concerning shares of stock outstanding and their book value? What makes this information reliable?
- *Comparability*: Where in Dixon Sporting Goods annual report is information found that allows the reader to make comparisons with other companies? Where is information that allows comparison with Dixon Sporting Goods past performance?
- *Materiality*: Why does the threshold vary from one company to the next?
- *Conservatism*: Why are expenses recognized when they are likely, but revenues only when they are certain?

LO 3

Have students list as many businesses as they can to fit into each type of business: service, merchandiser, and manufacturer. Encourage them to think about small, local businesses, not just big corporations. Then, ask them to discuss types of assets and liabilities that could be found in these businesses and classify as current or noncurrent. Ask them to estimate the operating cycle for each type of business. Are some assets and liabilities common to all types of businesses?

LO 4

Have students review a classified balance sheet and identify the subtotals presented on a classified balance sheet. Practice comparing components of a balance sheet from year to year to get an idea of trends.

LO 5

Identify the important subtotals presented on a multi-step income statement and their importance to income statement analysis. Which format do students prefer and why? Can you determine the gross profit from a single-step income statement?

LO 6

Students have calculated a number of ratios, and will try to memorize all of them in anticipation of an exam. Point out that for most of the ratios the calculation is obvious. Once you know what gross profit is, what else could the gross profit ratio be but the ratio of gross profit to sales? Note that most of the ratios that use strictly income statement numbers are calculated with sales as a denominator. Assign a number of exercises from both the end of the text chapter and from the Projects and Activities section of this manual for practice in working *with* these ratios, not just calculating them, so that by the time they finish, students will have become thoroughly familiar with the ratios and will not have to memorize, which is a useless exercise. Always require a few words of comment on the ratio, if only to compare with a prior year or to ask what a "logical" level for that item might be. It is important to stress from the beginning that ratios are least useful taken alone. They must be compared to the company itself in past years, and to related companies, or industry averages. Can you compare the ratios of a grocery store to a manufacturing company?

LO 7

How does the statement of retained earnings link the income statement and the balance sheet? What causes owners' equity to increase? What causes owners' equity to decrease? Would a net loss cause owners' equity to increase or decrease?

LO 8

Discuss the difference between a cash inflow and a cash outflow, with examples of each.

LO 9

Briefly discuss the types of audit opinion: unqualified, qualified, adverse, and disclaimer. What does each mean for the company? How might each affect the opinions of current and potential investors? Have the students pick a company and go online and look at their financial statements. Who are the auditors? What kind of an opinion did they receive? What kind of opinion did companies such as Enron and WorldCom receive before their frauds were exposed?

Projects and Activities

LO 2 What Makes Accounting Information Useful? Qualitative Characteristics

In-class discussion: How understandable are the financial statements of Dixon Sporting Goods?

You have been introduced in these opening chapters to the concept of presenting financial data in the form of organized statements, and have not learned much detail about how and why items find their way into these statements. You have, however, had the opportunity to look at the reports of more than one large corporation. Examine the income statement, balance sheet, and statement of cash flows of Dixon Sporting Goods.

1. **Team presentation**: Work together with four or five classmates to prepare a presentation for your class to explain the Dixon Sporting Goods financial statements: the income statement, the balance sheet, the statement of retained earnings, and the statement of cash flows, or the equivalents of these for Dixon Sporting Goods. Explain what each line item is.
2. **Class response and discussion**: What is difficult to understand in the Dixon Sporting Goods financial statements? Is it the overall presentation, or just a few items? Do these difficulties make it doubtful that you could make a meaningful decision based on these statements? Were your classmates able to clarify any of these items for you?
3. Would some additional training in accounting probably clear up a lot of your questions, or is it the presentation itself that makes the statements difficult to understand? What would you change about the statements?
4. Do the statements, taken as a whole, fulfill the goal of understandability as set out by the FASB? Review the definition of "understandability" given in this chapter.

Solution

1. and 2. Students once again look closely at a set of financial statements. They will find the Dixon Sporting Goods statements reasonably straightforward, and probably understandable by most people: revenues, costs and expenses, cash, and supplies are all nearly everyday terms. Few will question at this point in their learning where the numbers came from, so complicated accounting procedures are not a worry. The sorting of items between the statements probably would not make much sense at all to many laymen, but the students have had enough of an introduction that they should be beginning to see what goes where, and why. You might want to take a little time while they are looking at these statements to review this, since students continue to mix items within the statements well into the course.
3. The statement of cash flows will be the most difficult, mainly in the operating section where it is not intuitively obvious yet to students.
4. The students will have their own opinions about understandability, and about possible format changes.

In-class discussion: Asset valuation

Look at Dixon Sporting Goods balance sheet, and consider the value of its property, plant, and equipment at December 31, 2010, $219,400.

1. What, physically, might this number represent?
2. Could they sell these assets for $219,400? Is it what they paid for them?

Solution

1. These are assets used in their business to provide customers with the land, a store, and shelving, etc to place their products.
2. The amount given is what the items cost less the depreciation taken on these assets. Students sometimes mistakenly assume these assets are "worth" $219,400. They continue to see these items in the abstract, unconnected to physical realities, and need to be reminded about specifically what balance sheet amounts represent.

In-class discussion: Materiality

All businesses are subject to various types of legal proceedings. Merck & Co. Inc, a pharmaceutical drug company has been a defendant in a number of product liability lawsuits. In the notes to Merck's 2008 financial statements, the company states:

> "The Company currently anticipates that two U.S. *Vioxx* Product Liability Lawsuits will be tried in 2009. In each of these cases the Company believes it has strong points to raise on appeal and therefore that unfavorable outcomes in such cases are not probable. Unfavorable outcomes in the *Vioxx* litigation could have a material adverse effect on the Company's financial position, liquidity and results of operations."[1]

- Explain in your own words what Merck means by this statement. In particular, include what they mean by "material adverse effect" and "not probable." Who is in the best position to determine the outcome of a lawsuit?

Solution

An item with material effect would influence the decision of an informed reader of the financial statements. Merck believes that if the outcome of the litigation is not favorable, the numbers on the financial statement will be significantly different.. They noted their intent to vigorously defend against these claims, so they probably think they can win the judgment, thus an unfavorable outcome is "not probable" (less than 50% chance of occurring." The Company's legal counsel is in the best position to determine the outcome of the legal proceedings.

Tell the students that not all material issues involve numbers. The notes to Merck's financial statements states "The Company believes that is in compliance in all material respects with applicable environmental laws and regulations."[2] What does this mean?

[1] Merck & Co., Inc. . 2008 Annual Report (www.merck.com/finance/annualreport).
[2] Merck & Co., Inc. . 2008 Annual Report (www.merck.com/finance/annualreport)

LO Using a Classified Balance Sheet 4

Outside assignment: Grizzly, Inc. current ratio

Examine the accounts provided in the review problem for Grizzly, Inc. at December 31, 2010. Identify current assets and current liabilities.

1. What is the amount of Grizzly's working capital?
2. Calculate Grizzly's current ratio. Comment on this figure, based on the information given about this ratio in your text. What are the primary components of current assets?
3. What other information would make you better able to express an opinion on the strength of Grizzly's current ratio?

Solution

1. Current assets = $20,500
   Current liabilities = $9,700
   Working capital = $20,500 – $9,700 = $10,800
   Grizzly has $10,800 more current assets than current liabilities.
2. Current ratio = 20,500 ÷ 9,700 = 2.11 to 1

   The ratio appears reasonable if compared to the 2 to 1 rule of thumb in Chapter 2. Marketable securities, accounts receivable, and inventory figure prominently in the current assets. Accounts payable and the bank loan comprise the major current liabilities.
3. Students will probably remember that it is important to know how quickly the company turns working capital into cash. Turnover calculations have not been introduced yet, but students will recognize from their reading that this information is helpful.

   Comparisons with other years, and with similar companies, would assist analysis. If this type of analysis will be frequently assigned, schedule a lab session where students can learn together how to use some of the electronic information sources available to them.

   The items are made, but the labor to make them, plus all the costs of running the factory in which they are made. When students think about this, they see why so much of financial accounting takes its examples from retailing, where the inventory structure is so much simpler. A service company, of course, has no cost of goods sold because they do not sell goods. Many do, however, have inventories of spare parts for equipment, materials used in performing their service and so on. They are not inventories in the sense of being "merchandise for resale," but are often listed as inventories, and accounted for by the same methods.

LO 6 Using an Income Statement

Outside assignment: Whose statement?

It is often possible to tell a lot about a company by looking at one or more of their financial statements, without knowing anything else about them. Carefully look over the following financial statement from an actual company.

XXX Corporation Consolidated Statement of Operations Year Ended December 31, XXXX ($ millions)

Revenues:	
Passenger	$ 17,158
Cargo	662
Other	1,143
Total operating revenues	18,963
Expenses:	
Wages, salaries and benefits	8,032
Aircraft fuel	2,888
Depreciation and amortization	1,404
Other rentals and landing fees	1,197
Maintenance materials and repairs	1,165
Commissions to agents	835
Aircraft rentals	829
Food service	778
Other operating expenses	3,695
Special charges, net of U.S. grant	610
Total operating expenses	21,433
OPERATING INCOME	(2,470)
Other income (expense):	
Interest income	110
Interest expense	(538)
Interest capitalized	144
Miscellaneous – net	(2)
	(286)
Income before income taxes and extraordinary loss	(2,756)
Income tax provision	(994)
Income from continuing operations	(1,762)
NET EARNINGS (LOSS)	$ (1,762)

1. Which financial statement is this? Did the title confuse you, or is it an accurate description of what follows? Do you think it is *better* than the title you are accustomed to?
2. Does this business appear to be a retailer, a manufacturer, or a service company? How can you tell?
3. What business do you believe they are in? Again, what tells you this?
4. Can you calculate gross profit for this company? Can you calculate their profit margin? Why or why not?

Solution

1. The statement is the income statement. The statement of operations is an equally acceptable title for it, reflecting what the statement is—a summary of the company's operations for the year cited.
2. This is the 2005 income statement for AMR Corporation, the parent company of American Airlines, a service company. The lack of a gross profit line or any reference to cost of goods sold indicates a service company. Line items such as Passenger and Cargo revenues signal a transportation company, and expenses such as Aircraft Fuel and Aircraft Rentals clearly indicate an airline.
3. AMR has no gross profit (no cost of goods sold) so they have no gross profit rate. The profit margin (or loss margin, in this case) on the other hand can be calculated. The computation is net loss ÷ sales ([$1,762] ÷ $18,963 = 9.3%).

LO Other Elements of an Annual Report 9

Outside assignment: Annual reports

Have students pick a company and obtain their annual report online. Look at the Management's Discussion and Analysis. In your own words, what is management's outlook for the future? What are their major strengths and weaknesses?

Look at the Report of the Independent Auditors. Who audited the financial statements? What type of audit opinion did they give?

- Solution

Answers will vary depending on the company chosen by the student.

Food for thought: Auditor obligations

An article in *The Wall Street Journal* said that the auditors for Wiz Technology resigned in a dispute over the company's accounting for executive salaries. Even though the article was published many years ago, the issues are timeless especially in light of the current accounting scandals. The article said,

> In a filing with the Securities and Exchange Commission, the vendor of low-price computer software said its accountants, Corbin & Wertz of Irvine, Calif., disagreed with management's decision to capitalize an undisclosed amount of executive salaries and other costs as "inventory."
>
> Corbin & Wertz resigned after Wiz Technology filed its quarterly results with the SEC despite the accountants' objections, according to the 8-K filing. A Corbin & Wertz official declined to discuss the matter.[3]

Explain why, in your opinion, the auditors felt compelled to resign.

[3]*The Wall Street Journal*, July 3, 1995, "Accountants Resign At Wiz Technology Over Salary Entries."

Solution

Auditors certify that the statements are prepared in accordance with generally accepted accounting principles, consistently applied. If this was not the case, and if the company did not agree to an acceptable audit qualification in the auditors' opinion, the auditors could only choose between rendering an opinion that they did not believe to be true, or resigning to avoid rendering any opinion.

Another article in *The Wall Street Journal* noted that audit firms are dropping risky clients more frequently, in the wake of stockholder lawsuits against accountants, to avoid the costs of litigation.[4] With litigation settlement costs for the Big Five (now Big Four) accounting firms in excess of $1 billion a year, the firms feel that they must protect themselves by eliminating clients with potential problems. Many will also refuse clients making an initial public offering.

(a) Ethical decision: Auditor's report

You have been asked, as a member of a small CPA firm, to review the December 31 year-end financial statements of a small ($2 million revenues) company in an East Coast city. The company has applied for a long-term loan from the bank. You are interested to note as you begin your review of the company's records that a principal stockholder is your former college roommate. You are preparing your report and wonder about the following items:

- The company decided during the last month of the year to change their method of accounting for depreciation for this year's financial statements. You do not believe that any adjustments were made to prior years' reported results as a consequence of this change.
- You have been working at the bookkeeper's desk while she is away on vacation. You pushed the desk blotter aside at one point and noticed underneath it a bill to the company from a local florist for $55. The bill is dated December, but you do not see it recorded anywhere in the company's books. A number of other unopened envelopes are under the blotter, the contents of which cannot be judged from the outside.
- You read in yesterday's newspaper that a local manufacturer is seriously contemplating a move to Atlanta. You know from your audit that they are an important customer of the company you are reviewing.

Should these items be disclosed in your report? Why or why not? If you disclose, how should your disclosure be phrased? Should you disclose any other facts to the company, to your employer, or in your report? Should the audit have been conducted differently? In your answers, try to keep in mind some of the fundamental qualitative principles underlying financial reporting and cite them where relevant.

Solution

First, you probably should have stopped and called in another member of the firm to do the audit the moment you discovered the identity of the principal stockholder. Even if you have no ongoing relationship with your former roommate (and no indication is given one way or the other), it is always prudent to avoid even the appearance of impartiality or a conflict of interest.

- The change in accounting method should be disclosed. It affects comparability of the statements to prior years. As the statements now stand, they cannot be compared to prior years. Students are probably not going to realize that restatement is necessary, but they should note the lack of comparability, and therefore the inconsistency.

[4] *The Wall Street Journal*, June 26, 1995, "Big Accounting Firms Weed out Risky Clients."

- On the other hand, the florist's bill is immaterial and may not be a concern in and of itself. Perhaps worth questioning is its location. Why was it under the blotter, and what else was under there? This appears to be an unusual mail sorting system.
- The customer's planned exodus is a potential problem for the company. This disclosure may cause a conflict between the management of the company and the auditor. The auditor will see it as a contingency that should be a footnote to the statements. Management may prefer to ignore it, claiming it will not be a problem. The bank wants to be sure their loan will be repaid. The departure of a customer may influence their decision on the loan. They may hear about it from another source. The company will make a more positive impression if it discloses and explains the customer's move rather than allow the bank to find out, perhaps from only partial information, what the business implications of this event will be. A major loss of business will be seen as a possibility unless the company can produce evidence that their customer will still be sending orders from Atlanta, or that potential new customers exist to fill the gap. The auditor has a responsibility to disclose anything that could significantly impact the company financially. This item appears to fall into that category.