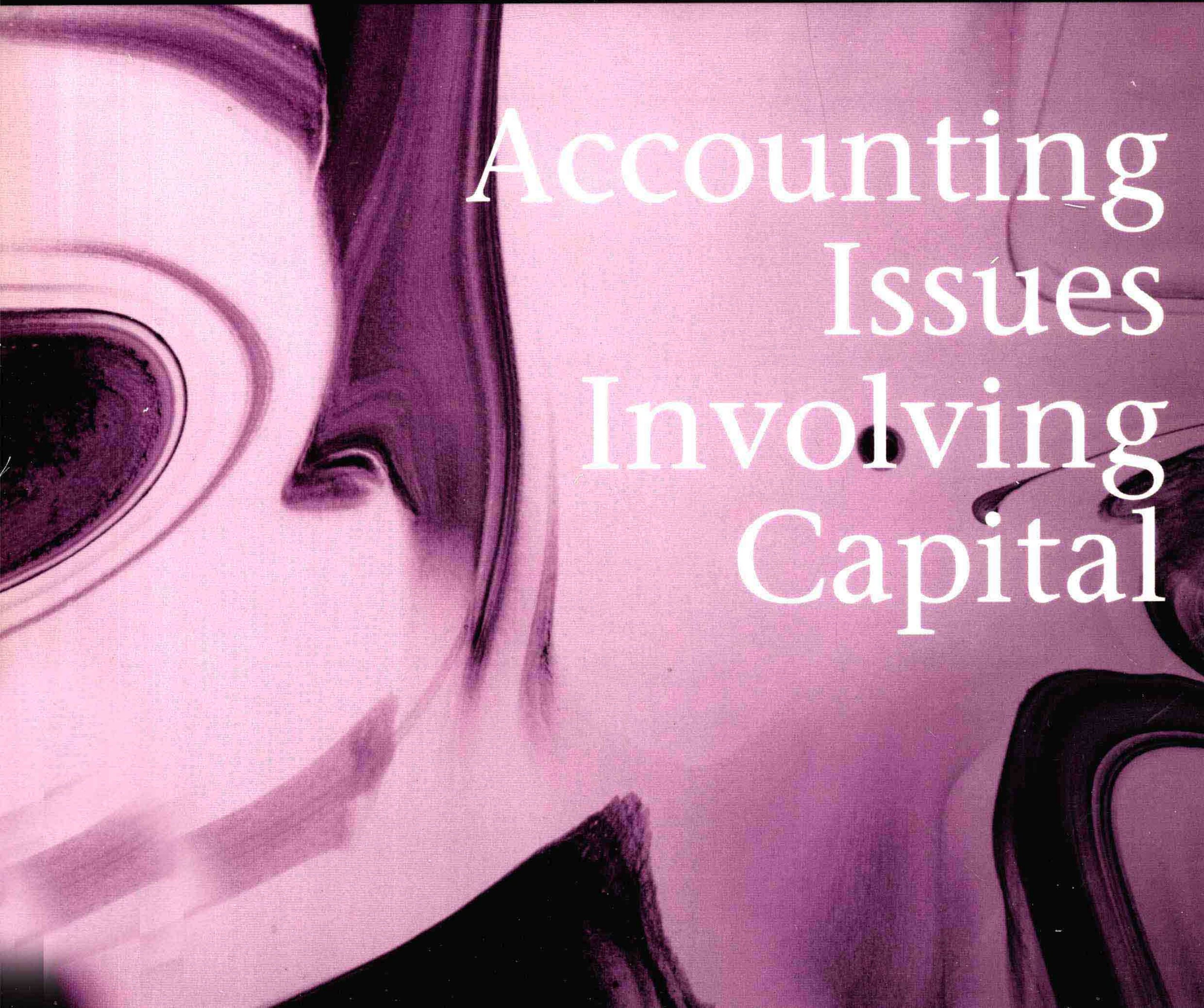
Core Concepts of Accounting Information

Theme IV

1998/1999 Edition

Karen V. Pincus



Accounting Issues Involving Capital

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CORE CONCEPTS OF ACCOUNTING INFORMATION

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CORE CONCEPTS OF ACCOUNTING INFORMATION

THEME IV: Accounting Issues Involving Capital

Karen V. Pincus

Theme Contents

Note: Detailed tables of contents for each module appear at the front of the modules.

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To these people and organizations--and especially to the students and teachers now using *Core Concepts of Accounting Information* who provide valuable feedback on many parts of the materials--I express my heartfelt thanks.

FEEDBACK ON COURSE MATERIALS

Comments, corrections, and suggestions for future topics and assignments are greatly appreciated. Address any feedback to:

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ORGANIZATION OF COURSE MATERIALS

Core Concepts of Accounting Information is organized into 4 broad themes:

Theme I: *The Users/Uses of Accounting Information*
Theme II: *Accounting Issues Involving Income and Cash Flows*
Theme III: *Accounting Issues Involving Economic Resources*
Theme IV: *Accounting Issues Involving Capital*

Each theme looks at a variety of topics that cut across the major functional areas of accounting--financial accounting, managerial accounting, systems, tax and auditing. Examples from business, non-profit and government organizations--both domestic and international--are used throughout the themes.

Each theme is further divided into modules that follow the same organizational pattern across the themes:

- The first module of each theme provides an introduction to the theme, describing the key points to be covered and presenting needed terminology.
- The remaining modules explore the topics of the theme from the perspective of a particular user group for accounting information: management, owners and creditors, government and other users.
- Theme I also contains a final module on the environment of accounting that introduces the body of technical rules, laws, standards and guidelines in the 5 major functional areas of accounting and discusses how to research accounting questions and problems.

Instructors may choose to use full themes or may prefer to select one or more modules to cover in a course.

Pagination

Core Concepts of Accounting Information is divided into themes and modules, which different schools put together in a variety of ways.

How do you find material within your bound text? After this preface, pagination is of the form **I-2-3**, where the initial roman numeral indicates the theme, the middle number indicates the module within the theme, and the final number indicates the page within the module. Thus, page I-2-3 indicates Theme I, Module 2, page 3.

MODULE 1: INTRODUCTION

Estimated Time Budget

Task	Time Estimate
Reading	90 - 120 minutes
Assignments	
Assignment IV-1-1	90 - 120 minutes
Assignment IV-1-2	30 - 60 minutes
Assignment IV-1-3	10 - 15 minutes
Assignment IV-1-4	120 - 180 minutes
Assignment IV-1-5	50 - 90 minutes
Assignment IV-1-6	30 - 60 minutes
Assignment IV-1-7	50 - 90 minutes
Assignment IV-1-8	90 - 120 minutes
Assignment IV-1-9	90 - 120 minutes
Assignment IV-1-10	20 - 40 minutes

Note: *These time estimates, like all the time budgets for this course, should be adjusted to suit your own learning style. Time estimates for assignments assume that readings were completed before attempting the assignments.*

MODULE I: INTRODUCTION

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MODULE 1: INTRODUCTION

Business? It's quite simple--it's other people's money.
-- Alexandre Dumas (1824-1895), The Question of Money

All organizations--business, not-for-profit and government--need capital to operate and finance growth. The economic resources (assets) that an organization uses in operations or invests for the future may be financed by:

- **debt capital**--money borrowed from creditors, and/or

- **equity capital**--money obtained from reinvesting accumulated earnings in the organization or, in the case of a business organization, from selling an interest in the business to investors (owners). In the case of nonbusiness (nonprofit or government) organizations, which have no owners, the **fund balance** plays a role analogous to that of a business's equity interests.

Of course, when creditors and investors provide capital, they establish an interest in the assets of an organization. Debt financing gives rise to **liabilities**, or obligations to creditors. Equity financing gives rise to **equities**, or ownership interests. This relationship between the economic resources of an organization and its sources of capital is expressed succinctly in the accounting equation, one form of which is:

Assets = Liabilities + Owners' Equity

In this module, we'll take a look at the right-hand side of the accounting equation, considering the various types of liabilities and equities and the blurring line between debt and equity in modern capital markets.

DEBT CAPITAL: LIABILITIES

Credit is but a transfer of capital from hand to hand; it is generally, and naturally, a transfer to hands more competent to employ the capital efficiently in production.
-- John Stuart Mill (1806-1873), Principles of Political Economy

Shakespeare may have said, "Neither a borrower nor a lender be," but the truth is that modern societies thrive on borrowing and lending. For business organizations, using money to make more money is a key goal. Borrowing and lending help achieve this economic goal. Capital is transferred from individuals or organizations that have money and a desire to increase their return (the lenders) to businesses with ideas and opportunities for using money to earn a return (the borrowers). For example, a business may borrow money to expand operations to new locations that increase future profit potential.

For nonprofit and government organizations, borrowing and lending help achieve social goals. For instance, a government entity may borrow money to construct a new school building with an eye toward improving the region's future economic potential. When the school's graduates use their education to earn an income, taxes on that income will help repay the government's debt. Thus, borrowing and lending serve economic and social functions.

In a credit transaction, capital changes hands between a lender and borrower. The lender is left with an *asset*, a receivable from the borrower. The borrower is left with a *liability*, an obligation to the lender. The borrower is willing to take on this liability--which, after all, requires settlement in the future--because of the desire for capital to take advantage of present opportunities or meet current needs. In its Statement of Financial Accounting Concepts #6, *Elements of Financial Statements*, the Financial Accounting Standards Board described the economic role of liabilities as one that hinges on time--in particular, the borrower's ability to use capital today while delaying settlement of an obligation into the future:

> *Most liabilities stem from human inventions--such as financial instruments, contracts and laws--that facilitate the functioning of a highly developed economy...Liabilities facilitate the functioning of a highly developed economy primarily by permitting delay–delay in payment, delay in delivery, and so on.*

In this section, we'll look at some typical liabilities, using 2 airlines (US Airways and Air Canada) as examples. Both are major carriers and both have been suffering from industry-wide economic pressures. From 1990 to 1993, the airline industry experienced aggregate losses of $15.6 billion, an amount greater than the industry's accumulated net income since commercial air travel was first offered 75 years earlier. Under these circumstances, capital needs become critical and **"servicing" debt** (making interest payments when due) can become difficult. From 1990 to 1992, 27 U.S. airlines and numerous non-U.S. airlines, including such giants as Pan American and TWA, filed for bankruptcy.

The pressures on the airline industry are particularly great because airlines are very capital intensive. To be competitive, airlines must have modern, efficient, reliable aircraft and terminal facilities. They must create and maintain information systems capable of providing real-time service to customers. They also need capital to pay operating costs such as leasing ticket counter space in airports, paying landing fees for the non-exclusive rights to use ramps, runways and other airport facilities, and paying expenses such as salaries and fuel costs. With such great need for capital, it is not surprising that the airline industry is a major user of both debt capital and equity capital.

In this section, we will discuss the sources of debt capital (and, in the following section, the sources of equity capital) for 2 airlines, US Airways and Air Canada. To begin, here is some background on these companies, including their experiences during the economic pressures from 1990-1993:

<u>US Airways Group, Inc.</u> US Airways first began operations in the late 1930s as All American Aviation, a Washington D.C.-based airmail service. The company was founded by pilot Richard duPont, a member of the same family that founded chemical giant E. I. du Pont de Nemours and Company. All American Aviation developed a system of hooks and ropes so its planes could drop off and pick up bags of mail without landing. Its "on the fly" system was so successful that the U.S. Army Air Corps adapted the method during World War II as a means to rescue pilots stranded in enemy territory.

The company operated as an airmail service until 1949, when it converted to passenger service operations. By the time it went public in 1978, it was a regional airline known as Allegheny Airlines. By 1979, as the company continued to expand its geographic operations, the name was again changed. The new corporate name was chosen after a survey asked passengers to rate Allegheny in comparison to other airlines, including a "ringer" that didn't exist. The "ringer," USAir, scored very well--even better than Allegheny Airlines--and the company had its new name, USAir, which changed to US Airways in 1997.

The company operated profitably through 1988, becoming one of the 10 largest U. S. airlines and expanding internationally, but ran into financial difficulties in 1989. Despite continuing efforts to reduce costs--including eliminating some flights, closing some facilities and reducing its workforce--the company suffered losses every year from 1989 through 1993 and still found itself with one of the highest costs per mile in the industry.

<u>Air Canada.</u> Air Canada has spent much of its life to date as a "Crown Corporation," a government enterprise. In 1988, the company was privatized and it began to operate as a Canadian business corporation. At the start of the 1990s, rising fuel costs, the threat of terrorism as a result of tensions in the Middle East, and economic slowdowns created many problems for the airline industry, so Air Canada ran into financial difficulties.

The airline operated at a loss in 1990 and began a restructuring plan, including flight reductions and a 12% staff reduction. Air Canada also sold its enRoute Card, Inc. subsidiary, then the world's largest airline-operated credit card, in order to reduce its need for **working capital** (funds available to meet short-term obligations). Credit card operations require significant amounts of working capital because competitive conditions are such that the credit card company must be able to pay money to retailers for the charged purchases quickly, but the consumers who use the credit card must be given a longer time to pay their bills (including finance charges).

As the industry continued to suffer from 1991 to 1993, Air Canada was hard hit, particularly since the Canadian airline industry was still adjusting to recent privatization. Under government operation, the industry had been structured in a way that wasn't efficient for the harshly competitive conditions of the 1990s. Air Canada experienced continuing losses in 1991, 1992 and 1993.

The Airline Industry: 1994 to 1998. Globally, the airline industry began to recover in 1994, operating above the break-even point (with global profits of $1.8 billion) for the first time since 1989. Since airlines have high fixed costs and low variable costs, even small moves above break-even volumes can have a substantial impact on profits. London's NatWest Securities has estimated the airline industry breaks even when, on average, flights are 66.5% full. But, with a relatively small volume increase to a 70% load-factor, industry profits grow to over $13 billion. On the other hand, small moves below break-even volume can create severe cash flow pressures and make it difficult to meet liabilities.

It was in 1994 that the fortunes of US Airways and Air Canada began to diverge. Air Canada's 1994 net income soared to $129 million, the second-best year in the company's history. But US Airways, with higher operating costs per mile than other major airlines and the misfortune of 2 major crashes during 1994, suffered a loss of $685 million. The company's auditors expressed substantial doubt about the airline's ability to continue operating as a going concern, while management worked to stem losses by reducing the fleet and cutting unprofitable routes.

Industry profits further improved from 1995 to 1997, when profits set a new record at $4.5 billion. Air Canada also had 3 profitable years, culminating in 1997 net income of $427 million, the strongest position of its public company lifetime. In 1995, US Airways reported its first annual profit in 7 years, followed by a stronger performance in 1996 and 1997. But its costs still are much higher (at about 12 cents a mile) than its competitors' costs (typically under 9 cents a mile), which makes US Airways more vulnerable to any economic slowdown and a target for acquisition by a financially stronger airline.

The liabilities of US Airways and Air Canada may be found in Figures IV-1-1 and IV-1-2 on the following pages. As you look at these figures, remember that one major source of capital is debt--borrowing funds that must later be repaid, usually with interest. When you look at the balance sheets of US Airways and Air Canada, you will see that both airlines count among their creditors:

- their suppliers,
- their customers,
- their employees,
- taxing authorities, and
- banks and other lenders.

Next, we'll take a closer look at each of these creditor groups.

Figure IV-1-1

US Airways Group, Inc. Consolidated Balance Sheets

December 31,		1997		1996
(dollars In millions, except per share amounts)				
ASSETS				
Current Assets				
Cash	$	**18**	$	21
Cash equivalents		**1,076**		930
Short-term investments		**870**		636
Receivables, net		**300**		337
Materials and supplies, net		**226**		249
Deferred income taxes		**147**		—
Prepaid expenses and other		**140**		137
Total Current Assets		**2,777**		2,310
Property and Equipment				
Flight equipment		**5,221**		5,202
Ground property and equipment		**877**		1,108
Less accumulated depreciation and amortization		**(2,528)**		(2,470)
		3,570		3,840
Purchase deposits		**155**		78
Total Property and Equipment, Net		**3,725**		3,918
Other Assets				
Goodwill, net		**616**		495
Other intangibles, net		**371**		283
Investment in marketable equity securities		**190**		—
Deferred income taxes		**270**		—
Other assets, net		**423**		525
Total Other Assets		**1,870**		1,303
	$	**8,372**	$	7,531
LIABILITIES & STOCKHOLDERS' EQUITY (DEFICIT)				
Current Liabilities				
Current maturities of long-term debt	$	**186**	$	84
Accounts payable		**323**		439
Traffic balances payable and unused tickets		**707**		715
Accrued aircraft rent		**509**		511
Accrued salaries, wages and vacation		**311**		423
Other accrued expenses		**492**		676
Total Current Liabilities		**2,528**		2,848
Long-Term Debt, Net of Current Maturities		**2,426**		2,616
Deferred Credits and Other Liabilities				
Deferred gains, net		**332**		360
Postretirement benefits other than pensions, non-current		**1,173**		1,093
Non-current employee benefit liabilities and other		**830**		439
Total Deferred Credits and Other Liabilities		**2,335**		1,892
Commitments and Contingencies				
Redeemable Cumulative Convertible Preferred Stock				
Series H, no par value, 358,000 shares issued and outstanding		**358**		358
Series F, no par value, 30,000 shares issued and outstanding as of December 31, 1996		—		300
Series T, no par value, 10,000 shares issued and outstanding as of December 31, 1996		—		101
Stockholders' Equity (Deficit)				
Series B cumulative convertible preferred stock, no par value, 4,263,000 depositary shares issued and outstanding as of December 31, 1996		—		213
Common stock, par value $1 per share, authorized 150,000,000 shares, issued and outstanding 91,482,000 and 64,306,000 shares, respectively		**91**		64
Paid-in capital		**1,906**		1,387
Retained earnings (deficit)		**(1,280)**		(2,118)
Common stock held in treasury, at cost, 39,929 shares as of December 31, 1997		**(3)**		—
Deferred compensation and other, net of tax		**(93)**		(130)
Unrealized gain on securities, net of tax		**104**		—
Total Stockholders' Equity (Deficit)		**725**		(584)
	$	**8,372**	$	7,531

Figure IV-1-2

Air Canada Consolidated Statement of Financial Position

(in millions)

December 31	1997	1996
Assets		
Current		
Cash and short-term investments (note 1d)	$ 650	$ 455
Accounts receivable	467	387
Spare parts, materials and supplies	225	197
Prepaid expenses	17	20
Deferred income taxes	35	—
	1,394	1,059
Property and equipment (note 2)	2,817	2,819
Deferred charges (note 3)	1,447	1,118
Investments and other assets (note 4)	333	445
	$ 5,991	$ 5,441
Liabilities		
Current		
Accounts payable and accrued liabilities	$ 668	$ 615
Advance ticket sales	400	270
Current portion of long-term debt	71	226
	1,139	1,111
Long-term debt and subordinated perpetual debt (note 5)	2,739	2,847
Other long-term liabilities	218	177
Deferred credits (note 7)	460	321
	4,556	4,456
Shareholders' Equity		
Convertible debentures (note 8)	201	186
Share Capital (note 9)	1,063	1,056
Retained earnings (deficit)	171	(257)
	1,435	985
	$ 5,991	$ 5,441

Suppliers as Sources of Debt Capital

Accounts Payable. Suppliers often extend short-term credit (sometimes called "trade credit") to organizations. If trade credit is granted, an organization may order and receive goods or services from suppliers now and pay for them later. When transactions take place on credit, the balance sheet of the supplier shows an accounts receivable asset and the balance sheet of the purchasing organization shows an **accounts payable** liability, sometimes referred to as **trade accounts payable**. The (trade) accounts payable account reports the amount due to suppliers for goods and services received, but not yet paid for.

Credit extended by suppliers may be interest-free for a short period, but often bears interest after the initial due date. For example, the terms of a credit agreement might specify that a supplier will refrain from charging interest if the purchasing organization pays the balance due within 30 days, but will charge interest on any unpaid amounts that are more than 30 days old. Under this arrangement, the supplier is providing a short-term (up to 30 days, or less if the bill is paid earlier) interest-free loan to the purchasing organization.

To encourage prompt payment, suppliers may offer **discounts** for early payment. A supplier may offer terms such as "2/10, n/30" (read "two-ten, net-thirty") which means the buyer gets a 2% discount off the purchase price if payment is made within 10 days, whereas the full amount payable is due within 30 days. When discounts are offered, the interest-free loan implicit in trade credit exists only until the discount date arrives. Once the discount date arrives, there is a cost attached to the credit. For example, if a buyer fails to pay a 2/10, n/30 bill for $1,000 within the discount period, the buyer has lost the $20 discount (2% × $1,000), even if the bill is paid when due on day 30. Thus, in effect, it cost the buyer $20 to borrow $1,000 for 20 days (from day 10, the last day to receive the discount, to day 30, when payment was made). On an annual basis, this is equivalent to borrowing money at an interest rate of approximately 36.5% since 2% for 20 days is equivalent to 0.1% interest per day:

$$\frac{\textbf{Discount percentage}}{\textbf{Days from discount date to due date}} \times \textbf{365 days/year} = \textbf{Annualized interest rate}$$

$$\frac{2\%}{(30 - 10 \text{ days})} \text{ daily interest} \times 365 \text{ days} = 0.1\% \times 365 = \underline{\underline{36.5\%}}$$

Accrued Liabilities to Suppliers. The term "accounts payable" generally is reserved for amounts owed for purchases of services, inventory and supplies used directly in operations. For an airline, accounts payable might relate to such things as jet fuel and meal service for flights. In 1997, for instance, US Airways used 1.13 billion gallons of jet fuel, at an average cost of 61.26 cents per gallon.

Related obligations for other operating needs, such as rent and insurance, are not usually classified as accounts payable. Instead, these obligations are often classified separately under an account title such as "other payables," "other