CASES IN FINANCIAL REPORTING

AN INTEGRATED APPROACH WITH AN EMPHASIS ON EARNINGS QUALITY AND PERSISTENCE

D. ERIC HIRST
MARY LEA McANALLY

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PREFACE

This book is a collection of financial accounting cases designed to help students become financial statement users. Learning accounting is very much like learning a new language. The best way to learn any language is to immerse oneself in the language and to converse with many people. Conversations speed up language acquisition and teach the nuances of the language. Conversations strengthen language skills and build breadth. We have created, with this collection of cases, a set of conversational opportunities for students. Students learn the language of accounting by reading financial statements and by responding to topical questions about those financial statements. By providing many different companies' financial statements, we speed up students' acquisition of accounting concepts and skills and teach the nuances of financial reporting. Students quickly learn to speak "accounting," the language of business.

These materials bridge a void in introductory financial accounting materials at the graduate level. Typically, M.B.A. students are required to read a textbook chapter and do some exercises to ensure concept comprehension. Assigned end of chapter material, however, is often not sufficiently challenging to students with stronger analytical abilities. Questions often focus on financial statement preparation rather than, as appropriate at the M.B.A. level, financial statement use. At the other extreme, full blown, unstructured discussion cases leave many students with a weak grasp of the mechanics and nuances of financial accounting. The cases presented here fill the void.

Each case contains financial statement information (typically, a balance sheet, income statement, statement of cash flow, and/or footnotes) and a number of topical questions. Students use the financial statement information to infer and interpret the economic events underlying the numbers. Some cases are accompanied by a related article taken from the business press. In those instances, information from the article is incorporated into the questions in the case. Many cases involve two companies within an industry and the case questions focus on intercompany comparisons of financial information.

Why These Materials are Unique

Financial Statement Diversity—This book comprises 45 cases covering 41 reporting entities. Students appreciate the exposure to many different companies and quickly learn that, while financial statements do not all look the same, they *can* all be understood and used. Students respond well to this diversity and those with experience can be called on, in class, to speak on cases in their industry.

Current Financial Statements—The cases contained herein are very current. The financial statements are dated primarily 1994. Some older cases have been included because they explicate a concept particularly well or because they demonstrate an uncommon trend. A prevalent complaint from students is that the material used in case courses is dated. While this is not a pedagogical concern, students are certainly more enthused and hence, more open to learning, when they judge the materials to be pertinent and timely.

International Financial Statements—Cases cover companies from France, Japan, and Canada as well as from the U.S. The globalization of business necessitates students' facility with financial statements other than those prepared in accordance with U.S. GAAP. Some international cases require that students recast the financials to an alternative set of GAAP. Students thus become sophisticated users of financial information.

Internet Access of Corporate Reports—The financial statements, MD&A, Forms 10-K and 10-Q, and other corporate information in the casebook have been downloaded from servers on the Internet. The presentation of the material has been left largely consistent with the on-line presentation. Students are increasingly required to access this type of information and the presentation in these cases builds familiarity.

Learning Objectives—Cases are prefaced with a set of learning objectives. These become the learning goals for students as they work through the cases. The focus of each case is made clear through these objectives.

Corporate Descriptions—Each case focuses on one or two sets of financial statements. A brief description of the companies in the case reminds students that accounting information is used in specific business contexts. Reported financial accounting numbers are the result of a series of complex, professional estimates and judgments. Many of these are influenced by industry practice. Correctly reading and interpreting financial information are predicated on a student's awareness of a company's business and industry.

How to Use These Materials

These cases are designed for use in conjunction with an introductory financial accounting textbook. Each case stands alone. While some cases naturally precede others, there is no prescribed order.

Although the cases are companion to a text they are much more than supplementary material. For the past four years, these materials have been used as the primary basis for the class meetings in the semester-long M.B.A. introductory financial accounting class at the University of Texas at Austin. The cases provide the learning ground for students (who are expected to prepare the questions before class). The questions, when handled by the students, raise most of the salient points in each topic area. Short (10-15 minute) lectures have occasionally been included to supplement the real world applications provided by the case material.

The cases are presented in the order they are used by the authors. We have organized our course around two main themes—earnings persistence and the quality of earnings. The first third of the course is spent learning the basic framework of financial reporting, acquiring skills in basic financial statement preparation, and in understanding how financial statements aid in the investment decision process. In achieving the latter, we emphasize how financial statements classify items and how such classifications are important in the prediction of the timing of future cash flows. Thus, we introduce the notion of earnings *persistence* and how it affects firm valuation. The remainder of the course explores the accounting issues for the major financial statement line items. We place particular emphasis on the latitude and judgment management has in arriving at the reported numbers. This introduces the notion of the *quality* of earnings. The cases included here help students acquire the skills necessary to identify quality of earnings issues and learn how to deal with them (for example, by restating the financials under different assumptions or accounting methods).

Not all the cases are used over the course of the semester. For each class meeting, one case is assigned as the main case. Students have, in the past, handed in their responses to the main case *before it is discussed in class*. This serves three purposes. First, it ensures that students are ready to discuss the material during the class period. Second, it provides evidence of students' progress or need for assistance and can be used for evaluation purposes. Third, and most importantly, it puts the onus for learning the material on the student. Often, the case affords them their initial encounter with accounting concepts. This means that the students teach themselves the material. Their learning becomes *active*. The alternative is for students to come to class and have an instructor teach the material to them. This makes their learning *passive*. Research in psychology shows that active learning leads to greater retention and deeper comprehension.

The other cases on the same topic can be used as supplemental cases. In the past at UT, students have been expected to be familiar with the supplemental case but not to have completed all the questions. These cases are often used for discussion purposes and to highlight additional points that the main case did not touch upon.

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Although, we have made every effort to avoid errors, any that remain are solely our responsibility. Should you have any suggestions for improving this product, we would love to hear from you. We can be reached by telephone, fax, or e-mail as follows:

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Cases in Financial Reporting

CONTENTS

EVALUATING FINANCIAL REPORTING DISCLOSURES—

Balance Sheet Components and Issues in the Quality of Earnings

Assets

Liabilities

Owners' Equity

Intercorporate Investments

Financial Statement Analysis

Maytag Corp.—Understanding Financial Statements

1

Maytag Corporation is a leading appliance enterprise headquartered in Newton, Iowa. The company is focused on five principal areas of home management: laundry, cooking, dishwashing, refrigeration and floor care. Vending equipment is an additional corporate business. Maytag's appliance brands include Maytag, Hoover, Jenn-Air, Magic Chef and Admiral.

Learning Objectives

- Become familiar with a set of financial statements and the notes thereto.
- Perform a basic analysis and interpretation of the financial statements.
- Recognize the role of estimation in the preparation of financial statements.

Examine the 1994 financial statements of Maytag Corporation.

a. What is the nature of Maytag's business? That is, based on what you know about the company and on the accompanying financial statements, how does Maytag make money?

b. Construct common-size balance sheets and income statements for Maytag. That is, recast the balance sheet line items in terms of their percentage of total assets and the income statement line items in terms of their percentage of net sales.

i. What are Maytag's major sources of revenues? That is, what products generate the bulk of its sales?

HOME APPLIANCES AND VENDING EQUIPMENT

ii. What are Maytag's major expenses? LONG TERM DEBT POST RETIREMENT BENEFITS

iii. What are Maytag's major investments? That is, what are its major assets?

MACHINERY, INVENTORY, ACC REC

iv. How has Maytag financed (i.e., paid for) these investments? That is, what are Maytag's major liabilities and equities?

LONG TERM DEBT, ACC PAYABLE

c. Does Maytag generate cash? How did it do so in each of 1994, 1993, and 1992? NO

d. Who are Maytag's external auditors? What sort of audit opinion did Maytag receive in 1994? In your own words, what does the opinion mean? Why is the audit report dated one month after Maytag's year end?

ERNST & YOUNG

APPROVAL OF STATEMENTS

e. Refer to the note entitled "Contingencies." What does the company mean by a *significant* amount.

DEPENDS ON FUTURE DEVELOPMENTS

NOT LIKELY

f. Based on your review of the financial statements and the notes thereto, list as many of the estimates underlying the financial statements as you can. Are any accounts "estimate-free"?

ESTIMATES JUST ABOUT EVERYWHERE

SHORT & LONG TERM DEBT

PROPERTY, PLANT, EQUIPMENT - DEP

INVENTORY

CLASSIFIED MULTI-STEP

MAYTAG CORPORATION

STATEMENTS OF CONSOLIDATED INCOME (LOSS)

In thousands except per share data

	Year ended December 31		
	1994	1993	1992
Net sales	$3,372,515	$2,987,054	$3,041,223
Cost of Sales	2,496,065	2,262,942	2,339,406
Gross profit	876,450	724,112	701,817
Selling, general and administrative expenses	553,682	515,234	528,250
Special charges	-	50,000	95,000
Operating income	322,768	158,878	78,567
Interest expense	(74,077)	(75,364)	(75,004)
Loss on business disposition	(13,088)	-	-
Other-net	5,734	6,356	3,983
Income before income taxes and cumulative effect of accounting changes	241,337	89,870	7,546
Income taxes	90,200	38,600	15,900
Income (loss) before cumulative effect of accounting changes	151,137	51,270	(8,354)
Cumulative effect of accounting changes	(3,190)	-	(307,000)
Net income (loss)	$ 147,947	$ 51,270	$ (315,354)
Income (loss) per average share of Common stock:			
Income (loss) before cumulative effect of accounting changes	$ 1.42	$ .48	$ (.08)
Cumulative effect of accounting changes	$ (.03)		$ (2.89)
Net income (loss) per Common share	$ 1.39	$ .48	$ (2.97)

PRE TAX

AFTER TAX

See notes to consolidated financial statements.

MAYTAG CORPORATION

STATEMENTS OF CONSOLIDATED FINANCIAL CONDITION

In thousands except share data

Assets	December 31 1994	1993
Current assets		
Cash and cash equivalents	$ 110,403	$ 31,730
Accounts receivable, less allowance–(1994–$20,037; 1993–$15,629)	567,531	532,353
Inventories	387,269	429,154
Deferred income taxes	45,589	46,695
Other current assets	19,345	16,919
Total current assets	1,130,137	1,056,851
Noncurrent assets		
Deferred income taxes	72,394	68,559
Pension investments	112,522	163,175
Intangible pension asset	84,653	4,928
Other intangibles, less allowance for amortization–(1994–$56,250; 1993–$46,936)	310,343	319,657
Other noncurrent assets	44,979	35,266
Total noncurrent assets	624,891	591,585
Property, plant and equipment		
Land	32,600	46,149
Buildings and improvements	284,439	288,590
Machinery and equipment	1,109,411	1,068,199
Construction in progress	30,305	44,753
	1,456,755	1,447,691
Less allowance for depreciation	707,456	626,629
Total property, plant and equipment	749,299	821,062
Total assets	$2,504,327	$2,469,498

PRE PAID TAXES

GOODWILL FROM BOUGHT BUSINESSES

MAYTAG CORPORATION

STATEMENTS OF CONSOLIDATED FINANCIAL CONDITION

In thousands except share data

Liabilities and Shareowners' Equity	December 31 1994	1993
Current liabilities		
Notes payable	$ 45,148	$ 157,571
Accounts payable	212,441	195,981
Compensation to employees	61,311	84,405
Accrued liabilities	146,086	178,015
Income taxes payable	26,037	16,193
Current maturities of long-term debt	43,411	18,505
Total current liabilities	534,434	650,670
Noncurrent liabilities		
Deferred income taxes — EXPECTED TAX	38,375	44,882
Long-term debt	663,205	724,695
Postretirement benefits other than pensions — BIG ESTIMATES	412,832	391,635
Pension liability	59,363	17,383
Other noncurrent liabilities	64,406	53,452
Total noncurrent liabilities	1,238,181	1,232,047
Shareowners' equity		
Common stock:		
Authorized—200,000,000 shares (par value $1.25) Issued—117,150,593 shares, including shares in treasury	146,438	146,438
Additional paid-in capital	477,153	480,067
Retained earnings	420,174	325,823
Cost of Common stock in treasury (1994—9,813,893 shares; 1993—10,430,833 shares) — BOUGHT BACK, NOT AN ASSET - NOT AS MUCH OUTSTANDING	(218,745)	(232,510)
Employee stock plans	(60,816)	(62,342)
Foreign currency translation	(32,492)	(70,695)
Total shareowners' equity	731,712	586,781
Total liabilities and shareowners' equity	$2,504,327	$2,469,498

LIABILITY

See notes to consolidated financial statements.

MAYTAG CORPORATION

STATEMENTS OF CONSOLIDATED CASH FLOWS

In thousands

INDIRECT

	Year ended December 31		
	1994	1993	1992
Operating Activities			
Net income (loss)	$147,947	$51,270	($315,354)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Loss on business disposition	13,088	-	-
Cumulative effect of accounting changes	3,190	-	307,000
Depreciation and amortization	119,358	111,781	103,351
Deferred income taxes	(10,058)	(35,833)	(30,210)
Reorganization expenses	(5,000)	(5,000)	95,000
Free flights promotion expenses	700	60,379	12,235
Changes in selected working capital items, exclusive of business disposed in 1994:			
Inventories	24,503	(29,323)	80,731
Receivables	(53,074)	(59,745)	(33,816)
Other current assets	(2,537)	11,136	27,765
Other current liabilities	43,387	(17,383)	(70,422)
Reorganization reserve	(26,686)	(39,671)	(15,530)
Free flights promotion reserve	(26,709)	(42,981)	(1,604)
Net change in pension assets and liabilities	14,089	43,513	(12,149)
Postretirement benefits	21,197	11,259	21,254
Other--net	5,967	11,913	14,814
Net cash provided by operations	269,362	71,315	183,065
Investing Activities			
Capital expenditures—net	(79,024)	(95,990)	(120,364)
Proceeds from business disposition (net of cash in business sold of $2,650)	79,428	-	-
Total investing activities	404	(95,990)	(120,364)
Financing Activities			
Proceeds from credit agreements and long-term borrowings	-	5,500	73,712
(Decrease) increase in notes payable	(118,134)	138,951	(2,378)
Reduction in long-term debt	(36,001)	(94,449)	(70,158)
Stock options exercised and other Common stock transactions	12,377	5,903	5,558
Dividends	(53,596)	(53,569)	(53,269)
Total financing activities	(195,354)	2,336	(46,535)
Effect of exchange rates on cash	4,261	(2,963)	(7,886)
Increase (decrease) in cash and cash equivalents	78,673	(25,302)	8,280
Cash and cash equivalents at beginning of year	31,730	57,032	48,752
Cash and cash equivalents at end of year	$110,403	$31,730	$ 57,032

+ T Bill, etc
VERY LIQUID

See notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Summary of Significant Accounting Policies:

PRINCIPLES OF CONSOLIDATION: The consolidated financial statements include the accounts and transactions of the Company and its wholly owned subsidiaries. Intercompany accounts and transactions are eliminated in consolidation.

Prior to the quarter ended December 31, 1994, the Company's European subsidiaries were consolidated as of a date one month earlier than subsidiaries in the United States. In the fourth quarter of 1994, this one month reporting lag was eliminated and European results for the quarter ended December 31, 1994 included activity for four months. The effect of this change increased net sales by $25.2 million in the fourth quarter of 1994, and the impact on net income was not significant.

Exchange rate fluctuations from translating the financial statements of subsidiaries located outside the United States into U.S. dollars and exchange gains and losses from designated intercompany foreign currency transactions are recorded in a separate component of shareowners' equity. All other foreign exchange gains and losses are included in income.

Certain reclassifications have been made to prior years' financial statements to conform with the 1994 presentation.

CASH EQUIVALENTS: Highly liquid investments with a maturity of 90 days or less when purchased are considered by the Company to be cash equivalents.

INVENTORIES: Inventories are stated at the lower of cost or market. Cost is determined by the last-in, first-out (LIFO) method for approximately 80 percent and 79 percent of the Company's inventories at December 31, 1994 and 1993. The remaining inventories, which are primarily outside the United States, are stated using the first-in, first-out (FIFO) method.

INTANGIBLES: Intangibles principally represent goodwill, which is the cost of business acquisitions in excess of the fair value of identifiable net tangible assets of businesses acquired. Goodwill is amortized over 40 years on the straight-line basis and the carrying value is reviewed annually. If this review indicates that goodwill will not be recoverable as determined based on the undiscounted cash flows of the entity acquired over the remaining amortization period, the Company's carrying value of the goodwill will be reduced by the estimated shortfall of cash flows.

INCOME TAXES: Certain expenses (principally related to accelerated tax depreciation, employee benefits and various other accruals) are recognized in different periods for financial reporting and income tax purposes.

PROPERTY, PLANT AND EQUIPMENT: Property, plant and equipment is stated on the basis of cost. Depreciation expense is calculated principally on the straight-line method to amortize the cost of the assets over their estimated useful lives.

SHORT AND LONG-TERM DEBT: The carrying amounts of the Company's borrowings under its short-term revolving credit agreements approximate their fair value. The fair values of the Company's long-term debt are estimated based on quoted market prices of comparable instruments.

FORWARD FOREIGN EXCHANGE CONTRACTS: The Company enters into forward foreign exchange contracts to hedge exposures related to foreign currency transactions. Gains and losses are recognized in the same period in which the underlying transaction is recorded.

Business Disposition

In December 1994, the Company sold the stock of its home appliance operations in Australia and New Zealand for $82.1 million in cash. The sale resulted in a pretax loss of $13.1 million and an after-tax loss of $16.4 million. Sales and related operating income(loss) for this business totaled $142 million and $12.6 million in 1994, $127.9 million and $3.4 million in 1993 and $131.8 million and $ (.1) million in 1992.

Inventories

In thousands	December 31 1994	1993
Finished products	$254,345	$282,841
Work in process, raw materials and supplies	132,924	146,313
	$387,269	$429,154

If the FIFO method of inventory accounting, which approximates current cost, had been used for all inventories, they would have been $77.1 million and $76.3 million higher than reported at December 31, 1994 and 1993.

Pension Benefits

[Portions of this note have been omitted]

The Company and its subsidiaries have noncontributory defined benefit pension plans covering most employees. Plans covering salaried and management employees generally provide pension benefits that are based on an average of the employee's earnings and credited service. Plans covering hourly employees generally provide benefits of stated amounts for each year of service. The Company's funding policy is to contribute amounts to the plans sufficient to meet minimum funding requirements.

A summary of the components of net periodic pension expense (income) for the defined benefit plans is as follows:

In thousands	Year ended December 31 1994	1993	1992
Service cost--benefits earned during the period	$ 28,550	$ 24,067	$ 21,469
Interest cost on projected benefit obligation	94,148	90,322	87,654
Return on plan assets:			
Actual return	559	(167,540)	(87,263)
Expected return higher (lower) than actual	(117,553)	54,399	(32,089)
Expected return on plan assets	(116,994)	(113,141)	(119,352)
Other net amortization and deferral	9,474	4,917	6,850
Net pension expense (income)	$ 15,178	$ 6,165	$ (3,379)

Assumptions used in determining net periodic pension expense (income) for the defined benefit plans in the United States were:

	1994	1993	1992
Discount rates	7.5%	8.5%	9.0%
Rates of compensation increase	5.0	6.0	6.0
Expected long-term rates of return on assets	9.5	9.5	9.5

For the valuation of pension obligations at the end of 1994 and for determining pension expense in 1995, the discount rate and rate of compensation increase have been increased to 8.5 percent and 6.0 percent respectively. Assumptions for defined benefit plans outside the United States are comparable to the above in all periods.

As of December 31, 1994, approximately 89 percent of the plan assets are invested in listed stocks and bonds. The balance is invested in real estate and short term investments.