CASES IN CORPORATE FINANCIAL REPORTING

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PREFACE

Textbooks that introduce students to the concepts, methods, and uses of financial accounting and reporting often provide little exposure to actual company financial statements. Questions, problem sets, and other assignment material tend to be hypothetical, simplistic, and devoid of the contextual richness of the corporate-reporting milieu. One consequence of such assignment material is that students who have completed the typical introductory course in financial accounting are sometimes bewildered and overwhelmed when confronted with real-world accounting issues. Real-world issues are immersed in a changing and complex environment. Moreover, that environment is all too often characterized by a lack of defined structure, an overabundance of irrelevant data, and an absence of a clear right or wrong answer.

This casebook attempts to bring theory and practice closer together. It stems from a conviction that the learning process is not complete unless the student understands the applications of the concepts and methods of accounting in the real world. Accordingly, the materials explore and analyze the fundamentals of financial accounting in the context of actual annual reports—the primary means of communication by business enterprises to investors, creditors, government, and other users. The overriding thrust of each case is to instill in students a critical ability to *identify* a particular accounting issue or concern and *evaluate* potential alternative treatments of that issue or concern. However, most of the cases go further. They enable students to examine certain financial and economic *consequences* of accounting treatments and assess or conjecture on what *motivates* preparers of financial statements to choose particular accounting treatments.

This book is best used as a supplement to one of the standard textbooks in financial accounting. However, it could also be used by itself or accompanied by readings to study many topical and sometimes controversial aspects of accounting and financial reporting. The cases are aimed at students with some prior exposure to the concepts and methods of accounting. Such students could, for example, be undergraduates at the intermediate level. Master's students and business executives, on the other hand, should find the materials appropriate at several levels. To guide instructors in using this text, the cases are ranked by degree of difficulty and expected time for completion. Also, an appendix (Appendix A) is provided showing the assignment of cases to chapters in selected introductory and intermediate accounting texts.

One last aspect of the text should be mentioned. Numerous cases adopt the perspective that accounting statements are the product of managerial decisions about the measurement and disclosure of financial information. As such, these materials may be used to cover issues of policy, management's motivations, and the economic effects of accounting choices. Since accounting researchers have studied such issues most comprehensively in recent years, an excellent opportunity is provided to introduce the results of academic research into the classroom.

In assembling the materials, master's candidate David L. Bauer of the Davis Graduate School of Administration provided competent research and technical assistance. I am grateful for his tireless efforts in reviewing company financial statements in order to identify interesting and challenging issues. Also, I wish to thank my former colleagues at Stanford's Graduate School of Business, whose pedagogical philosophies have no doubt shaped my thinking in preparing certain cases. Cases based on materials prepared by Robert K. Jaedicke, James M. Patell, and Mark A. Wolfson are included. My thanks to the reviewers of this text, Professor Thomas J. Burns, Ohio State University; Professor Trini U. Melcher, California State University; and Dr. Blaine A. Ritts, Bowling Green State University. Finally, I extend special thanks to John Grant Rhode, University of San Francisco, who class-tested a draft of the text; Linda Walters, who typed the manuscript; and Jack Ochs and Elinor Paige, Prentice-Hall, Inc., for their steady support and encouragement. Of course, I alone am responsible for any remaining errors.

The contents of this book are listed by topic. Apart from the cases in Section 1—on fundamental accounting relationships—the sequencing of the materials is up to the instructor. Instructors should carefully review all the cases before they are assigned to students to ensure that adequate coverage of the accounting issues involved has been given in class. Many cases, for instance, rely on information provided in the statement of changes in financial position. In this situation it is desirable, though not necessary, that some treatment of the statement of changes in financial position be given early in the course. A solutions manual containing detailed numerical solutions, as well as teaching suggestions, is available for instructors. Check figures are listed in Appendix B to this text.

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1.1. THE LTV CORPORATION

The accounting equation, articulating the income statement and balance sheet. (Straightforward: 30 minutes)

The LTV Corporation is a conglomerate engaged in five basic industries: steel, energy products and services, aerospace, meat and food products, and ocean shipping. It conducts its operations through Jones & Laughlin Steel Corporation and Youngstown Sheet and Tube Company, Continental Emsco Company, Vought Corporation and Kentron International, Wilson Foods Corporation, and Lykes Bros. Steamship Co. Headquarters are in Dallas.

Study LTV's 1979–80 Statements of Consolidated Financial Position and 1978–80 Statements of Consolidated Income.

1. Reconcile the 1979 and 1980 Statements of Income to show that Net Income = (Revenues − Expenses) + (Gains − Losses). Explain your treatment of cumulative effect on prior years of accounting change.
2. Reconcile the 1979 and 1980 Statements of Financial Position to show that Assets = Liabilities + Shareholders' Equity.
3. Compute dividends declared for 1980.
4. If noncurrent liabilities increased, we usually say that working capital has increased as a result. Working capital might also increase from (1) increases in shareholders' equity and (2) decreases in noncurrent assets, as in the sale of property, plant, and equipment.
   a. Calculate the change in working capital from 1979 to 1980.
   b. Show how that change in working capital is reflected in changes in shareholders' equity, changes in noncurrent assets, and changes in noncurrent liabilities.

5. Comment on the display of LTV's assets and liabilities. Do you find their presentation easier to understand than the conventional, more orthodox presentation used by most companies?

STATEMENT OF CONSOLIDATED FINANCIAL POSITION

The LTV Corporation and Subsidiaries
December 31
(In thousands)

	1980	1979 (1)
Current Assets		
Cash and short-term securities	$ 78,230	$ 90,481
Receivables	853,955	807,947
Inventories	1,047,105	983,451
Prepaid expenses	50,413	52,344
Total Current Assets	2,029,703	1,934,223
Current Liabilities		
Notes payable to banks	50,630	75,500
Accounts payable	536,621	499,130
Accrued liabilities	618,018	537,898
Current portion of long-term debt and capitalized lease obligations	21,708	20,131
Total Current Liabilities	1,226,977	1,132,659
Working capital	802,726	801,564
Investments and other assets	258,667	208,031
Property, plant and equipment	1,741,299	1,702,945
Total Assets Less Current Liabilities	2,802,692	2,712,540
Less Noncurrent Liabilities and Other Items		
Long-term debt	1,418,996	1,476,644
Capitalized lease obligations	70,157	74,564
Employee compensation and benefits	363,053	372,468
Deferred income taxes	27,252	8,324
Other noncurrent liabilities	83,520	62,774
Preferred stock with mandatory redemption	20,768	20,768
Total Noncurrent Liabilities and Other Items	1,983,746	2,015,542
Other Preferred Stock, Common Stock and Other Shareholders' Equity	$ 818,946	$ 696,998
Other Preferred Stock, Common Stock and Other Shareholders' Equity		
$2.60 Series B preferred stock	$ —	$ 4,438
Series 1 participating preference stock	1,000	513
Special stock, class AA	352	432
Common stock	17,896	12,322
Additional capital	501,038	498,300
Retained earnings	318,398	200,731
Less excess of redemption value over par value of $5 Series A preferred stock	(19,738)	(19,738)
Total Other Preferred Stock, Common Stock and Other Shareholders' Equity	$ 818,946	$ 696,998

STATEMENT OF CONSOLIDATED INCOME

The LTV Corporation and Subsidiaries
Years Ended December 31
(In thousands except per share data)

	1980	1979	1978
Net sales and revenues	**$8,009,958**	$7,996,809	$5,260,537
Operating costs and expenses:			
Cost of products sold	**7,277,216**	7,230,599	4,886,561
Depreciation and amortization	**128,830**	132,441	83,257
Selling, administrative and general expenses	**388,848**	351,996	195,206
Interest expense and debt discount	**151,305**	160,639	105,694
Interest and other income	**(55,947)**	(36,180)	(12,622)
Gains from early extinguishment of debt	**(31,187)**	(13,890)	(4,922)
Unusual credits	—	—	(16,721)
Total Costs and Expenses	**7,859,065**	7,825,605	5,236,453
Income from continuing operations before income taxes	**150,893**	171,204	24,084
Income taxes	**(23,000)**	(24,600)	(4,100)
Income from continuing operations	**127,893**	146,604	19,984
Discontinued operations — credit	—	5,500	6,500
Income before extraordinary credit and accounting change	**127,893**	152,104	26,484
Extraordinary credit — tax benefit of operating loss carryforward	—	7,100	—
Cumulative effect on prior years of accounting change	—	14,323	13,119
Net Income	**$ 127,893**	$ 173,527	$ 39,603
Earnings per share:			
Fully diluted:			
Continuing operations	**$ 2.96**	$ 3.62	$ 1.09
Discontinued operations	—	0.13	0.33
Before extraordinary credit and accounting change	**2.96**	3.75	1.42
Extraordinary credit	—	0.17	—
Accounting change	—	0.35	0.67
Net Income	**$ 2.96**	$ 4.27	$2.09
Primary:			
Continuing operations	**$ 3.95**	$ 5.02	$ 1.07
Discontinued operations	—	0.21	0.42
Before extraordinary credit and accounting change	**3.95**	5.23	1.49
Extraordinary credit	—	0.26	—
Accounting change	—	0.54	0.84
Net income	**$ 3.95**	$ 6.03	$ 2.33
Pro Forma Data:			
Pro forma amounts, assuming retroactive application of 1979 and 1978 cumulative effect of accounting change:			
Net Income		$ 159,204	$ 35,537
Earnings per share:			
Fully diluted		3.92	1.88
Primary		5.49	2.07

1.2. WHAT SHOULD MISS ANNIE DO?

Performance evaluation of J.P. and Ronnie's oil production, basic principles. (Moderate: 45 minutes)

J.P. and Ronnie (Tex) Richards are in competition to take over Richards Oil. J.P. told Ronnie, "This oil company ain't big enough for the both of us." The Richards have run out of money and, with the oil glut, there isn't much of a market for oil. However, they can sell crude to buy oil-drilling equipment. In Jack's (the recently deceased father of J.P. and Ronnie) will, J.P. and Ronnie were each left 12,000 barrels of oil and some land. J.P.'s parcel of land is smaller (15 acres) than Ronnie's (20 acres) because Ronnie was Jack's favorite. According to the will, Miss Annie must hand over the controlling rights to the son who does relatively better. Neither of the boys has enough oil to purchase drilling equipment outright, but arrangements can be made for payment after the wells produce. The boys have exactly one year to start the wells and produce the crude for comparison.

One year later, J.P.'s wells have produced 82,500 barrels of oil. He made arrangements to buy 10,000 barrels' worth of drilling equipment. The equipment is now capable of producing only 247,500 more barrels of oil. Of the original 12,000 barrels given to J.P. by Jack, he used 8,000 barrels for drilling expenses. At the end of the year, Ronnie had 115,000 barrels of oil. He made arrangements to purchase 15,000 barrels' worth of equipment, but after a fire at the beginning of the year, he found that he only had 5,000 barrels' worth. The equipment had not been insured. What remains of the equipment has 180,000 barrels of production capability left. Ronnie used up all of his original 12,000 barrels allotted for drilling. During the year, however, Ronnie, having a soft heart for Miss Annie, did send 5,000 barrels of produced oil to Miss Annie so that she could go to camp. But upon hearing what Ronnie did, at the end of the year J.P. sent Miss Annie a brand new Mercedes-Benz valued at 12,000 barrels of produced oil. Miss Annie was charmed by both her son's gifts.

Now Miss Annie must determine which son did better so that she can hand over to him the controlling rights to run Richards Oil, and kiss the other son good-bye.