Solutions for Financial Accounting 5th Edition by Dyckman

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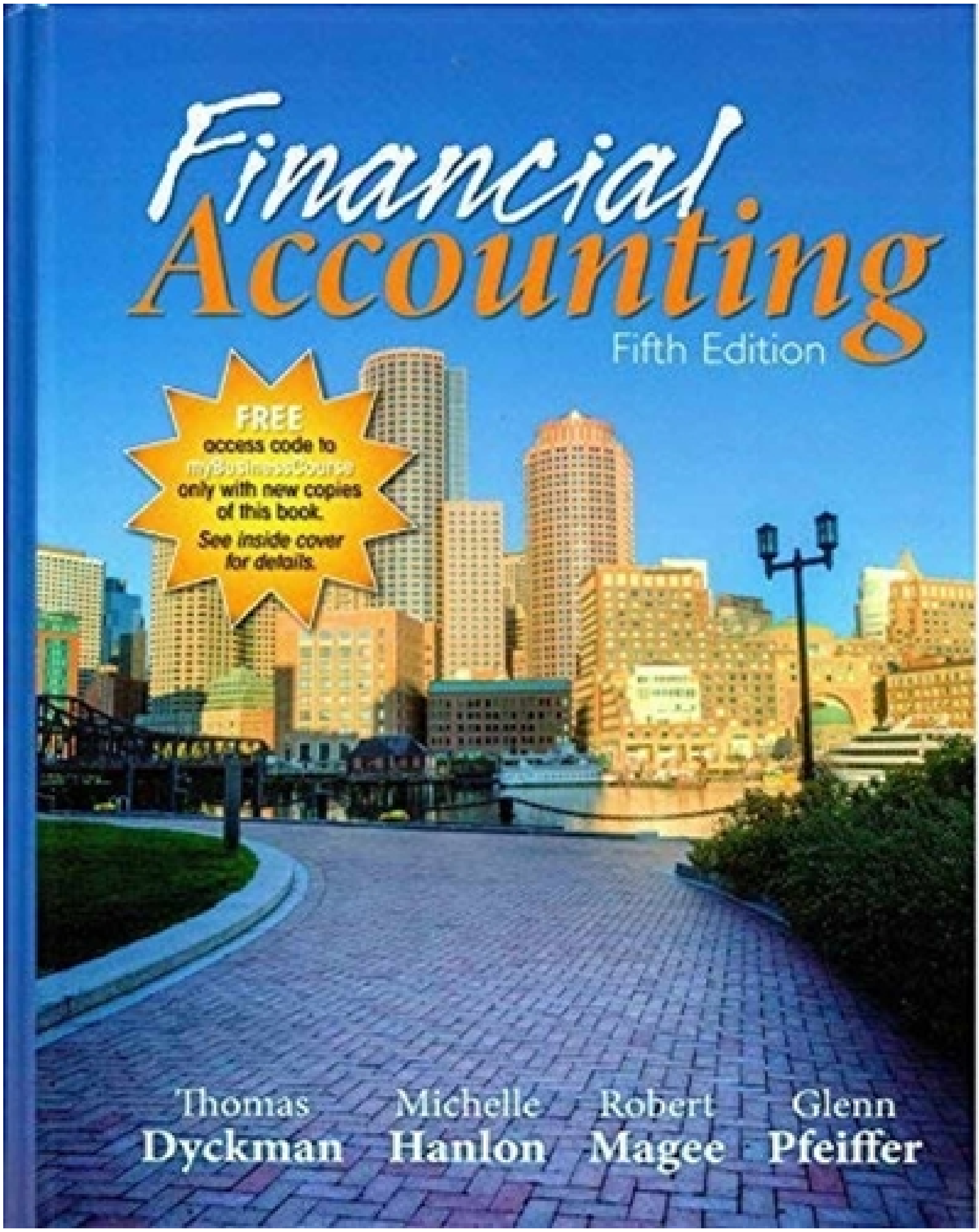

Solutions

Chapter 1

Introducing Financial Accounting

Learning Objectives – coverage by question

	Mini-Exercises	Exercises	Problems	Cases and Projects
LO1 – Identify the users of accounting information and discuss the costs and benefits of disclosure.	25	28, 34		49, 50
LO2 – Describe a company's business activities and explain how these activities are represented by the accounting equation.	19, 20, 21	27, 29, 32, 33	36, 37, 38	47
LO3 – Introduce the four key financial statements including the balance sheet, income statement, statement of stockholders' equity and statement of cash flows.	22, 23, 24	29, 30, 31	37, 38, 39, 40, 41, 42, 43, 44, 45	46, 47, 49
LO4 – Describe the institutions that regulate financial accounting and their role in establishing generally accepted accounting principles.	26	34		50
LO5 – Compute two key ratios that are commonly used to assess profitability and risk – return on equity and the debt-to-equity ratio.		32, 33	36, 43, 44, 45	46, 47, 48, 49
LO6 – Appendix 1A – Explain the conceptual framework for financial reporting.		35		

QUESTIONS

Q1-1. Organizations undertake planning activities that subsequently shape three major activities: financing, investing, and operating. Financing is the means used to pay for resources. Investing refers to the buying and selling of resources necessary to carry out the organization's plans. Operating activities are the actual carrying out of these plans. (Planning is the glue that connects these activities, including the organization's ideas, goals and strategies.)

Q1-2. An organization's financing activities (liabilities and equity = sources of funds) pay for investing activities (assets = uses of funds). An organization cannot have more or less assets than its liabilities and equity combined and, similarly, it cannot have more or less liabilities and equity than its total assets. This means: assets = liabilities + equity. This relation is called the accounting equation (sometimes called the *balance sheet equation*, or BSE), and it applies to all organizations at all times.

Q1-3. The four main financial statements are: income statement, balance sheet, statement of stockholders' equity, and statement of cash flows. The income statement provides information relating to the company's revenues, expenses and profitability over a period of time. The balance sheet lists the company's assets (what it owns), liabilities (what it owes), and stockholders' equity (the residual claims of its owners) as of a point in time. The statement of stockholders' equity reports on the changes to each stockholders' equity account during the year. Some changes to stockholders' equity, such as those resulting from the payment of dividends and unrealized gains (losses) on marketable securities, can only be found in this statement as they are not included in the computation of net income. The statement of cash flows identifies the sources (inflows) and uses (outflows) of cash, that is, from what sources the company has derived its cash and how that cash has been used. All four statements are necessary in order to provide a complete picture of the financial condition of the company.

Q1-4. The balance sheet provides information that helps users understand a company's resources (assets) and claims to those resources (liabilities and stockholders' equity) as of a given *point in time*.

An income statement reports whether the business has earned a net income (also called profit or earnings) or a net loss. Importantly, the income statement lists the types and amounts of revenues and expenses making up net income or net loss. The income statement covers a *period of time*.

Q1-5. Your authors would agree with Mr. Buffett. A recent study of top financial officers suggests they find earnings and the year-to-year changes in earnings as the most important items to report. We would add cash flows particularly from operations, and the year-to-year changes.

Q1-6. The statement of cash flows reports on the cash inflows and outflows relating to a company's operating, investing, and financing activities over a *period of time*. The sum of these three activities yields the net change in cash for the period. This statement is a useful complement to the income statement which reports on revenues and expenses, but conveys relatively little information about cash flows.

Q1-7. Articulation refers to the updating of the balance sheet by information contained in the income statement or the statement of cash flows. For example, retained earnings is increased each period by any profit earned during the period (as reported in the income statement) and decreased each period by the payment of dividends (as reported in the statement of cash flows and the statement of stockholders' equity). It is by the process of articulation that the financial statements are linked.

Q1-8. Return refers to income, and risk is the uncertainty about the return we expect to earn. The lower the risk, the lower the expected return. For example, savings accounts pay a low return because of the low risk of a bank not returning the principal with interest. Higher returns are to be expected for common stocks as there is a greater uncertainty about the realized return compared with the expected return. Higher expected return offsets this higher risk.

Q1-9. Companies often report more information than is required by GAAP because the benefits of doing so outweigh the costs. These benefits often include lower interest rates and better terms from lenders, higher stock prices and greater access to equity investors, improved relationships with suppliers and customers, and increased ability to attract the best employees. All of these benefits arise because the increased disclosure reduces uncertainty about the company's future prospects.

Q1-10. External users and their uses of accounting information include: (a) lenders for measuring the risk and return of loans; (b) shareholders for assessing the return and risk in acquiring shares; and (c) analysts for assessing investment potential. Other users are auditors, consultants, officers, directors for overseeing management, employees for judging employment opportunities, regulators, unions, suppliers, and appraisers.

Q1-11. Managers deal with a variety of information about their employers and customers that is not generally available to the public. Ethical issues arise concerning the possibility that managers might personally benefit by using confidential information. There is also the possibility that their employers and/or customers might be harmed if certain information is not kept confidential.

Q1-12. Return on equity (ROE) is computed as net income divided by average stockholders' equity (an average of stockholders' equity for the current and previous year is commonly used, but the ratio is sometimes computed only with beginning or ending stockholders' equity). The return on equity is a popular measure for analysis because it compares the level of return earned with the amount of equity invested to generate the return. Furthermore, it combines both the income statement and the balance sheet and, thereby, highlights the fact that companies must manage *both* well to achieve high performance.

Q1-13. While businesses acknowledge the increasing need for more complete disclosure of financial and nonfinancial information, they have resisted these demands to protect their competitive position. These companies must weigh the benefits they receive from the market as a result of more transparent and revealing financial reporting against the costs of divulging proprietary information.

Q1-14. Generally Accepted Accounting Principles (GAAP) are the various methods, rules, practices, and other procedures that have evolved over time in response to the need to regulate the preparation of financial statements. They are primarily set by the Financial Accounting Standards Board (FASB), an entity of the private sector with representatives from companies that issue financial statements, accounting firms that audit those statements, and users of financial information.

Q1-15. International Financial Reporting Standards (IFRS) are the accounting methods, rules and principles established by the International Accounting Standards Board (IASB). The need for IFRS stems from the wide variety of accounting principles adopted in various countries and the lack of comparability that this variety creates. IFRS are intended to create a common set of accounting guidelines that will make the financial statements of companies from different countries more comparable.

The IASB has no enforcement authority. As a consequence, the strict enforcement of IFRS is left to the accounting profession and/or securities market regulators in each country. Many countries have reserved the right to make exceptions to IFRS by applying their own (local) accounting rules in selected areas. Some accountants and investors argue that a little diversity is a good thing – variations in accounting practice reflect differences in cultures and business practices of various countries. However, one concern is that IFRS may create the false impression that everyone is following the same rules, even though some variation will continue to permeate international financial reporting.

Q1-16. The auditor's primary function is to express an opinion on whether the financial statements fairly present the financial condition of the company and are free from material misstatements. Auditors do not prepare the financial statements; they only audit them and issue their opinion on them.

Q1-17.[A] The objectives of financial accounting are to provide information:

- That is useful to investors, creditors, and other decision makers who possess a reasonable knowledge of business activities and accounting
- To help investors and creditors assess the amount, timing and uncertainty of cash flows. This includes the information presented in the cash flow statement as well as other information that might help investors and creditors assess future dividend and debt payments
- About economic resources and financial claims on those resources. This includes the information in the balance sheet and any supporting information that might help the user assess the value of the company's assets and future obligations
- About a company's financial performance, including net income and its components (i.e., revenues and expenses)
- That allows decision makers to monitor company management to evaluate their effective, efficient, and ethical stewardship of company resources

Q1-18.[A] The four qualitative characteristics of accounting information are relevance, reliability, consistency and comparability. *Relevant* accounting information has the ability to make a difference in a decision. *Reliable* accounting information is accurate and free of misstatement or bias. These two characteristics are the primary drivers of the quality of accounting information. Reliable information increases the confidence of the decision maker. However, the information must also be relevant to the decision at hand. These two characteristics can be at odds, in that the most relevant information sometimes lacks reliability.

Comparability and *consistency* allow users to identify similarities and differences between sets of economic phenomena. Comparability refers to the use of similar accounting methods across companies, while consistency refers to the use of similar methods over reporting periods. Both improve the users' ability to interpret the information by making comparisons to other companies or earlier periods.

MINI EXERCISES

M1-19. (10 minutes)

($ millions)

Assets	=	Liabilities	+	Equity
$2,283.2		$1,321.8		$961.4

WhiteWave receives more of its financing from creditors ($1,321.8 million) versus owners ($961.4 million). Its owner financing comprises 42.1% of its total financing ($961.4 mil / $2,283.2 mil.).

M1-20. (10 minutes)

($ millions)

Assets	=	Liabilities	+	Equity
$90,055		$56,615		$33,440

Coca-Cola receives more of its financing from creditors ($56,615 million) than from owners ($33,440 million). Its owner financing comprises 37.1% of its total financing ($33,440 mil./ $90,055 mil.). This percentage has been decreasing; several years ago, the percentage was 50%

M1-21. (15 minutes)

($ millions)

	Assets	=	Liabilities	+	Equity
Hewlett-Packard	$ 105,676		$ 78,020		(a) $ 27,656
General Mills	$23,145.7		(b) $16,140.3		$7,005.4
Harley-Davidson	(c) $ 9,405.0		$ 6,395.5		$3,009.5

The percent of owner financing for each company follows:

Hewlett-Packard, 26.2% ($27,656 mil./ $105,676 mil.);

General Mills, 30.3% ($7,005.4 mil./ $23,145.7 mil.);

Harley-Davidson, 32.0% ($3,009.5 mil./ $9,405.0 mil.).

The creditor percent of financing is computed as 100% minus the owner percent. Therefore, Harley-Davidson is more owner-financed (32.0%) than the other two firms, while Hewlitt-Packard has the highest percentage of creditor (non-owner) financing (73.8% = 100% - 26.2%).

M1-22. (15 minutes)

For its annual report dated September 27, 2014, Apple reports the following amounts (in $ millions):

Assets	=	Liabilities	+	Equity
$231,839	=	$120,292	+	$111,547

As shown, the accounting equation holds for Apple. Also, we can see that Apple's creditor financing is 51.9% of its total financing ($120,292 mil./$231,839 mil).

M1-23. (20 minutes)

NIKE Statement of Retained Earnings For Year Ended May 31, 2013	
Retained earnings, May 31, 2012	$5,526
Net income for the year ended May 31, 2013	2,472
Common stock dividends	(727)
Other changes*	(1,651)
Reinvested earnings, May 31, 2013	$5,620

*Includes $1,647 million for repurchase of common stock and $4 million for stock purchased from employees.

Nike was more profitable 2014 versus 2013. Net income was $2,693 million in 2014 compared to $2,472 in 2013. Note: As reported in the text, ROE was 24.6% in 2014 compared to 23.0% in 2013.

M1-24. (20 minutes)

a. BS
b. IS
c. BS
d. BS and SE
e. SCF
f. BS and SE
g. SCF and SE
h. SCF and SE
i. IS and SE

M1-25. (10 minutes)

There are many stakeholders affected by this business decision, including the following (along with a description of how):

- You/Manager—your reputation, self-esteem, and potentially your livelihood can be affected.
- Creditors/Bondholders– credit decisions based on inaccurate information can occur.
- Shareholders—buying or selling shares based on inaccurate information can occur.
- Management/Employees of your company—repercussions of your decision extend to them; also, your decision may suggest an environment condoning dishonesty

Indeed, our decisions can affect many more parties than we might initially realize.

M1-26. (10 minutes)

Internal controls are rules and procedures that involve monitoring an organization's activities, transactions, and interactions with customers, employees and other stakeholders to promote efficiency and to prevent wrongful use of its resources. They help prevent fraud, ensure the validity and credibility of accounting reports, and are often crucial to effective and efficient operations.

The absence or failure of internal controls can adversely affect the effectiveness of both domestic and global financial markets. Enron (along with other accounting scandals) provided a case in point. Because the failure of internal controls can have significant economic consequences, Congress is interested in making sure that publicly- traded companies have adequate internal controls and that any concerns about internal controls are properly reported.

EXERCISES

E1-27. (15 minutes)

($ millions)	Assets	=	Liabilities	+	Equity
Motorola Solutions, Inc	$ 11,851		$ 8,162		$ 3,689
Kraft Foods Group, Inc. ...	$ 23,148		$17,961		$ 5,187
Merck & Co Inc.	$105,645		$53,319		$52,326

The percent of owner financing for each company follows:
Motorola Solutions, 31.1% ($3,689 mil./ $11,851 mil.);
Kraft Foods, 22.4% ($5,187 mil./ $23,148 mil.);
Merck & Co, 49.5% ($52,326 mil./ $105,645 mil.).

The creditor percent of financing is computed as 100% minus the owner percent. Merck is more owner-financed, while Kraft is more creditor-financed.

E1-28. (15 minutes)

External users and some questions they seek to answer with accounting information from financial statements include:

1. Shareholders (investors), who seek answers to questions such as:
   a. Are resources owned by a business adequate to carry out plans?
   b. Are the debts owed excessive in amount?
   c. What is the current level of income (and its components)?

2. Creditors, who seek answers for questions such as:
   a. Does the business have the ability to repay its debts?
   b. Can the business take on additional debt?
   c. Are resources sufficient to cover current amounts owed?

3. Employees (and potential employees), who seek answers to questions such as:
   a. Is the business financially stable?
   b. Can the business afford to pay higher salaries?
   c. What are growth prospects for the organization?

E1-29. (20 minutes)

($ millions)

a. Using the accounting equation:

($ millions)	Assets	=	Liabilities	+	Equity
Intel	$92,358		$34,102		$58,256

b. Starting with the accounting equation at the *beginning* of the year:

($ millions)	Assets	=	Liabilities	+	Equity
JetBlue Airways............	$7,070		$5,182		$1,888

Using the accounting equation at the *end* of the year:

($ millions)	Assets	=	Liabilities	+	Equity
JetBlue Airways.........	$7,350		$5,216		$2,134
	($7,070+$280)		($5,182+$34)		

Alternative approach to solving part (b):
ΔAssets($280) = ΔLiabilities($34) + ΔEquity(?)
where "Δ" refers to "change in."
Thus: Δ *Ending* Equity = $280 - $34 = $246 and
Ending equity = $1,888 + $246 = $2,134

c. Starting with the accounting equation at the *end* of the year:

($ millions)	Assets	=	Liabilities	+	Equity
Walt Disney	$81,241		$33,091		$48,150
			($32,940+$151)		

Using the accounting equation at the *beginning* of the year:

($ millions)	Assets	=	Liabilities	+	Equity
Walt Disney	$74,898		$32,940		$41,958
	($81,241-$6,343)				

E1-30. (10 minutes)

Computation of dividends

	Retained earnings, 2012	$16,953
+	Net income	2,410
–	Cash dividends	(?)
=	Retained earnings, 2013	$17,952

Thus, dividends were $1,411 million for 2013. This dividends amount comprises 58.5% ($1,411/ $2,410) of its 2013 net income.

E1-31. (20 minutes)

COLGATE-PALMOLIVE COMPANY
Income Statement
For the year ended December 31, 2013
($millions)

Revenues	$17,420
Cost of goods sold	7,219
Gross profit	10,201
Other expenses, including income taxes	7,791
Net income (or loss)	$ 2,410

E1-32. (15 minutes)

a. Return on equity (ROE) = Net income / Average stockholders' equity

= $2,410 / [($2,536 + $2,390)/2]

= 97.8%

b. Debt-to-equity = Total liabilities / Stockholders' equity

= $11,340* / $2,536

= 4.47

*$11,340 = $13,876 - $2,536

E1-33. (150 minutes)

a.	Return on equity (ROE)	=	Net income / Average stockholders' equity
		=	€8,720 / [(€43,363 + €39,330)/2]
		=	21.1%
b.	Debt-to-equity	=	Total liabilities / Stockholders' equity
		=	€125,155* / €43,363
		=	2.89

*€125,155 = €168,518 - €43,363

E1-34. (20 minutes)

a. Financial information provides users with information that is useful in assessing the financial performance of companies and, therefore, in setting securities prices. To the extent that securities prices are accurate, the costs of the funds that companies raise will accurately reflect their relative efficiency and risk of operations. Those companies that can effectively utilize capital better will be able to obtain that capital at a reasonable cost, and society's financial resources will be effectively allocated.

b. First, the preparation of financial statements involves and understanding of complex accounting rules and a significant amount of assumptions and estimation. Second, GAAP allows for differing accounting treatments for the same transaction. And third, auditors are at a relative information disadvantage vis-à-vis company accountants. As the capital markets place increasing pressures on companies to perform, accountants are often placed in a difficult ethical position to use the flexibility given to them under GAAP in order to bias the financial results.

E1-35. (15 minutes)

1.	e	6.	g
2.	f	7.	j
3.	i	8.	c
4.	a	9.	d
5.	h	10.	b

PROBLEMS

P1-36. (40 minutes)

a.

Year	Assets	Liabilities	Equity	Net Income
2011	$138,354	$70,353	$68,001	$11,927
2012	$132,244	$68,209	$64,035	$10,904
2013	$139,263	$70,554	$68,709	$11,402

b. 2012 ROE = $10,904 / [($68,001+$64,035)/2] = 16.5%

2013 ROE = $11,402 / [($64,035+$68,709)/2] = 17.2%

P&G's ROE increased in 2013, and was slightly above the median for Fortune 500 companies in both years.

c. 2012 debt-to-equity = $68,209 / $64,035 = 1.065

2013 debt-to-equity = $70,554 / $68,709 = 1.027

P&G's debt-to-equity ratio also declined in 2013 and it is below the median for Fortune 500 companies in both years.

P1-37. (30 minutes)

a.

GENERAL MILLS, INC.
Income Statement
For Year Ended May 25, 2014
($ millions)

Sales	$17,909.6
Cost of goods sold	11,539.8
Gross profit	6,369.8
Other expenses, including income taxes	4,508.5
Net income	$ 1,861.3

GENERAL MILLS, INC.
Balance Sheet
May 25, 2014
($ millions)

Cash & cash equivalents	$ 867.3	Total liabilities	$16,140.3
Noncash assets	22,278.4	Stockholders' equity	7,005.4
Total assets	$23,145.7	Total liabilities and equity	$23,145.7

GENERAL MILLS, INC.
Statement of Cash Flows
For Year Ended May 25, 2014
($ millions)

Net cash flows from operations	$ 2,541.0
Net cash flows from investing	(561.8)
Net cash flows from financing	(1,824.1)
Effect of exchange rates on cash	(29.2)
Net change in cash	125.9
Cash, beginning year	741.4
Cash, ending year	$ 867.3

b. $7,005.4 /$23,145.7 = 30.3% contributed by owners

P1-38. (30 minutes)

a.

ABERCROMBIE & FITCH
Income Statement
For Year Ended February 1, 2014
($ millions)

Sales	$ 4,116.9
Cost of goods sold	1,541.5
Gross profit	2,575.4
Other expenses including income taxes	2,520.8
Net income	$ 54.6

ABERCROMBIE & FITCH
Balance Sheet
February 1, 2014
($ millions)

Cash asset	$ 600.1	Total liabilities	$ 1,121.5
Noncash assets	2,250.9	Stockholders' equity	1,729.5
Total assets	$ 2,851.0	Total liabilities and equity	$ 2,851.0

ABERCROMBIE & FITCH
Statement of Cash Flows
For Year Ended February 1, 2014
($ millions)

Net cash flows from operations	$ 175.5
Net cash flows from investing	(173.9)
Net cash flows from financing	(40.8)
Effect of exchange rate changes on cash	(4.2)
Net change in cash	(43.4)
Cash, beginning year	643.5
Cash, ending year	$ 600.1

b. $1,729.5 / $2,851.0 = 60.7% contributed by owners
$1,121.5 / $2,851.0 = 39.3% contributed by creditors

P1-39. (30 minutes)

TILLY'S, INC.
Income Statements
For years ended February 1, 2014 and February 2, 2013
($ thousands)

	2014	2013
Sales	$495,837	$467,291
Cost of goods sold	343,542	317,096
Gross profit	152,295	150,195
Other expenses, including income taxes	134,158	126,302
Net income	$ 18,137	$ 23,893

TILLY'S, INC.
Balance Sheets
February 1, 2014 and February 2, 2013
($ thousands)

	2014	2013
Cash asset	$ 25,412	$ 17,314
Noncash assets	206,995	188,067
Total assets	$232,407	$205,381
Total liabilities	$ 91,484	$ 88,085
Stockholders' equity	140,923	117,296
Total liabilities and stockholders' equity	$232,407	$205,381

TILLY'S, INC.
Cash Flow Statements
For years ended February 1, 2014 and February 2, 2013
($ thousands)

	2014	2013
Cash flow from operating activities	$43,794	$41,730
Cash flow from investing activities	(37,530)	(72,326)
Cash flow from financing activities	1,834	22,819
Change in cash	8,098	(7,777)
Cash balance, beginning of the year	17,314	25,091
Cash balance, end of the year	$25,412	$17,314

P1-40. (30 minutes)

TESLA MOTORS, INC. Income Statements For years ended December 31, 2013 and 2012 ($ thousands)		
	2013	**2012**
Sales	$2,013,496	$ 413,256
Cost of goods sold	1,557,234	383,189
Gross profit	456,262	30,067
Other expenses, including income taxes	530,276	426,280
Net income (loss)	$ (74,014)	$ (396,213)

TESLA MOTORS, INC. Balance Sheets December 31, 2013 and 2012 ($ thousands)		
	2013	**2012**
Cash asset	$ 845,889	$ 201,890
Noncash assets	1,571,041	912,300
Total assets	$2,416,930	$1,114,190
Total liabilities	$1,749,810	$ 989,490
Stockholders' equity	667,120	124,700
Total liabilities and stockholders' equity	$2,416,930	$1,114,190

TESLA MOTORS, INC. Cash Flow Statements For years ended December 31, 2013 and 2012 ($ thousands)		
	2013	**2012**
Cash flow from operating activities	$257,994	$(266,081)
Cash flow from investing activities	(249,417)	(206,930)
Cash flow from financing activities	635,422	419,635
Change in cash	643,999	(53,376)
Cash balance, beginning of the year	201,890	255,266
Cash balance, end of the year	$845,889	$201,890

P1-41. (15 minutes)

CROCKER CORPORATION Statement of Stockholders' Equity For Year Ended December 31, 2016	Contributed Capital	Retained Earnings	Stockholders' Equity
December 31, 2015	$ 70,000	$ 30,000	$100,000
Issuance of common stock	30,000		30,000
Net income		50,000	50,000
Cash dividends		(25,000)	(25,000)
December 31, 2016	$100,000	$ 55,000	$155,000

P1-42. (15 minutes)

DP SYSTEMS, INC. Statement of Stockholders' Equity For Year Ended December 31, 2016	Common Stock	Retained Earnings	Stockholders' Equity
December 31, 2015	$ 550	$2,437	$2,987
Net income		859	859
Cash dividends		(281)	(281)
December 31, 2016	$ 550	$3,015	$3,565

P1-43. (15 minutes)

a. Return on equity is net income divided by average stockholders' equity.

Nokia's ROE: €-739 / [(€6,660 + €9,239)/2] = -0.093 or -9.3%.

b. Debt-to-equity is total liabilities divided by stockholders' equity.

Nokia's debt-to-equity: (€25,191 − €6,660) / €6,660 = 2.78.

c. Revenues less expenses equal net income. Taking the revenues and net income numbers for Nokia, yields:

€12,709 million − Expenses = €-739 million.

Therefore, expenses must equal €13,448 million.

P1-44. (20 minutes)

a.

BEST BUY CO., INC. Income Statement For the year ended February 1, 2014 ($ millions)	
Sales revenue …………………………………	$42,410
Cost of goods sold …………………………..	32,720
Gross profit ……………………………………	9,690
Other expenses, including income taxes ……	9,167
Net income (or loss) …………………………..	$ 523

b. Best Buy's ROE = $523 mil. / [($3,715 mil. + $3,989 mil.)/2] = 13.6%.

c. Best Buy's debt-to-equity = ($14,013 - $3,989) / $3,989 = 2.51

P1-45. (20 minutes)

a.

FACEBOOK, INC. Income Statement For the years ended December 31, 2013 and 2012 ($ millions)		
	2013	**2012**
Revenue	$ 7,872	$ 5,089
Operating expenses	5,068	4,551
Gross profit from operations	2,804	538
Other expenses, including income taxes	1,304	485
Net income	$ 1,500	$ 53

b. Stockholders' equity: 2013 -- $17,895 mil. - $2,425 mil. = $15,470 mil.
2012 -- $15,103 mil. - $3,348 mil. = $11,755 mil.

2013 ROE = $1,500 mil. / [($15,470 mil. + $11,755 mil.)/2] = 11.0%.
2012 ROE = $53 mil. / [($11,755 mil. + $4,899 mil.)/2] = 0.6%.

c. 2013 debt-to-equity = $2,425 / $15,470 = 0.16.
2012 debt-to-equity = $3,348 / $11,755 = 0.28.

d. Beginning retained earnings + income – dividends = ending retained earnings
$1,659 mil. + $1,500 mil. – dividends = $3,159 mil.
Dividends = $0

CASES and PROJECTS

C1-46. (40 minutes)

a.

STARBUCKS CORPORATION
Income Statement
For the years ended September 29, 2013 and September 30, 2012

($ millions)	**2013**	**2012**
Sales revenue	$ 14,892.2	$ 13,299.5
Cost of goods sold	6,382.3	5,813.3
Gross profit on sales	8,509.9	7,486.2
Other expenses, including income taxes	8,501.1	6,101.5
Net income	$ 8.8	$ 1,384.7

b. 2013 stockholders' equity: $11,516.7 mil. – $7,034.4 mil. = $4,482.3 mil.
2012 stockholders' equity: $8,219.2 mil. -- $3,104.7 mil. = $5,114.5 mil.

2013 ROE: $8.8 / [($4,482.3 + $5,114.5)/2] = 0.2%
2012 ROE: $1,384.7 / [($5,114.5 + $4,387.3)/2] = 29.1%

c. 2013 debt-to-equity: $7,034.4 / $4,482.3 = 1.57
2012 debt-to-equity: $3,104.7 / 5,114.5 = 0.61

d. 2013 ROE restated: ($8.8 + $2,784.1) / [($4,482.3 + $2,784.1 + $5,114.5)/2] = 45.1%

The litigation charge of $2,784.1 is added to the net income number and to the 2013 stockholders' equity amount to arrive at this number. This does not take into account the effect of income taxes. If we allow for a 35% tax rate, the restated ROE is lower ($2,784.1 x 0.65 = $1,809.7):

2013 ROE restated: ($8.8 + $1,809.7) / [($4,482.3 + $1,809.7 + $5,114.5)/2] = 31.9%

e. The primary cost to Starbucks of disclosing information about the pending litigation is that the disclosure may cause potential investors and creditors to hold a less favorable view of the company. A secondary concern is that such disclosure may actually affect the outcome of the litigation.

The primary benefit to disclosure is that by disclosing information about the lawsuit before its completion, the company cannot be accused of withholding relevant information from stakeholders. This prevents potential lawsuits from investors or creditors and contributes to the company's reputation for reliable financial reporting.

C1-47. (40 minutes)

The Gap, Inc.

a. ROE = $1,280 / [($3,062 + $2,894)/2] = 43.0%

b. Debt-to-equity = ($7,849 - $3,062) / $3,062 = 1.56

Nordstrom, Inc.

a. ROE = $734 / [($2,080 + $1,913)/2] = 36.8%

b. Debt-to-equity = ($8,574 - $2,080) / $2,080 = 3.12

Nordstrom had the lower ROE and also relies more on debt than The Gap.

c.

THE GAP, INC. 2013 Income Statement ($millions)	
Revenues	$16,148
Cost of goods sold	9,855
Gross profit	6,293
Other expenses, including income taxes	5,013
Net income (or loss)	$ 1,280

NORDSTROM, INC. 2013 Income Statement ($millions)	
Revenues	$12,540
Cost of goods sold	7,737
Gross profit	4,803
Other expenses, including income taxes	4,069
Net income (or loss)	$ 734

The Gap: $6,293 / $16,148 = 39.0%

Nordstrom: $4,803 / $12,540 = 38.3%

d. The Gap earned a higher ROE than Nordstrom (43.0% vs. 36.8%), though both are well above the median for the *Fortune* 500 in 2013. Nordstrom's debt-to-equity ratio is 3.12 vs. about 1.56 for The Gap. The Gap reported a slightly higher gross profit per dollar of sales revenue (39.0% vs. 38.3% for Nordstrom). These two percentages are very close, reflecting the similarity of their retail operations. One important difference (not provided or apparent in the information supplied) is that Nordstrom has a larger consumer credit business than The Gap.

C1-48. (30 minutes)

a. JetBlue
ROE = $168 / {[($7,350-$5,216) + ($7,070 - $5,182)] /2} = 8.4%

Southwest
ROE = $754 / {[($19,345-$12,009) + ($18,596-$11,604)] /2} = 10.5%

b. JetBlue
Debt-to-equity = $5,216 / ($7,350 - $5,216) = 2.44

Southwest
Debt-to-equity = $12,009 / ($19,345 - $12,009) = 1.64

c. JetBlue
$168 / $5,441 = 3.1%

Southwest
$754 / $17,699 = 4.3%

d. JetBlue reported a profit of $168 million in 2013, whereas it had reported losses as recently as 2008. JetBlue's ROE was 8.4% for the year. In comparison, Southwest earned an ROE of 10.5% in 2013. Both of these ROE numbers are below the average for *Fortune* 500 companies. JetBlue uses more creditor financing. Its debt-to-equity ratio is 2.44 compared to a debt-to-equity ratio of 1.64 for Southwest. In addition, JetBlue's reported net income equaled 3.1% of revenues, while Southwest reported net income equal to 4.3% of revenues. The numbers for both airlines reflect the poor performance of the airline industry in general, resulting from high fuel costs, high labor costs, and intense competition.

C1-49. (20 minutes)

a. $285,000 Assets - $45,000 Liabilities = $240,000 Net Assets. $72,000 Average Annual Income / $240,000 Investment = 30% return. Seale's return would be 24% ($72,000 Average Annual Income / $300,000 Investment), assuming no adjustment is made for Meg's salary. (See part b.)

b. No. Withdrawals do not affect net income, because they are not part of the firm's operating activities. However, in calculating Krey's return in part a, Seale might wish to "impute" an amount for Krey's half-time work in computing Krey's return on investment. Thus, if Seale believes that Krey's services are worth $18,000 (half of the $36,000 salary she expects to pay a full-time manager), annual income should be calculated at $54,000 instead of $72,000. If Seale hires a full-time manager at $36,000, her return will be only 12% [($72,000 - $36,000)/$300,000].

c. Yes, the difference between net income shown in the financial statements and net income shown on the tax return can be legitimate, because income tax rules for determining revenues and deductions from revenues differ from generally accepted accounting principles. Seale may obtain additional assurance about the propriety of the financial statements by engaging a licensed professional accountant to audit the financial statements and render a report on them.

C1-50. (15 minutes)

It is important for a CPA to be independent when performing audit services because third parties will be relying on the audited financial statements in making decisions. The financial statements are the representations of the corporation's management. The audit by a CPA adds credibility to the financial statements. Only if third parties believe that the CPA is independent will a CPA be able to add credibility to financial statements.

Jackie is not independent for two reasons: (1) her brother is president and chair of the board of directors of the company to be audited and (2) Jackie is on the board of directors of the company to be audited. The auditing profession takes the position that Jackie's other activities for the company—consulting and tax work—do not impair a CPA's independence. This last point may generate some discussion, particularly in this case when the potential auditor is the same person (Jackie) who is doing the consulting work. Usually, when the same CPA firm does both auditing and consulting work, those tasks are assigned to different persons to ensure auditor independence.