

P5-1

- a. The accounting fraud would have understated expenses, overstated income, overstated assets and overstated equity. Total cash flows would have been unaffected. However, since the expenditures were capitalized instead of expensed, they would have been reported in the statement of cash flows as investing activities instead of operating activities. This would have meant that the company's cash flow from operating activities would have been overstated. The cash flows instead appeared as outflows in the investing section. Properly reflecting the cash flows would have meant that the cash flow from operating activities was significantly less, as were the cash outflows for investing activities. Since investors are looking for positive cash flows from operating activities and significant growth evidenced by capital spending, both changes will have a significant effect on investors' confidence in WorldCom.
- b. The statement is misleading because it implies that the company's cash flows were affected by the accounting fraud. In fact, as explained later in the article, the operating cash flows were overstated, but not the total cash flow of the company.
- c. Any material misstatement or omission in a bond offering could result in lawsuits against the bond underwriters and the directors of the company. Underwriters are required to perform "due diligence" to ensure that information presented to potential investors is accurate.
- d. The company had been in negotiations with banks for a \$5 billion line of credit at the time of the announcement. In all likelihood, banks instead would foreclose on existing loans, essentially forcing the company into bankruptcy.

P5-2

- a. **Income statement:**
Sales revenue would be overstated
Cost of goods sold would be overstated
Gross margin would be overstated
Operating income and net income would be overstated
- Balance sheet:**
Accounts receivable would be overstated
Inventory would be understated
Retained Earnings would be overstated

Cash flow Statement: If wholesalers had 120 days to pay, no payments would have been received by Bristol-Myers Squibb. The cash flow statement would be unaffected.

- b. Since the company has essentially "robbed from Peter to pay Paul," 2002 would show much lower sales and profits. The company announced that earnings in 2002 would be just half of those in 2001, because wholesalers would need time to work down the inventories that had been shipped.

P5-3

- a. The temporary account that was debited was "write-off—computer project and severance costs." This account is found in the 1999 income statement. The total write-off was \$2,180,000. The portion related to the computer system was \$1,414,000 (cash flow statement and note); the remaining portion of \$766 million was related to severance costs.
- b. The computer system most likely appeared as an asset in the property, plant and equipment section of the balance sheet.
- c. The write-off increased costs and expenses for 1999 and decreased the company's operating income.
- d. The statement of cash flows shows an amount of \$1,414,000 related to the computer project write-off. It is added back to net income in the operating section because, while the write-off decreased the company's income, it did not represent a cash outflow. Therefore, net cash provided by operating activities is greater than the amount of net income that appears in the income statement.
- e. The most likely liability account credited would be accrued expenses. None of the other liabilities presented on the balance sheet would be appropriate for accrued severance costs.
- f. See part a. Note: there is a 1 million dollar discrepancy between the totals recorded in the income statement and the amount described in the note. This is most likely a rounding difference.
- g. Any amounts related to severance costs that have not been paid would be reflected in the increase in the trade accounts payable and accrued expenses category. It is difficult to tell how much of the increase of \$1,106,000 was related to the severance costs, but it is reasonable to assume that a large portion of the costs had been accrued but not paid as of February 27, 1999, since the increase indicates that the company's cash flow is greater than the net income reported in the income statement.
- h. A cash overdraft account would increase when the company writes a check for more than the amount in the cash account. Often, arrangements are made with banks so that the bank will cover such overdrafts for a fee. Material amounts are required to be disclosed separately in the balance sheet. An increase in the account would mean that the company wrote checks for more than the balance in its checking account. A decrease would mean that the company has paid off the amounts owed to the bank.

i. Lillian Vernon incurs substantial expenses related to catalogs that will be mailed in future accounting periods. Since the catalogs will not generate revenues until future periods, the costs related to the preparation represent future economic benefits. It is therefore appropriate to record such costs as assets.

j. The change in retained earnings cannot be explained from the information given. Retained earnings at the end of 1999 was \$100,760,000. If net income of \$6,289,000 is added, the retained earnings would be \$107,049,000 at the end of 2000. Since the ending balance is \$103,847,000, a \$3,202,000 reduction of retained earnings is unexplained. The most likely explanation would be a declaration of a dividend to stockholders during 1999. The information related to the dividend could be found in the financing section of the statement of cash flows, a statement of changes in stockholders' equity or Lillian Vernon's footnotes.

k. The most likely journal entry would be:

	DR	CR
Compensation expense	x	
Deferred compensation		x

l. Since there was an increase in the amount of a liability, Lillian Vernon has accrued that portion of the expense but not yet paid it. It is added back because the company's cash flow will be greater than the amount of income reported in the income statement.

m. There would be an increase in selling, general and administrative expenses in the income statement, which would result in a decrease in operating income.

P5-4

a.

1996 Deferred subscriber acquisition costs

Balance at June 30 1995	77,229	
Increases (Cash outflows)	363,024	126,072 Amortization Noncash adjustment
Balance at June 30 1996	314,181	

b.

1995 Deferred subscriber acquisition costs

Balance at June 30 1994	X		
Increases (Cash outflows)	111,761	60,924	X + 111,761 – 60,924 = 77,229 Amortization X = 26,392 Noncash adjustment
Balance at June 30 1995	77,229		

c.

1994 Deferred subscriber acquisition costs

Balance at June 30 1993	X		
Increases (Cash outflows)	37,424	17,922	X + 37,424 – 17,922 = 26,392 Amortization X = 6,890 Noncash adjustment
Balance at June 30 1994	26,392		

P5-5

a. If Microsoft decides that all amounts in Unearned Revenue are earned in fiscal 2000, revenues will increase \$4.2 billion, net income will increase \$4.2 billion on the income statement. On the balance sheet, liabilities will decrease \$4.2 billion and retained earnings will increase. The cash flow statement will be unaffected as all amounts from the unearned revenue account would have been received in cash in prior years.

b. The \$3 billion received in 2000 will increase the asset cash and increase the liability unearned revenue on the balance sheet. There will be no effect on net income. Cash provided by operating activities will increase by \$3 billion. The \$2 billion of the \$4.2 billion that has been earned will increase revenues by \$2 billion and net income will increase by \$2 billion on the income statement. On the balance sheet, the liability account unearned revenue will decrease \$2 billion and retained earnings will increase. The cash flow statement will be unaffected by the \$2 billion of revenue recognized, as all amounts from the unearned revenue account would have been received in cash in prior years. (If the indirect method is used, there will be a subtraction to net income of \$2

billion in order to obtain cash flow from operations.)

The ending balance in Unearned revenue will be \$5.2 billion. (\$4.2 billion + \$3 billion – \$2 billion.)

P5-6

a. The loss will decrease income on the income statement by \$2 million. On the balance sheet, assets and equity will decrease by \$2 million. In the cash flow statement, the \$2 million loss will be added back to net income to arrive at cash provided by operating activities. The loss is a noncash expense.

b. Annual depreciation expense prior to the write down would have been \$1 million. After the write down, annual depreciation expense will be \$800,000:

Book value of assets prior to the write down:\$	10 million
Write down	<u>(2)million</u>
Book value of assets after the write down\$	8 million
Remaining useful life	10 years
Annual depreciation expense	\$800,000

Annual depreciation expense (which is now \$.8 million vs \$1 million before the write down) will increase expenses and reduce net income in the income statement, decrease assets and equity in the balance sheet and have no effect on cash flows. However, the expense must be added back to net income in the operating section of the Statement of Cash Flows because it is a noncash expense.

c. After the asset has been retired, there will be no effect on the financial statements. No further depreciation will be recorded in the income statement. The fully depreciated asset will be removed from the balance sheet, having no effect on total assets, and there is no cash flow effect.

P5-7

a. In the first year of a company's life, the requirement that R&D costs be expensed as incurred increases total expenses and decreases net income in the income statement. Since companies are not allowed to capitalize the research, assets and equity are less on the balance sheet. There is no difference on the statement of cash flows since the amount of cash paid for R&D is the same regardless of how it is accounted for on the income statement and balance sheet. (In the indirect cash flow method, there would be an expenditure under investments. It would be like the treatment for depreciation.)

b. In subsequent years, expenses on the income statement will be lower than they would have been, as the company would have been amortizing the capitalized research. Income will be higher. Assets on the balance sheet would

be lower due to the absence of capitalized R&D. Because the entire amount was expensed in the year incurred, retained earnings will be lower by the difference between the R&D that was expensed in the first year and the cumulative total of R&D that would have been expensed each year by amortizing the capitalized R&D. The difference will "wash out" after 10 years.

P5-8

a. If an acquiring company writes off in-process R&D, its expenses will be greater and income less in the year of the write-off. Assets will be lower and equity will be lower. The write-off does not affect cash, as the amount paid for the acquired company will be the same regardless of how the R&D is accounted for. However, since it is a non-cash expense, it would be added back in the operating section to determine cash provided by operating activities in the statement of cash flows.

b. In the year after the write-off, income will be greater, since the amount of assets to be depreciated and amortized will be less than they would have been if the in process R&D had been capitalized. This will result in lower depreciation expense and higher income. Assets on the balance sheet will be less than they would have been and retained earnings will be less than it would have been. (The difference in retained earnings will be the difference between the R&D written off in the first year and the cumulative amortization expense that was not recorded). Over the useful life of the assets acquired, the difference will "wash out." The cash flow statement will not be affected.

c. By writing off in-process R&D, an acquiring firm reduces the depreciation and amortization expense in future years. This will result in much higher earnings than would have been reported if the R&D had been capitalized. In addition, because there are often significant acquisition costs, companies often take a "big bath" of expenses in the year of acquisition. The in-process R&D costs tend to get "lost in the shuffle" of all of the merger related costs. By comparison, subsequent years' earnings will be greater. Financial ratios such as earnings per share, return on assets and return on equity will be overstated in future accounting periods.

d. The SEC felt that significant abuses were taking place related to in-process R&D. In a speech before the Software and Service Industry Analyst Group on 2/10/99, Lynn E. Turner, the Chief Accountant of the SEC discussed some of the abuses that had taken place related to this account. He identified the following concerns:

- Some believe that unreasonably large write-offs of purchased R&D are being used to hype a company's stock price.

- The excess up-front write-offs avoid future amortization and depreciation expense, resulting in higher earnings, higher earnings per share,

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higher return on assets, and higher return on equity.

•Since the in-process R&D was valued based on expected future cash flows to be derived from it, investors' future expectations of the value of future projects are overly optimistic if the in-process R&D is overstated. (Source: Securities and Exchange Commission)

Refer to answer c for the reasons that companies would want to write off as much as possible to this account.

P5-9

a.	Restructuring expenses	100,000,000
	Estimated liability for restructuring costs	
		100,000,000

b. Expenses will be higher and net income will be lower in the income statement. Liabilities will increase and retained earnings will decrease in the balance sheet. The accrual is a noncash expense that will be added back to net income to determine cash provided by operating activities in the statement of cash flows.

c. The income statement will not be affected in the period the restructuring costs take place. On the balance sheet, the asset cash will decrease and the estimated liability for restructuring costs will decrease. In the cash flow statement, cash flows from operating activities will decrease as the company pays cash for the actual restructuring costs.

d. By intentionally overestimating restructuring costs, the company will show lowered earnings in the year that the costs are accrued. If the actual restructuring costs are less than what was estimated, the difference will flow through to the income statements of the future periods when those restructuring costs are actually paid. This makes the subsequent years' comparative income statements look greatly improved over the year the restructuring costs were accrued. Management can justify its bonuses earned because of the improvement to company results. As with in-process R&D, companies tend to take a "big bath" on expenses since many costs get "lost in the shuffle" of the restructuring that is taking place.

P5-10

a. Failure to account for the returns would overstate revenues, overstating income on the income statement. On the balance sheet, the assets accounts receivable would be overstated and retained earnings would be overstated. The cash flow statement would be unaffected, as the fraud represents non-cash transactions.

b. In the first year of the fraud, sales and cost of goods sold will be overstated, resulting in an overstated gross margin and net income. On the balance sheet, accounts receivable will be overstated by the amount of the revenue overstatement and inventory will be understated by the amount of the cost of goods sold overstatement. Retained earnings will be overstated by the amount of the profit overstatement.

c. In the following year, the company will experience the results of "robbing from Peter to pay Paul." Revenues will be understated by the amount of revenue recognized in the previous year. Cost of goods sold will be understated by the amount of cost of goods sold recognized in the previous year. The net result will be an understatement of income equal to the overstatement that was recorded in the previous year. There will be no effect on the company's balance sheet. This is referred to as a "counterbalancing" error in accounting. Because profits were overstated in the first year and understated in the second year, Retained earnings will have the same balance as it would have had if the fraud had not taken place. Assuming that all receivables are collectible and a proper physical inventory is taken at the end of the second year, total assets will be correctly stated. The negative impact on investors is misleading profits and comparative numbers. Also, because the effect "washes out" in the second year, management tends to continue the practice for more than one year. There is no effect on the statement of cash flows, as the total cash flows are the same regardless of when the revenues are recorded.

P5-11

- a. The accounting change will have no effect on Critical Path's assets. If the amounts in question are unearned revenue, this implies that cash has already been collected for services yet to be performed.
- b. The accounting change will increase Critical Path's liabilities. Unearned revenue is a liability.
- c. The accounting change will decrease Critical Path's equity. Revenues will decrease, which will decrease Retained earnings.

P5-12

Management's position:

- The company has a legally binding agreement with Hosoi to provide funeral arrangements.
- The first 30% of the contract is non-refundable.
- The non-refundable portion of the contract is considered earned because it covers initial services performed by GLP.
- Non-consolidation is appropriate because GLFPT is a separate legal entity operating independently of GLP.
- Selling expenses are related to the sale of the initial contract, not the servicing of funerals at a later date and should not be deferred.
- Hosoi, not GLP, would be responsible for additional costs related to funerals not covered by contracts.
- There is no reason to believe that Hosoi will not fulfill its contractual obligation.

If management's position is appropriate, there would be no accounting changes. The results of GLP and GLFPT would not be consolidated.

Auditor's position:

- The earnings process is not complete. The money received on contracts is specifically related to the providing of funeral services to be performed in the future.
- The most important criterion of whether revenue should be recognized (delivery has occurred or services have been rendered) has not been met.
- GLP will be held responsible for additional costs in the event that Hosoi fails to perform its obligations.
- The matching principle is being violated by recognizing selling expenses related to providing funerals before the related revenue of providing the service has been recognized.
- GLP is legally responsible to cover any costs if Hosoi is unable to fulfill

its contract. GAAP require that a company disclose contingencies where it is "reasonably possible" that payments may be required in the future.

- Consolidation should take place between GLP and GLFPT because the Prepaid Funeral Service Contract gives GLP absolute authority to control the actions of GLFPT. GLP is responsible to the contract holders for fulfillment if GLFPT assets are insufficient to meet the need.
- Consolidation should take place because more than a nominal capital investment in GLFPT has been made by GLP and the risks and rewards of the assets or debt of GLFPT remains with GLP. The two are "in substance" one entity even if "in form" they are two separate entities.
- The time value of money and inflation may make it impossible to make a profit providing the service in the future when actual costs may escalate dramatically.

Changes that would take place if the auditor's position were used:

Income Statement: Revenues would decrease; selling expenses would decrease; net income would decrease.

Balance sheet: Prepaid expenses related to the deferred selling expenses would increase; unearned revenue would increase; total assets and total liabilities would increase due to the consolidation of GLP and GLFPT. Equity would decrease by the amount of the decrease in net income.

Cash flow statement: Neither position will change the cash flows of the company.