

[LIFO-FIFO, R&D capitalization]

Schering-Plough Corporation is a holding company which was incorporated in 1970. Subsidiaries of Schering-Plough Corporation are engaged in the discovery, development, manufacturing and marketing of pharmaceutical and health care products worldwide. Products include prescription drugs, animal health, over-the-counter (OTC), foot care and sun care products. Enclosed are the financial statements of Schering-Plough, a six year summary of operations and selected footnotes.

Questions

- 1 What will be the Net Income for the year ending December 31, 1996, for Schering Plough if it uses the FIFO method for all inventories - domestic and foreign ?
- 2 What will be the Net Income for the year ending December 31, 1996, for Schering Plough if it uses the LIFO method for all inventories - domestic and foreign? Note that as reported in the financial statements, Schering Plough uses LIFO only for a fraction of the total inventories.
- 3 Compute the current ratio as of December 31, 1996, as reported and using the FIFO method for all inventories - domestic and foreign.
- 4 Compute the inventory turnover ratio as reported, using the FIFO method for all inventories - domestic and foreign and using the current cost method for all inventories - domestic and foreign.

Use the following "Six-Year Selected Financial & Statistical Data" for these questions.

- 5 What is the return on equity for Schering Plough in years ending December 1994-1996 ? Suppose you capitalize the research and development expenditures of Schering Plough. Assume that all R & D expenditures were spent on July 1 of each year in one shot and that all R & D assets are amortized over 3 years. So in the first year one sixth of the expenditure will be expensed and the rest capitalized.
- 6 Compute the R & D expense and Net Income with R & D capitalized for years ending December 31, 1994 to 1996.
- 7 Compute the shareholder's equity with R & D capitalized on December 31, 1994 to 1996.
- 8 Compute the return on equity of Schering Plough with R & D capitalized for years ending December 31, 1994 to 1996.
- 9 Comment on the direction of change and variability of Net Income, Return on Equity due to the capitalization of R & D expenditures.

Six-Year Selected Financial & Statistical Data

(in millions, except per share figures)

Operating Results	1996	1995	1994	1993	1992	1991
Sales	5,655.8	5,104.4	4,536.6	4,229.1	3,944.6	3,475.4
Income before income taxes	1,606.4	1,394.7	1,226.7	1,073.1	962.8	847.6
Income from cont. operations*	1,212.8	1,053.0	926.2	815.6	722.1	635.7
Net income	1,212.8	886.6	922.0	730.8	720.4	645.6
Property, net	2,246.3	2,098.9	2,082.3	1,967.7	1,748.5	1,490.4
Total assets	5,398.1	4,664.6	4,325.7	4,316.9	4,156.6	4,013.2
Long-term debt	46.4	87.1	185.8	182.3	184.1	753.6
Shareholders' equity	2,059.9	1,622.9	1,574.4	1,581.9	1,596.9	1,346.1
Average Shareholders' equity	1,841.4	1,598.7	1,578.2	1,589.4	1,471.5	673.1
Effective tax rate	24.50%	24.50%	24.50%	24.00%	25.00%	25.00%
Cash dividends	474.0	416.4	379.4	339.6	300.2	273.6
Depreciation and amortization	173.2	157.1	144.6	130.9	124.5	118.0
Number of employees	20,600	20,100	20,000	20,300	19,800	19,000
Average shares outstanding	367.7	369.7	382.5	390.2	400.3	429.0
Shares outstanding at year-end	365.4	364.2	372.0	387.1	399.0	403.6
Research and development	722.8	656.9	610.1	567.3	510.5	416.5
Capital expenditures	324.5	293.8	268.2	339.9	372.8	319.2

* Income from continuing operations before extraordinary item and cumulative effect of accounting changes

Consolidated Balance Sheets

(Dollars in millions, except per share figures)

At December 31,

1996**1995****Assets****Current Assets:**

Cash and cash equivalents.	535.1	321.4
Accounts receivable, less allowances: 1996, \$73.0; 1995, \$73.0	542.0	569.3
Inventories.	594.1	502.0
Prepaid expenses, deferred income taxes and other current assets.	693.4	563.6
Total current assets	2,364.6	1,956.3

Property, at cost:

Land	41.3	41.4
Buildings and improvements	1,562.6	1,528.2
Equipment.	1,296.3	1,250.8
Construction in progress	462.3	315.6
Total.	3,362.5	3,136.0
Less accumulated depreciation.	1,116.2	1,037.1
Property, net.	2,246.3	2,098.9
Other Assets.	787.2	609.4
	5,398.1	4,664.6

Liabilities and Shareholders' Equity**Current Liabilities:**

Accounts payable	560.6	509.5
Short-term borrowings and current portion of long-term debt	855.1	841.3
U.S., foreign and state income taxes	458.7	384.2
Accrued compensation	205.3	205.1
Other accrued liabilities.	519.4	422.0
Total current liabilities.	2,599.1	2,362.1

Long-Term Liabilities:

Long-term debt	46.4	87.1
Deferred income taxes.	267.4	255.1
Other long-term liabilities.	425.3	337.4
Total long-term liabilities.	739.1	679.6

Shareholders' Equity:

Common shares - 600,000,000 authorized shares, \$1 par value; issued - 1996, 507,368,360; 1995, 502,965,000	507.4	503.0
Paid-in capital.	172.3	49.5
Retained earnings.	5,080.6	4,341.8
Foreign currency translation adjustment and other	(140.6)	(103.9)
Total.	5,619.7	4,790.4
Less treasury shares, at cost - 1996, 142,001,799 shares; 1995, 138,796,653 shares	3,559.8	3,167.5
Total shareholders' equity	2,059.9	1,622.9
	5,398.1	4,664.6

See Notes to Consolidated Financial Statements.

Schering-Plough Corporation and Subsidiaries**Statements of Consolidated Income** (Dollars in millions, except per share figures)

For The Years Ended December 31,	1996	1995	1994
Sales	5,655.8	5,104.4	4,536.6
Costs and expenses:			
Cost of sales	1,077.8	1,004.8	906.8
Selling, general and administrative	2,209.1	1,990.4	1,755.5
Research and development.	722.8	656.9	610.1
Other expense, net.	39.7	57.6	37.5
Total costs and expenses	4,049.4	3,709.7	3,309.9
Income before income taxes.	1,606.4	1,394.7	1,226.7
Income taxes.	393.6	341.7	300.5
Income from continuing operations	1,212.8	1,053.0	926.2
Discontinued operations:			
Loss from operations	-	(10.2)	(4.2)
Loss on disposal	-	(156.2)	-
Net income.	1,212.8	886.6	922.0
Earnings per common share:			
Continuing operations.	\$3.30	\$2.85	\$2.42
Discontinued operations:			
Loss from operations	-	(\$0.03)	(\$0.01)
Loss on disposal.	-	(\$0.42)	-
Earnings per common share	\$3.30	\$2.40	\$2.41

See Notes to Consolidated Financial Statements.

Notes to Consolidated Financial Statements**Accounting Policies**

(Dollars in millions, except per share figures)

Inventories

Inventories are valued at the lower of cost or market. Cost is determined by using the last-in, first-out method for substantially all domestic inventories. The cost of all other inventories is determined by the first-in, first-out method. Year-end inventories consisted of the following:

	1996	1995
Finished products	296.7	213.2
Goods in process.	173.0	179.4
Raw materials and supplies.	124.4	109.4
Total inventories	594.1	502.0

Inventories valued on a last-in, first-out basis comprised approximately 45 percent and 39 percent of total inventories at December 31, 1996 and 1995, respectively. The estimated replacement cost of total inventories at December 31, 1996 and 1995 was \$644.5 and \$549.7, respectively.

Income Taxes

U.S. and foreign operations contributed to income before income taxes as follows:

	1996	1995	1994
United States.	1,090.6	916.7	765.6
Foreign.	515.8	478.0	461.1
Total income before income taxes	1,606.4	1,394.7	1,226.7

The components of income tax expense were as follows:

Current:			
Federal.	296.5	262.1	120.6
Foreign.	122.0	93.7	119.2
State.	13.7	29.3	19.6
Total current.	432.2	385.1	259.4
Deferred:			
Federal and state.	(24.5)	(23.1)	51.3
Foreign.	(14.1)	(20.3)	(10.2)
Total deferred	(38.6)	(43.4)	41.1
Total income tax expense	393.6	341.7	300.5

The difference between the U.S. statutory tax rate and the Company's effective tax rate was due to the following:

	1996	1995	1994
U.S. statutory tax rate.	35.00%	35.00%	35.00%
Increase (decrease) in taxes resulting from:			
Lower rates in other jurisdictions, net	(10.30)%	(10.70)%	(9.80)%
Research tax credit.	(0.40)%	(0.30)%	(0.60)%
All other, net	0.02%	0.50%	(0.10)%
Effective tax rate	24.32%	24.50%	24.50%

The lower rates in other jurisdictions are primarily attributable to certain employment and capital investment actions taken by the Company. As a result, income from manufacturing activities in these jurisdictions is subject to lower tax rates for years through 2010.

As of December 31, 1996 and 1995, the Company had total deferred tax assets of \$485.3 and \$426.6, respectively, and deferred tax liabilities of \$406.7 and \$379.5, respectively. Valuation allowances are not significant. Significant deferred tax assets at December 31, 1996 and 1995 were for operating costs not currently deductible for tax purposes and totaled \$374.2 and \$302.7, respectively. Significant deferred tax liabilities at December 31, 1996 and 1995 were for depreciation differences, \$219.0 and \$207.4, respectively, and retirement plans, \$47.0 and \$41.0, respectively. Other current assets include deferred income taxes of \$344.5 and \$300.9 at December 31, 1996 and 1995, respectively.

Deferred taxes are not provided on undistributed earnings of foreign subsidiaries (considered to be permanent investments), which at December 31, 1996, approximated \$2,181.7. Determining the tax liability that would arise if these earnings were remitted is not practicable.

As of December 31, 1996, the U.S. Internal Revenue Service has completed its examination of the Company's tax returns for all years through 1988 and there are no unresolved issues outstanding for those years. Total income tax payments during 1996, 1995 and 1994 were \$306.2, \$318.9 and \$173.1, respectively.