

ATC 7-7 Corporate Governance *Sometimes debt is not debt*

David Sheridan was a well-respected CPA in his mid-fifties. After spending 10 years at a national accounting firm, he was hired by Global, Inc., a multinational corporation headquartered in the United States. He patiently worked his way up to the top of Global's accounting department and in the early 1990s, took over as chief financial officer for the company. As the Internet began to explode, management at Global, Inc., decided to radically change the nature of its business to one of e-commerce. Two years after the transition, Internet commerce began to slow down, and Global was in dire need of cash in order to continue operations. Management turned to the accounting department.

Global, Inc., needed to borrow a substantial amount of money but couldn't afford to increase the amount of liabilities on the balance sheet for fear of the stock price dropping and banks becoming nervous and demanding repayment of existing loans. David discovered a way that would allow the company to raise the needed cash to continue operations without having to report the long-term notes payable on the balance sheet. Under an obscure rule, companies can set up separate legal organizations that do not have to be reported on the parent company's financial statements, if a third party contributes just 3 percent of the start-up capital. David called a friend, Brian Johnson, and asked him to participate in a business venture with Global. Brian agreed, and created a special purpose entity with Global named BrianCo. For his participation, Brian was awarded a substantial amount of valuable Global stock. Brian then went to a bank and used the stock as collateral to borrow a large sum of money for BrianCo. Then, Global sold some of its poor or underperforming assets to BrianCo for the cash that Brian borrowed. In the end, Global got rid of bad assets, received the proceeds of the long-term note payable, and did not have to show the liability on the balance sheet. Only the top executives and the accountants that worked closely with David knew of the scheme, and they planned to use this method only until the e-commerce portion of Global became profitable again.

Required

- How did David's scheme affect the overall appearance of Global's financial statements? Why was this important to investors and creditors?
- Review the AICPA's Articles of Professional Conduct (see Chapter 1) and comment on any of the standards that have been violated.
- Name the features of the fraud triangle and explain how they materialize in this case.

ATC 7-8 Research Assignment *Analyzing long-term debt at Union Pacific Railroad*

Many companies have a form of debt called *capital leases*. A capital lease is created when a company agrees to rent an asset, such as equipment or a building, for such a long time that GAAP treats the lease as if the asset were purchased using borrowed funds. A capital lease creates a liability for the company that acquired the leased asset because it has promised to make payments to another company for several years in the future. If a company has any capital leases, it must disclose them in the footnotes to the financial statements, and will sometimes disclose them in a separate account in the liabilities section of the balance sheet.

Using the most current Forms 10-K for Union Pacific Corporation, complete the requirements below. To obtain the 10-Ks use either the EDGAR system following the instructions in Appendix A, or the company's website.

Required

- What was Union Pacific's debt to assets ratio? (You will need to compute total liabilities by subtracting "Common shareholders' equity" from total assets.)
- How much interest expense did Union Pacific incur?
- What amount of liabilities did Union Pacific have as a result of capital leases? Footnote 5 presents information about Union Pacific's leases.
- What percentage of Union Pacific's long-term liabilities was the result of capital leases?
- Many companies try to structure (design) leasing agreements so their leases will *not* be classified as capital leases. Explain why a company such as Union Pacific might want to avoid reporting capital leases.

Part of
DD-1



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Survey of Accounting,
Second Edition

8. Proprietorships,
Partnerships, and
Corporations

Text

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ATC 8-5 Business Applications Case Using the P/E ratio

During 2010, Jason Corporation and Fitzgerald Corporation reported net incomes of \$7,000 and \$9,600, respectively. Each company had 2,000 shares of common stock issued and outstanding. The market price per share of Jason's stock was \$50, while Fitzgerald's stock sold for \$85 per share.

Required

- a. Determine the P/E ratio for each company.
- b. Based on the P/E ratios computed in Requirement a, which company do investors believe has more potential for growth in income?

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ATC 8-6 Writing Assignment Comparison of organizational forms

Jim Baku and Scott Hanson are thinking about opening a new restaurant. Baku has extensive marketing experience but does not know that much about food preparation. However, Hanson is an excellent chef. Both will work in the business, but Baku will provide most of the funds necessary to start the business. At this time, they cannot decide whether to operate the business as a partnership or a corporation.

Required

Prepare a written memo to Baku and Hanson describing the advantages and disadvantages of each organizational form. Also, from the limited information provided, recommend the organizational form you think they should use.

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ATC 8-7 Ethical Dilemma Bad news versus very bad news

Louise Stinson, the chief financial officer of Bostonian Corporation, was on her way to the president's office. She was carrying the latest round of bad news. There would be no executive bonuses this year. Corporate profits were down. Indeed, if the latest projections held true, the company would report a small loss on the year-end income statement. Executive bonuses were tied to corporate profits. The executive compensation plan provided for 10 percent of net earnings to be set aside for bonuses. No profits meant no bonuses. While things looked bleak, Stinson had a plan that might help soften the blow.

After informing the company president of the earnings forecast, Stinson made the following suggestion: Since the company was going to report a loss anyway, why not report a big loss? She reasoned that the directors and stockholders would not be much more angry if the company reported a large loss than if it reported a small one. There were several questionable assets that could be written down in the current year. This would increase the current year's loss but would reduce expenses in subsequent accounting periods. For example, the company was carrying damaged inventory that was estimated to have a value of \$2,500,000. If this estimate were revised to \$500,000, the company would have to recognize a \$2,000,000 loss in the current year. However, next year when the goods were sold, the expense for cost of goods sold would be \$2,000,000 less and profits would be higher by that amount. Although the directors would be angry this year, they would certainly be happy next year. The strategy would also have the benefit of adding \$200,000 to next year's executive bonus pool ($\$2,000,000 \times 0.10$). Furthermore, it could not hurt this year's bonus pool because there would be no pool this year since the company is going to report a loss.

Some of the other items that Stinson is considering include (1) converting from straight-line to accelerated depreciation, (2) increasing the percentage of receivables estimated to be uncollectible in the current year and lowering the percentage in the following year, and (3) raising the percentage of estimated warranty claims in the current period and lowering it in the following period. Finally, Stinson notes that two of the company's department stores have been experiencing losses. The company could sell these stores this year and thereby improve earnings next year. Stinson admits that the sale would result in significant losses this year, but she smiles as she thinks of next year's bonus check.

Required

- a. Explain how each of the three numbered strategies for increasing the amount of the current year's loss would affect the stockholders' equity section of the balance sheet in the current year. How would the other elements of the balance sheet be affected?

