CHAPTER 5 – CASES TO ACCOMPANY THE FINANCIAL ACCOUNTING RESEARCH SYSTEM (FARS)

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Case 3: Charitable Contributions and Debt: A Comparison of St. Jude Children’s Research Hospital/ALSAC and Universal Health Services
Case 4: Clarus Corporation: Recurring Revenue Recognition
Case 5: When Would Market to Book Be Less Than One? Does Acquisition by Stock Explain JDS Uniphase Corp.?
Case 6: UPS: The Tax Environment and Disclosure of Contingencies
Case 7: Embezzlement-Related Disclosures: Compliance with Guidance?
Case 8: What Constitutes a Subsequent Event? Related Gain Contingency Considerations
Case 9: Reconciling International Practices to Those of the FASB: Cash Flow
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CASE 1

New Financing: Do Credit Agreements Pose Unique Accounting and Disclosure Challenges? Gunther International

CASE TOPICS OUTLINE

1. Terms of New Credit Arrangement
   A. Restructuring
   B. Guarantors
2. Collateral
3. Subordination
4. Warrants
   A. Valuation
   B. Disclosure
   C. Context
5. Rights Offering

Gunther International has had a rocky road, financially. You joined the company upon graduation and recall having heard about it being significantly restructured in September 1992. It was then that two shareholders assumed control of the corporation and infused additional capital. Your department has been rocked by recent discoveries of accounting issues that have caused a delay in reported numbers. You assisted in crafting the language that appeared in the 8-K filing:

Item 5. Other Events.

On June 23, 1998, the registrant issued a press release announcing that it does not expect to release its final results for the fourth quarter and the full fiscal year ended March 31, 1998 until later in July 1998. A copy of the press release is attached hereto as an exhibit. During the course of the year-end audit, the Company’s auditors, Arthur Andersen LLP, identified errors in the accumulation of contract costs and certain items of expense that were not properly accounted for. The Company, with the assistance of its auditors, is continuing to review the nature and extent of these matters, as well as the effect these matters may have on the Company’s financial results. Based on the information that is available at this time, the Company currently expects to report a net loss for the fiscal year ended March 31, 1998 of approximately $2.4 to $3.0 million. The Company also expects
to restate its results for each of the first three quarters of fiscal 1998. Previously issued financial statements for the interim periods of fiscal 1998 should not be relied upon.

The net losses referred to above are expected to result in a violation of certain financial covenants contained in the Company’s senior credit facility. The Company has informed representatives of its senior lender about these matters and intends to meet with them to discuss a satisfactory resolution of the situation. If a satisfactory resolution is not reached, the Company may suffer an event of default under its senior credit facility and the Company’s ability to continue to borrow thereunder may be impaired.

The Company is moving forward at an aggressive pace to definitively announce its financial results as quickly as possible. The Company continues to maintain a large installed base of customers using its products and believes that its products continue to be well received in the market place. The Company expects to have a record backlog of sales under contract in excess of $5 million as of June 30, 1998.

The Company’s expectations are preliminary and are subject to the completion of its year-end audit. The estimated amount of loss, anticipated release of final results and the potential consequences of these matters, including without limitation the resolution of expected violations under the Company’s senior credit facility discussed in this report constitute forward-looking statements, and the Company’s actual results could differ from those discussed above . . . . (Source: 8-K filed 6/23/98)

As the 8-K suggests, a good deal of uncertainty surrounds the financing arrangements of the company going forward. The treasurer’s department has been working long hours to explore the options. They requested financial numbers under the existing, though somewhat tenuous financing arrangement. While in preliminary form, assume you have access to something similar to what eventually appeared as the restated financial disclosures in Tables 5.1-1 and 5.1-2.

**Table 5.1-1  Summary Financial Data—Income Statement Related***

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Systems</td>
<td>$ 8,630,103</td>
<td>$ 8,716,473</td>
<td>$ 8,458,700</td>
</tr>
<tr>
<td>Maintenance</td>
<td>6,454,716</td>
<td>4,911,794</td>
<td>4,022,562</td>
</tr>
<tr>
<td>Total Sales</td>
<td>15,084,819</td>
<td>13,628,267</td>
<td>12,481,262</td>
</tr>
<tr>
<td><strong>Cost of Sales:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Systems</td>
<td>7,030,092</td>
<td>5,573,323</td>
<td>5,821,526</td>
</tr>
<tr>
<td>Maintenance</td>
<td>4,771,692</td>
<td>4,088,858</td>
<td>2,826,853</td>
</tr>
<tr>
<td>Total Cost of Sales</td>
<td>11,801,784</td>
<td>9,662,181</td>
<td>8,648,379</td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td>3,283,035</td>
<td>3,966,086</td>
<td>3,832,883</td>
</tr>
<tr>
<td><strong>Operating Expenses:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Selling and Administrative</td>
<td>5,050,863</td>
<td>4,680,946</td>
<td>4,213,832</td>
</tr>
<tr>
<td>Research and Development</td>
<td>618,735</td>
<td>435,404</td>
<td>255,243</td>
</tr>
</tbody>
</table>
New Financing: Do Credit Agreements Pose Unique Accounting and Disclosure Challenges? Gunther International

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Operating Expenses</td>
<td>5,669,598</td>
<td>5,116,350</td>
<td>4,469,075</td>
</tr>
<tr>
<td>Operating Loss</td>
<td>(2,386,563)</td>
<td>(1,150,264)</td>
<td>(636,192)</td>
</tr>
<tr>
<td>Other Expenses:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Expense, Net</td>
<td>(245,552)</td>
<td>(184,426)</td>
<td>(243,363)</td>
</tr>
<tr>
<td>Net Loss</td>
<td>$(2,632,115)</td>
<td>$(1,334,690)</td>
<td>$(879,555)</td>
</tr>
<tr>
<td>Net Loss Per Share</td>
<td>$ (0.61)</td>
<td>$ (0.32)</td>
<td>$ (0.23)</td>
</tr>
</tbody>
</table>

*The summary financial data presented should be read in conjunction with the information set forth in the financial statements and notes thereto. Source: January 14, 1999 10-KSB/A filing by Gunther International.

Table 5.1-2  Summary Financial Data—Balance Sheet Related*

<table>
<thead>
<tr>
<th></th>
<th>1998 (As Restated)</th>
<th>1997 (As Restated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>$3,118,386</td>
<td>$3,616,493</td>
</tr>
<tr>
<td>Total Assets</td>
<td>8,036,929</td>
<td>8,663,040</td>
</tr>
<tr>
<td>Current Liabilities</td>
<td>7,981,871</td>
<td>5,661,800</td>
</tr>
<tr>
<td>Long-Term Debt, less current maturities</td>
<td>1,884,551</td>
<td>2,213,618</td>
</tr>
<tr>
<td>Stockholders’ Equity (Deficit)</td>
<td>(1,829,493)</td>
<td>787,622</td>
</tr>
</tbody>
</table>

*The summary financial data presented should be read in conjunction with the information set forth in the financial statements and notes thereto. Source: January 14, 1999 10-KSB/A filing by Gunther International.

The reason for the tenuous situation with the creditors is the reported error that resulted in the debt covenant violations on the line of credit held by Bank of Boston. Credit agreements, often the lifeblood of a company, can take a variety of forms, with diverse covenants and commitments. Gunther’s solution to this covenant violation has been to find new financing and pay off the line of credit with the Bank of Boston. You have worked with colleagues in both the controller’s office and the treasurer’s department to craft the following language for inclusion in yet another 8-K filing:

GUNThER ANNOUNCES COMPLETION OF COMPREHENSIVE FINANCING TRANSACTION

NORWICH, CT (October 2, 1998)—Gunther International, Ltd. (NASDAQ: SORT) today announced it has successfully completed a comprehensive $5.7 million financing transaction, the proceeds of which have been utilized to completely restructure and replace the Company’s pre-existing senior line of credit, fund a full settlement with the Company’s third party service provider, and provide additional working capital to fund the Company’s ongoing business operations.

Under the terms of the transaction, a newly formed limited liability company organized by the Tisch Family Interests and Mr. Robert Spiegel (the “New Lender”) loaned an aggregate of $4 million to the Company. At the same time, the Company’s senior lender reached an agreement with the guarantor of a portion of the Company’s senior line of credit (the “Guarantor”) whereby the Guarantor consented to the liquidation of approximately $1.7 million of collateral and the application of the proceeds of such
collateral to satisfy and repay in full a like amount of indebtedness outstanding under the
senior credit facility. The balance of the indebtedness outstanding under the senior credit
facility, approximating $350,000, was repaid in full from the proceeds of the new
financing. The Company executed a new promissory note in favor of the Guarantor
evidencing the Company’s obligation to repay the amount of the collateral that was
liquidated by the senior lender. The Company’s obligations to the Guarantor are
completely subordinated to the Company’s obligations to the New Lender. In addition,
approximately $1.4 million of the new financing was utilized to pay the Company’s third
party service provider all amounts that were due and owing to the service provider for
performing maintenance on Company systems.

To induce the New Lender to enter into the financing transaction, the Company, the
New Lender, Park Investment Partners, Gerald H. Newman, the estate of Harold S.
Geneen (the “Estate”), Four Partners, and Robert Spiegel entered into a separate voting
agreement, pursuant to which they each agreed to vote all shares of Gunther stock held by
them in favor of (i) that number of persons nominated by the New Lender constituting a
majority of the Board of Directors, (ii) one person nominated by the Estate and (iii) one
person nominated by Park Investment Partners. In addition, the Company granted the New
Lender a stock purchase warrant entitling the New Lender, any time during the period
commencing on January 1, 1999 and ending on the fifth anniversary of the transaction, to
purchase up to 35% of the pro forma, fully diluted number of shares of the Common Stock
of the Company, determined as of the date of exercise. The exercise price of the warrant is
$1.50 per share.

Contemporaneously with the consummation of the transaction, Frederick W. Kolling
III and James H. Whitney resigned from the Board of Directors, and Thomas Steinberg
and Robert Spiegel were elected to fill the vacancies created by the resignations. Another
inside director, Alan W. Morton, resigned from the Board prior to the consummation of
the transactions.

The Company is continuing to review the previously announced issues regarding the
accumulation of contract costs and the recognition of revenues and expenses relating to
the Company’s systems business. The Company expects to be in a position to release
information concerning the results of the review by the end of October.

Gunther International, Ltd. is a leading manufacturer of intelligent document
finishing systems and ink jet printing solutions. (Source: 8-K, filed 10/7/98)

Requirement A.1: Disclosure

As soon as the 8-K is released, the company’s attention is directed toward the anticipated filing of a
10-K, which will need to provide full disclosure concerning this new financing arrangement in ac-
cordance with generally accepted accounting principles (GAAP). You have been asked to outline all
associated accounting and disclosure issues that arise as a result of this transaction. The intent is that
your outline will become a basis for a joint presentation with the controller to the board of directors.

1. List all relevant FARS references in the order of relevance to the transaction.
2. Clearly set forth permissible alternatives.
3. Draft your recommendation, as to both accounting for and disclosing of the transaction.
Hints Regarding Solution
a. Develop a comprehensive list of search words associated with the transaction.
b. Consider how the former arrangement might have been recorded in comparison to the current transaction, including potential balance sheet, income statement, and cash flow implications.
c. Consider broader disclosure requirements’ association with particular transactions.
d. Context matters to accounting and disclosure decisions. Carefully consider the inter-relationship of the two press releases, giving particular attention to the various stakeholders affected by your recommendations.

Requirement A.2: Interdisciplinary Considerations
The board of directors is expected to be very interested in details concerning the transaction, making it imperative that interdisciplinary considerations be discussed as a part of your presentation.

1. Why is corporate governance so interrelated with credit arrangements?
2. Why are warrants frequently integrated into lending contracts?
3. Do contracts in economic settings generally slip into default when problems with past representations in financial statements arise? Be specific.
4. What are the consequences of delaying financial statement information for four months or longer?
5. Describe and justify a management strategy for Gunther International, in light of these past events.

Requirement B: Subsequent Filings
On January 14, 1999, Gunther International filed a 10-KSB/A (accessible at http://www.sec.gov) that contained the following disclosures:

The undersigned registrant hereby amends its Annual Report on Form 10-KSB for the fiscal year ended March 31, 1998 to amend Items 6 and 7 of Part II and Item 13 of Part III, as set forth in this amendment.

ITEM 6. MANAGEMENT’S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS. SUMMARY OF RECENT EVENTS . . . The Audit Committee’s review has since been completed and it has been determined that accounts receivable were overstated and accounts payable and deferred service revenues were understated at March 31, 1997 and costs and estimated earnings in excess of billings on uncompleted contracts were overstated at March 31, 1998. As a result, the accompanying financial statements and management’s discussion and analysis of financial condition and results of operations include restated results as of and for the years ended March 31, 1997 and 1998. Also, certain amounts were reclassified between selling and administrative expenses, cost of sales, and research and development expenses to more appropriately reflect the results of operations. The effect of the restatement for the year ended March 31, 1997 was to reduce operating results to a net loss of $(1,334,690), or $(0.32) per share, from net income of $258,889, or $0.06 per share. The effect of the restatement for the year ended March 31,
1998 was to decrease the net loss to $(2,632,115), or $(0.61) per share, from a net loss of $(2,701,819), or $(0.63) per share.

On October 2, 1998, the Company entered into a $5.7 million comprehensive financing transaction with the Bank of Boston, Connecticut, N.A. (the “Bank”), the Estate of Harold S. Geneen (the “Estate”) and Gunther Partners LLC (the “New Lender”), the proceeds of which have been utilized to restructure and replace the Company’s pre-existing senior line of credit, fund a full settlement with the Company’s third party service provider and provide additional working capital to fund the Company’s ongoing business operations. Under the terms of the transaction, the New Lender loaned an aggregate of $4.0 million to the Company. At the same time, the Bank reached an agreement with the Estate, which had guaranteed a portion of the Company’s senior line of credit, whereby the Estate consented to the liquidation of approximately $1.7 million of collateral and the application of the proceeds of such collateral to satisfy and repay in full a like amount of indebtedness outstanding under the senior credit facility. The balance of the indebtedness outstanding under the senior credit facility, approximately $350,000, was repaid in full from the proceeds of the new financing. The Company executed a new promissory note in favor of the Estate evidencing the Company’s obligation to repay the amount of the collateral that was liquidated by the Bank. The Company’s obligations to the Estate are subordinated to the Company’s obligations to the New Lender. The principal balance of the $4.0 million debt is to be repaid in monthly installments of $100,000 from November 1, 1998 and continuing to and including September 1, 1999, $400,000 on October 1, 1999 and the balance shall be due on October 1, 2003. Interest shall be paid quarterly, at the rate of 8% per annum, beginning January 1, 1999 and continuing until the principal and interest due is paid in full. The debt is secured by a first priority interest in all tangible and intangible property and a secondary interest in patents and trademarks. . . .

The promissory note in favor of the Estate for approximately $1.7 million is to be repaid at the earlier of one year after the Company’s obligations to the New Lender are paid in full or on October 2, 2004. Interest, at 5.44% per annum, shall accrue on principal and unpaid interest, which is added to the outstanding balance and is due at the time of principal payments. The indebtedness is secured by all tangible and intangible personal property of the Company but is subordinated to all rights of the New Lender. (Source: January 14, 1999, 10-KSB/A filing by Gunther International)

1. Given these subsequent disclosures, would you propose any adjustments to the accounting or disclosure suggestions you presented prior to the resolution of the restatement? Explain the basis for your response.
2. Would you expect the new lender to make any adjustments to the current contractual arrangement when the credit arrangement is reconsidered at renewal?
3. What would be the accounting or disclosure implications of your expectations? Explain how the following subsequent development might influence your expectations, if you were requested to update your evaluation as of July 1999.

On June 29, 1999, a 10-KSB filing states within the Management’s Discussion and Analysis (Item 6, Subhead Liquidity and Capital Resources):

The company did not make its required payments on their respective due dates and certain other information required by the loan agreement was not provided to the New Lender.
The New Lender waived these deficiencies. As of March 31, 1999, all amounts due on the debt had been paid. . . .

In the event the Company is unable to meet its payment obligations through April 1, 2000, in accordance with the Note Loan and Security Agreement, the new Lender will be willing to renegotiate the payment terms based upon available cash flow such that the payment terms would be acceptable to both the Company and the Lender. *(Source: 10-KSB filing 6/29/99)*

**Requirement C: The Aftermath**

At fiscal year ended March 31, 2001, in its 10-KSB/A filing as of July 3, 2001, events associated with the past financing arrangements are detailed, alongside the following disclosure:

Through June 30, 1999, the Company had made principal payments to Gunther Partners LLC aggregating $800,000, plus interest. In September 1999, the Company experienced a deficiency in operating cash flow and Gunther Partners LLC agreed to lend the Company an additional $800,000 and to otherwise restructure the payment terms of the note. As amended, the outstanding balance due Gunther Partners LLC is due in principal installments of $200,000 commencing on October 1, 2001 through April 1, 2002; $100,000 on May 1, 2002; and $2,500,000 on October 1, 2003. If, at any time prior to October 1, 2001, the accumulated deficit of the Company improves by $1.0 million or more compared to the amount at June 30, 1999 of $14.4 million (a “Triggering Event”), then the principal payments otherwise due from October 1, 2001 through May 1, 2002 shall . . . become due in consecutive monthly installments beginning on the first day of the second month following the Triggering Event. On April 4, 2000, the Company borrowed an additional $500,000 from Gunther Partners LLC.

In June 2001, the Company entered into a recapitalization agreement (the “Recapitalization Agreement”) with the Estate, Gunther Partners LLC and certain other stockholders. The Recapitalization Agreement provides that the Company will effectuate a registered public offering (“Rights Offering”) of up to 16,000,000 shares of its Common Stock (the “Offered Shares”) to its existing stockholders by subscription right on a pro-rata basis at a subscription price of $0.50 per share. The rights to subscribe to the Offered Shares will be granted at a ratio to be determined by the Board of Directors of the Company (the “Basic Subscription Right”). In addition, the Company’s stockholders will be granted the right to “oversubscribe” for additional shares not purchased by other stockholders, up to the total amount of the Offered Shares (the “Oversubscription Right”). In the event that the Company’s stockholders, other than Gunther Partners LLC, do not subscribe for and purchase all 16,000,000 of the Offered Shares, Gunther Partners LLC will subscribe for and purchase from the Company in the Rights Offering a number of shares equal to 16,000,000 less the number of shares subscribed for stockholders other than Gunther Partners LLC, up to a maximum of 14,000,000 shares. The net proceeds of the Rights Offering (a minimum of $7 million less offering expenses), will be used to repay in full the notes payable to Gunther Partners LLC ($4.5 million) and a stockholder and director ($500,000), to purchase all notes payable to the Estate for a total of $500,000 and to purchase 919,568 shares of the Company’s Common Stock held by the Estate for $137,935 (or $0.15 per share). The balance of the net proceeds from the Rights Offering
will be used for general working capital purposes. (Source: Gunther International Ltd 10-KSB/A 7/30/2001)

1. How much of the net proceeds from the rights offering will likely be available for general working capital purposes?
2. Compare the terms of the rights offering to the warrants embedded in the earlier financing arrangement. Why do you believe a rights offering approach is being pursued rather than a shelf registration targeting new shareholders?
3. What disclosures would you recommend be made by the company related to its financing, liquidity, and capital resources?

Directed Self-Study

What happened to Gunther International on December 4, 2003? [Access sec.gov for the answer.]

Key Terms and Glossary

- **balloon payment**: a large final payment on a loan that is repaid in installments.
- **collateral**: assets that agreement gives the creditor the right to repossess and/or to convert into cash if the borrower defaults on the lending arrangement; also referred to as security for a loan, leading to the terminology of secured debt.
- **compound interest**: distinguished from simple interest by reinvesting each interest payment in order to earn more interest.
- **continuous compounding**: assumes continuous compounding of interest rather than compounding at fixed intervals.
- **cum rights**: with rights or rights on, distinguished from ex rights.
- **deficit**: arises in retained earnings when the cumulation of all prior years’ net income or losses, less dividends declared, is negative.
- **ex rights**: purchase of shares not entitled to the rights to buy shares in the company’s rights issue.
- **exercise price**: the price at which the holder of a warrant or similar instrument is permitted to buy the stock or other instrument to which it is convertible or is transferable.
- **funded debt**: matures after more than one year.
- **guarantor**: that individual or entity promising to pay should the borrower default.
- **line of credit**: a credit arrangement that permits a borrower to obtain funds up to a certain amount with prespecified terms, and an associated cost for the unused line of credit.
- **maturity**: that date at which an agreement comes to an end, such as a bond, reaching that date on which repayment is demanded in the absence of a renewal.
- **promissory note**: a written agreement specifying the terms of the debt.
- **restatement**: adjustment of past reported financial statements.
- **restructuring**: when applied to debt, refers to the renegotiation of terms that could include extension of the due date of principal and interest payments, reduction in the rate of interest on existing debt, and/or forgiveness by creditors of a portion of principal or accrued interest; also applied to changes in strategy and operations of a company (e.g., downsizing).
- **rights offering**: the issue of securities to current stockholders that is sometimes referred to as a privileged subscription issue.
- **secured debt**: refers to obligations that if defaulted upon, lead to a first claim on specified assets.
- **subordination**: refers to the rights of a party being legally set behind another’s, such as subordination of debt meaning that claims would not be fulfilled until unsubordinated debt commitments were met; subordinated debt is often called junior debt, receiving payment only after senior debt has been paid in full.
- **warrant**: instrument permitting the purchase of a specified number of shares at a specified dollar amount.
- **working capital**: current assets less current liabilities (i.e., net working capital).
Further Readings


Reilly, David. 2006. “No more ‘stealth restating’—SEC forces companies to highlight earnings changes, not just tack them on to their newest filings.” Wall Street Journal (September 21), pp. C1, C3.


“The creditors are a superstitious sect, great observers of set days and times. Blessed is he that expects nothing for he shall never be disappointed.

—Benjamin Franklin, Poor Richard’s Almanac
CASE 2

Microsoft: Does Income Statement Classification Matter?

CASE TOPICS OUTLINE
1. Microsoft Disclosure
   A. Primary Business Alignment
   B. Direct Cost Recording
2. Consistency of Presentation

Microsoft filed its 10-K on September 28, 1999, and disclosed the following:

Reclassifications. The Company changed the way it reports revenue and costs associated with product support, consulting, MSN Internet access, and certification and training of system integrators. Amounts received from customers for these activities have been classified as revenue in a manner more consistent with Microsoft’s primary businesses. Direct costs of these activities are classified as cost of revenue. Prior financial statements have been reclassified for consistent presentation. Certain other reclassifications have also been made for consistent presentation. (Source: 10-K filed 9/28/99)

The financial statements for 1999 and 1998, as originally reported and as reclassified, are reported in Table 5.2-1.

Requirement: Disclosure and Strategy-Related Considerations

You are a personal financial advisor to a number of clients, one of whom is a sophisticated investor in Microsoft. The client, who just received the September 1999 10-K filing is perplexed as to the meaning of the reclassifications, reflected in Table 5.2-1. Moreover, given the earnings per share effects are zero, the client does not understand why the disclosure was made at all.

1. Explain why Microsoft has provided the detail evidenced in Table 5.2-1. Support your explanation with appropriate citations from FARS.
2. Do you believe that the type of disclosure provided by Microsoft was essential in order for the corporation to comply with GAAP? Why or why not?
Table 5.2-1  Reclassified Historical Income Statements by Year*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating expenses:</td>
<td>$13,222</td>
<td>$13,983</td>
<td>$14,484</td>
<td>$15,262</td>
</tr>
<tr>
<td>Cost of revenue</td>
<td>1,090</td>
<td>2,145</td>
<td>1,197</td>
<td>2,460</td>
</tr>
<tr>
<td>Research and development</td>
<td>1,889</td>
<td>2,030</td>
<td>2,502</td>
<td>2,601</td>
</tr>
<tr>
<td>Acquired in-process technology</td>
<td>0</td>
<td>0</td>
<td>296</td>
<td>296</td>
</tr>
<tr>
<td>Sales and marketing</td>
<td>2,766</td>
<td>2,331</td>
<td>3,412</td>
<td>2,828</td>
</tr>
<tr>
<td>General and administrative</td>
<td>392</td>
<td>392</td>
<td>433</td>
<td>433</td>
</tr>
<tr>
<td>Other expenses</td>
<td>60</td>
<td>60</td>
<td>230</td>
<td>230</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>6,197</td>
<td>6,958</td>
<td>8,070</td>
<td>8,848</td>
</tr>
<tr>
<td><strong>Operating income</strong></td>
<td>7,025</td>
<td>7,025</td>
<td>6,414</td>
<td>6,414</td>
</tr>
<tr>
<td><strong>Investment income</strong></td>
<td>1,318</td>
<td>1,318</td>
<td>703</td>
<td>703</td>
</tr>
<tr>
<td><strong>Gain on sale</strong></td>
<td>160</td>
<td>160</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Income before income taxes</strong></td>
<td>8,503</td>
<td>8,503</td>
<td>7,117</td>
<td>7,117</td>
</tr>
<tr>
<td><strong>Provision for income taxes</strong></td>
<td>2,920</td>
<td>2,920</td>
<td>2,627</td>
<td>2,627</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$5,583</td>
<td>$5,583</td>
<td>$4,490</td>
<td>$4,490</td>
</tr>
<tr>
<td><strong>Earnings per share:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic</td>
<td>$1.11</td>
<td>$1.11</td>
<td>$0.92</td>
<td>$0.92</td>
</tr>
<tr>
<td>Diluted</td>
<td>$1.02</td>
<td>$1.02</td>
<td>$0.84</td>
<td>$0.84</td>
</tr>
</tbody>
</table>

*1997 Fiscal Year Reclassifications are likewise presented as reported and reclassified in the Microsoft filing.

3. Should business strategy influence the classification of revenue and associated costs in an information system? Give an example of how classification of revenue and associated costs might differ between two companies that provide services associated with system design, software development, Internet sites, and other products analogous to those of Microsoft.

Directed Self-Study

Access the June 30, 2006 annual report for Microsoft at sec.gov and determine if it contains any indication of reclassifications on the income statement. Compare and contrast the nature of any disclosures found to those profiled in the case.

Do Dell’s Woes Relate to Classification?

On February 2, 2007, the Wall Street Journal reported “Dell’s Woes Mount as Investors File Improper Accounting Suit” (by Don Clark, Christopher Lawton and John R. Wilke, p. A4). Do the allegations involve classification issues? Explain. Use FARS to evaluate each of the allegations.
Key Terms and Glossary

**consistency** comparability across time of generally accepted accounting principles’ application

**direct costs** those costs that fluctuate directly with the product, such as raw materials and direct labor used to create physical products

**reclassifications** changes in the account used to record or present a transaction, event, or estimate

Further Readings


Make the scheme of accounts conform with the operating organization of the enterprise, because accounting data can thus be made to reveal the results of management’s use of its opportunities.

—A.C. Littleton

Hospitals are an industry in which both not-for-profits and investor-owned facilities operate. The sources of capital available to the not-for-profits include charitable contributions and debt offerings—unless they are governmental, in which case, higher taxes are also an alternative. Debt availability is always, in part, a function of performance, and just as failures have arisen in both sectors, about one-third of the investor-owned hospitals have been described as losing money. Of interest is how can one effectively evaluate such an industry, with this type of diversity in organizational forms and capital availability? A necessary prerequisite to such an evaluation is to have a firm understanding of how charitable contributions are presented.

St. Jude Children’s Research Hospital/ALSAC has the mission of finding cures for children with catastrophic diseases through research and treatment. For the fiscal year 1999, this entity reported total assets of $221,664,232 and income of $177,071,890. A Web site at http://www.stjude.org, as well as Guidestar’s listing, references a Form 990 (Return of Organization Exempt from Income Tax) filing, availability of audited financial statements upon request, and information that the hospital has 2,100 employees and 350 volunteers. Founded in 1962, the organization seeks funds
from contributions and grants for unrestricted operating expenses, specific projects, buildings, and endowments. More than 4,000 patients are seen annually, with a hospital maintaining 56 beds. The Form 990, Part III states that the hospital provided 15,231 inpatient days of care during the fiscal year and patients made 40,982 clinic visits. ALSAC is the American Lebanese Syrian Associated Charities, Inc., the fund-raising arm of St. Jude Children’s Research Hospital. It reported 1999 total assets of $1,007,699,320 and income of $274,123,399. This organization reports the number of employees as 565 and the number of volunteers as 800,000. With its sole focus on the hospital, ALSAC’s self-description explains that no child has ever been turned away due to an inability to pay for treatment and explains key accomplishments in the research area achieved by St. Jude’s research and treatment of children with catastrophic diseases. What is borne out by the example of St. Jude is the fact that a review of the Form 990 filed for the fiscal year ending 6/30/99 indicates in Part VI the names of related organizations: ALSAC and St. Jude Hospital Foundation, both of which are tax exempt. To gain a sense of capital availability to a not-for-profit entity, affiliated entities must be considered. In addition, the role of volunteers is a source of human capital not effectively captured within the framework of financial statements for not-for-profits, as reflected in the Form 990 for the fiscal year ending 6/30/99 for ALSAC, which states in Part VI:

Unpaid volunteers have made significant contributions of their time, principally in fund-raising activities. The value of these services is not recognized in the financial statements since it is not susceptible to an objective measurement or valuation and because the activities of these volunteers are not subject to the operating supervision and control present in an employer/employee relationship.

Hence, as one evaluates capital sources and uses by not-for-profits, care is needed to consider affiliated organizations’ role, total contributions, and the effect of volunteerism on the comparability between not-for-profit and investor-owned operations.

Universal Health Services, Inc. filed its 10-K on March 28, 2001, for the calendar year 2000, which includes comparative information for 1999. Analysts have described the company as the most aggressive company in the industry over the 1999–2001 time frame in making acquisitions, particularly of not-for-profit operations and investor-owned operations experiencing losses. The company is praised for its high operating leverage, the relatively small number of shareholders relative to the magnitude of total revenue, and stock price as a multiple of earnings. The company operates 59 hospitals and, as of 1999, had an average number of licensed beds of 4,806 at acute care hospitals and 1,976 at behavioral health centers, with patient days of 963,842 and 444,632, respectively. Of interest is a commentary on the competition found in the company’s filing:

**Competition**

In all geographical areas in which the Company operates, there are other hospitals which provide services comparable to those offered by the Company’s hospitals, some of which are owned by governmental agencies and supported by tax revenues, and others of which are owned by nonprofit corporations and may be supported to a large extent by endowments and charitable contributions. Such support is not available to the Company’s hospitals. Certain of the Company’s competitors have greater financial resources, are better equipped and offer a broader range of services than the Company. Outpatient treatment and diagnostic facilities, outpatient surgical centers and freestanding ambulatory surgical centers also impact the healthcare marketplace. In recent years, competition
among healthcare providers for patients has intensified as hospital occupancy rates in the United States have declined due to, among other things, regulatory and technological changes, increasing use of managed care payment systems, cost containment pressures, a shift toward outpatient treatment and an increasing supply of physicians. The Company’s strategies are designed, and management believes that its facilities are positioned, to be competitive under these changing circumstances. *(Source: 10-K filed 3/28/2001)*

Financial information is provided in Tables 5.3-1 and 5.3-2 for both the not-for-profit and the investor-owned hospitals.

**Table 5.3-1  Financial Comparisons of the Not-for-Profit Entities**

<table>
<thead>
<tr>
<th>Fiscal Year Ended 1999</th>
<th>St. Jude Children’s Research Hospital Form 990*</th>
<th>American Lebanese Syrian Associated Charities, Inc. (ALSAC) Form 990*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions, gifts, grants and similar amounts received: Direct public support</td>
<td>$91,978,426</td>
<td>$231,793,748</td>
</tr>
<tr>
<td>Indirect public support</td>
<td></td>
<td>2,906,934</td>
</tr>
<tr>
<td>Government contributions (grants)</td>
<td>31,469,447</td>
<td></td>
</tr>
<tr>
<td>Program service revenue, including government fees and contracts (i.e., health insurance revenue)</td>
<td>46,034,710</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>24,217,029</td>
<td>4,230,764</td>
</tr>
<tr>
<td>Pledges receivable</td>
<td></td>
<td>23,604,748</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>9,363,328</td>
<td></td>
</tr>
<tr>
<td>Program service expenses</td>
<td></td>
<td>99,282,906</td>
</tr>
<tr>
<td>Program service expenses: Research</td>
<td>87,225,830</td>
<td></td>
</tr>
<tr>
<td>Program service expenses: Education and training</td>
<td>5,471,186</td>
<td></td>
</tr>
<tr>
<td>Program service expenses: Medical Services</td>
<td>93,735,602</td>
<td></td>
</tr>
<tr>
<td>Reconciliation of revenue, gains, and other support to audited numbers: net unrealized gains on investments</td>
<td>−4,023,815</td>
<td>65,891,269</td>
</tr>
<tr>
<td>Deferred grant revenue</td>
<td>1,857,628</td>
<td>(Statement 5)</td>
</tr>
<tr>
<td>Support from American Lebanese Syrian Associated Charities, Inc.</td>
<td>91,978,426</td>
<td>91,978,426</td>
</tr>
<tr>
<td>(Statement 7) (paid per Statements 4, 6)</td>
<td></td>
<td>2,746,295</td>
</tr>
<tr>
<td>Excluded contributions</td>
<td></td>
<td>(Statement 1)</td>
</tr>
<tr>
<td>Excess or (deficit) for the year</td>
<td>−10,933,191</td>
<td>120,521,982</td>
</tr>
</tbody>
</table>
### Table 5.3-1

<table>
<thead>
<tr>
<th>Fiscal Year Ended 1999</th>
<th>St. Jude Children’s Research Hospital Form 990*</th>
<th>American Lebanese Syrian Associated Charities, Inc. (ALSAC) Form 990*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets or fund balances at end of year</td>
<td>199,707,440</td>
<td>994,501,910</td>
</tr>
<tr>
<td>Temporarily restricted</td>
<td>15,715,890</td>
<td>15,715,890</td>
</tr>
<tr>
<td>Permanently restricted</td>
<td>14,000,000</td>
<td>247,147,826</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>21,956,792</td>
<td>7,017,192</td>
</tr>
<tr>
<td>Schedule of deferred debits &amp; credits by contract (FAS 116 adjustment noted to result in this deferred revenue)</td>
<td>157,628</td>
<td></td>
</tr>
</tbody>
</table>

*The GuideStar.org Web site ([http://www.guidestar.org](http://www.guidestar.org)) provides access to Forms 990 in .PDF format.

### Table 5.3-2

**Universal Health Services, Inc.’s Financial Excerpts***

**Income Statements (in thousands)**

<table>
<thead>
<tr>
<th>Reported 1999 Calendar Year</th>
<th>Net revenues</th>
<th>Operating charges</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$2,042,380</td>
<td>1,913,346</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Components:</th>
<th>Net income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries, wages, and benefits</td>
<td>793,529</td>
</tr>
<tr>
<td>Provision for doubtful accounts</td>
<td>166,139</td>
</tr>
<tr>
<td>Lease and rental expense</td>
<td>49,029</td>
</tr>
<tr>
<td>Interest expense, net</td>
<td>26,872</td>
</tr>
</tbody>
</table>

| Total assets                  | 1,497,973 |
| Total liabilities             | 856,362   |
| Total retained earnings       | 482,960   |
| Capital stock                 | 306       |
| Paid-in capital in excess of par | 158,345 |


**Requirement A: Recording Revenue**

1. What is meant by the reference in Table 5.3-1 to an FAS 116 adjustment?
2. How are contributions recorded? Is there a distinction between pledges receivable and accounts receivable?
3. Are there circumstances when financial statements can quantify volunteers’ services?
4. Can financial statement users of not-for-profit hospitals’ financial statements expect to be fully informed regarding affiliated parties, such as the linkages between St. Jude Children’s Research Hospital, ALSAC, and the foundation cited? Explain.

**Requirement B: Revenue Mix (Strategy-Related Considerations)**

The 10-K filing of Universal Health Services, Inc. describes the mix of revenue sources, as depicted in Table 5.3-3.

**Table 5.3-3 Patient Revenue Mix**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Third Party Payors</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medicare</td>
<td>32.3%</td>
<td>33.5%</td>
<td>34.3%</td>
<td>35.6%</td>
<td>35.6%</td>
</tr>
<tr>
<td>Medicaid</td>
<td>11.5%</td>
<td>12.6%</td>
<td>11.3%</td>
<td>14.5%</td>
<td>15.3%</td>
</tr>
<tr>
<td>Managed Care (HMOs and PPOs)</td>
<td>34.5%</td>
<td>31.5%</td>
<td>27.2%</td>
<td>19.1%</td>
<td>N/A</td>
</tr>
<tr>
<td>Other Sources</td>
<td>21.7%</td>
<td>22.4%</td>
<td>27.2%</td>
<td>30.8%</td>
<td>49.1%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

N/A-Not available (Source: 10-K filed 3/28/2001)

1. How does this revenue mix compare with the revenue blend of the not-for-profit entity, St. Jude Children’s Research Hospital (ALSAC)? Access the latest SEC filing and compare the reported revenue mix; has it changed?
2. What does that imply as to the strategies of investor-owned hospitals in managing risk and ensuring adequate capital relative to not-for-profit entities? An opportunity exists to explore the greater social and political questions that are frequently debated about the compatibility of profit-oriented entities and quality of health care, relative to not-for-profit entities. As background, identify what the latest SEC filings report concerning charity care.

**Directed Self-Study**

Access the 10-Q (from sec.gov) for the quarterly period ended June 30, 2006 and explain how Hurricane Katrina affected Universal Health Services. The same 10-Q reports on a funding commitment the company has made to the alma mater of the Chairman of the Board of Directors and Chief Executive Officer. Describe the disclosure and explain why the event is an “Other Related Party Transaction.” [Download the 10-Q in text format and apply the Find capability in your word processor. Also access FARS and identify the guidance relevant to each event.]
Health Insurance, Public Policy, and Backdating

A key factor in the health care industry is health insurance. Public policy has debated universal health care, changes to governmental programs such as Medicare, adjustment of tax policy regarding employers’ and employees’ deduction for premiums, and alternative approaches to this sector of the economy. State and local governments, under a new accounting rule, have recently estimated their total retiree health bill to be about $1.1 trillion. Over the past decade, some governmental units used pension funds to help pay for double-digit growth in health care for retired public workers. Explain how accounting interacts with public policy. Use FARS as a resource, according particular attention to FAS 158.

Health insurer UnitedHealth has been the focus of media coverage involving what is known as the “options backdating scandal”. UnitedHealth’s internal probe estimates its past decade exposure at half a billion dollars (“UnitedHealth Faces Formal Probe,” Wall Street Journal, December 27, 2006, p. B8). Is there a relationship between the magnitude of the restatement and the nature of the health care sector of the economy? Explain. The SEC’s Division of Corporation Finance shared a “Sample LetterSent in Response to Inquiries Related to Filing Restated Financial Statements for Errors in Accounting for Stock Option Grants” dated January 2007 (http://www.sec.gov/divisions/corpfin/guidance/oilgasltr012007.htm.) How helpful do you find such guidance?

Key Terms and Glossary

**fund balance** “refers . . . to a common group of assets and related liabilities within a not-for-profit organization and to the net amount of those assets and liabilities. . . . While some not-for-profit organizations may choose to classify assets and liabilities into fund groups, information about those groupings is not a necessary part of general purpose external financial reporting” (CON6, Footnote 45); fund balances may refer to such fund groups as operating, plant, endowment, and other funds (FAS 117, Par. 98).

**permanent restriction** “A donor-imposed restriction that stipulates that resources be maintained permanently but permits the organization to use up or expend the donated assets as specified and is satisfied either by the passage of time or by actions of the organization” (FAS 117, Par. 168). Separate line items may be reported within temporarily restricted net assets or in notes to financial statements to distinguish between temporary restrictions for (a) support of particular operating activities, (b) investment for a specified term, (c) use in a specified future period, or (d) acquisition of long-lived assets. Donors’ temporary restrictions may require that resources be used in a later period or after a specified date (time restrictions), or that resources be used for a specified purpose (purpose restrictions), or both. For example, gifts of cash and other assets with stipulations that they be invested to provide a source of income for a specified term and that the income be used for a specified purpose are both time and purpose restricted. Those gifts often are called **term endowments** (FAS 117, Par. 15).
Further Readings


Accounting deals with a system which is a human creation, designed to satisfy human needs, and which must therefore, above all, be useful. The accounting environment is prone to many influences of a nondeterministic nature, influences related not only to long-term legal, cultural and political traditions, but also to short-term movements of mass psychology. . . . The subject matter is of such diversity and changing complexity that attempts to make predictions in accounting are akin to the difficulties of predicting the conditions of turbulence inside a tornado or the problem of “forecasting” next month’s weather.

In principle it is possible for meteorologists to predict the weather at noon in Chicago on January 1, 1981, just as it is possible in principle to predict an eclipse of the sun a thousand years hence. In practice, weather predictions (unlike astronomical predictions) are unreliable over the space of a month let alone a millennium. Accountants, like meteorologists, are also faced with a complex world of many interacting bodies. Nevertheless, they might be able to adopt the pure scientific method, and perhaps enjoy as much success with it as meteorologists, if—like—meteorologists—they only had to deal with the behavior of inhuman molecules. But in contrast, the accountant’s “molecules” think and feel, they have traditions and cultures, they are governed by laws, act sometimes rationally and often irrationally, and are susceptible to an enormous variety of psychological, social, economic, cultural, and political influences. . . . Accountancy . . . deals with problems
involving equity and balance and the resolution of conflict between different groups of human beings with widely varying interest and objectives.

—Edward Stamp

Clarus Corporation announced a change in its business strategy to support a broader range of software licensing arrangements. This meant definitionally that the company would move from the up-front license fee revenue model that had been used toward a subscription-based licensing arrangement that would require a ratable revenue recognition approach. The company understood that as a result of this change in policy, historical and future financial statement figures might not be comparable.

Clarus Corporation issued a press release on December 15, 2000, excerpts from which follow:

Clarus Expands Business Strategy and Model; Clarus Announces Initiatives To Serve the Growing Large to Mid-Sized Enterprise Market

Clarus (NASDAQ:CLRS), a leading business-to-business (B2B) e-commerce solution provider, today announced its strategy to meet the growing demand in the large to mid-size enterprise (LME) market. This expansion of its market strategy is designed to accelerate adoption and results in a business model with a greater emphasis on recurring revenue.

Clarus has focused on the LME market and has established itself as a leader in B2B e-commerce solutions. . . . Industry experts . . . report the LME market is entering a period of accelerated adoption. The Clarus solutions are designed to meet the needs of this target market by offering lower cost of ownership and speed of deployment advantages. As Clarus intensifies its focus on the needs of the LME market it will leverage key strategic partners . . . to deliver “turnkey” packages and fixed-fee offerings.

“Global market adoption of electronic procurement solutions is less than one percent and even lower in the LME space,” said Steve Jeffery, president and CEO of Clarus. “Clarus is positioned to meet this market opportunity with the right mix of products, services, partnerships and pricing.”
Key to meeting the demand in this market will be breaking down the barriers to widespread adoption by reducing the risks and costs associated with traditional licensing and implementation of software. Clarus will move to a business model that will provide its customers greater flexibility to choose the way in which they procure their e-commerce solutions. Under this model, Clarus will recognize revenue from the sale of its products over a fixed period of time, reducing the upfront revenue recorded as compared with its traditional model, while generating an increase in the amount of sales backlog.

“This business model and strategy is an evolution of Clarus’ longtime focus on the LME market,” stated Jeffery. “We believe this shift will not only allow us to drive rapid customer adoption through directly addressing the needs of this target market, but will also provide a more stable and predictable financial model.”

In order to meet the unique needs of the LME market, the majority of future Clarus contracts with customers will not meet the criteria for immediate revenue recognition. Instead, a recurring, predictable revenue stream will be recognized over an estimated 12 to 24 month period. Clarus anticipates that approximately 90 percent of its license business will be contracted under agreements requiring ratable revenue recognition.

Clarus also provided guidance for fourth quarter 2000 and for its fiscal year 2001 and 2002. Under the ratable revenue recognition model, the company expects fourth quarter 2000 revenue to be in the range of $4 million to $4.5 million, with an operating loss per share, excluding non-cash charges, of approximately $1.40. For fiscal year 2001, the company expects revenue to be in the range of $45 million to $50 million, and EPS, excluding non-cash charges, of ($2.14). Fiscal year 2002 projections are for revenues in the range of $115 million to $120 million, and EPS, excluding non-cash charges, of $1.08. The company plans to reach breakeven on a cash basis in the first quarter 2002, with profitability on a cash basis projected for the second quarter 2002.

Clarus will host an investor conference call to discuss this announcement today.

About Clarus Corp.

Atlanta-based Clarus Corporation (www.claruscorp.com; NASDAQ: CLRS), a leader in business-to-business (B2B) e-commerce, provides B2B procurement software and trading services that exploit the global marketplace of the Internet to manage corporate purchasing and enable digital marketplaces. . . . provides a comprehensive range of critical trading services such as payment settlement, supplier enablement, auctions, integration, and analytics. Designed to provide unprecedented interoperability. . . .


Analysts describe Clarus as a company providing e-business solutions that enable procurement, supply-chain management, customer-and-supplier relationship management, and demand management processes of various enterprises—citing such competitors as Global Sources, Commerce One, FreeMarkets, and Ariba. In evaluating Clarus, the analysts compare a trading price in mid-2001 around $6 as low relative to a so-called cash per share value estimate from $7 to $10. The analysts
point out that revenue growth is not evidenced in the financial statements because of a change in revenue recognition from what they refer to as a traditional license model and an up-front license model, toward a recurring revenue recognition model. As a result, quarter-to-quarter revenue comparisons witness a large decline from September to December. An interesting point is that the increased backlogs are essentially sources of future revenue.

In its annual filing with the SEC, Clarus Corporation described its revenue stream and relevant accounting principles as follows:

Sources of Revenue

The Company’s revenue consists of license fees and services fees. License fees are generated from the licensing of the Company’s suite of products. Services fees are generated from consulting, implementation, training, content aggregation and maintenance support services.

Revenue Recognition

The Company recognizes revenue from two primary sources, software licenses and services. Revenue from software licensing and services fees is recognized in accordance with Statement of Position (“SOP”) 97-2, “Software Revenue Recognition”, and SOP 98-9, “Software Revenue Recognition with Respect to Certain Transactions”.

Accordingly, the Company recognizes software license revenue when: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the fee is fixed or determinable; and (4) collectibility is probable.

SOP No. 97-2 generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements. The fair value of an element must be based on evidence that is specific to the vendor. License fee revenue allocated to software products generally is recognized upon delivery of the products or deferred and recognized in future periods to the extent that an arrangement includes one or more elements to be delivered at a future date and for which fair values have not been established. Revenue allocated to maintenance is recognized ratably over the maintenance term, which is typically 12 months and revenue allocated to training and other service elements is recognized as the services are performed.

Under SOP No. 98-9, if evidence of fair value does not exist for all elements of a license agreement and post-contract customer support is the only undelivered element, then all revenue for the license arrangement is recognized ratably over the term of the agreement as license revenue. If evidence of fair value of all undelivered elements exists but evidence does not exist for one or more delivered elements, then revenue is recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. Revenue from hosted software agreements are recognized ratably over the term of the hosting arrangements. *(Source: 10-K filed on 3/21/2001)*

**Requirement A: Comparing Revenue Recognition Approaches**

Clarus Corporation’s 1999 and 2000 data divided between its previous human resources and financial software business (ERP) and the current e-commerce business, along with a few other pieces of financial information are reported in Table 5.4-1.
Table 5.4-1  Financial Information

<table>
<thead>
<tr>
<th>Clarus Corporation Results of Operations*</th>
<th>Year Ended December 31, 2000</th>
<th>Year Ended December 31, 1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues: e-commerce</td>
<td></td>
<td></td>
</tr>
<tr>
<td>License fees</td>
<td>$24,686</td>
<td>$9,969</td>
</tr>
<tr>
<td>Services fees</td>
<td>9,361</td>
<td>1,515</td>
</tr>
<tr>
<td>Total revenues development</td>
<td>34,047</td>
<td>11,484</td>
</tr>
<tr>
<td>Revenues: ERP</td>
<td></td>
<td></td>
</tr>
<tr>
<td>License fees</td>
<td>0</td>
<td>5,132</td>
</tr>
<tr>
<td>Services fees</td>
<td>0</td>
<td>21,526</td>
</tr>
<tr>
<td>Total revenues</td>
<td>0</td>
<td>26,658</td>
</tr>
<tr>
<td>Cost of revenues: e-commerce</td>
<td></td>
<td></td>
</tr>
<tr>
<td>License fees</td>
<td>154</td>
<td>400</td>
</tr>
<tr>
<td>Services fees</td>
<td>12,776</td>
<td>3,130</td>
</tr>
<tr>
<td>Total cost of revenues</td>
<td>12,930</td>
<td>3,530</td>
</tr>
<tr>
<td>Cost of revenues: ERP</td>
<td></td>
<td></td>
</tr>
<tr>
<td>License fees</td>
<td>0</td>
<td>951</td>
</tr>
<tr>
<td>Services fees</td>
<td>0</td>
<td>11,387</td>
</tr>
<tr>
<td>Total cost of revenues</td>
<td>0</td>
<td>12,338</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>98,455</td>
<td>37,429</td>
</tr>
<tr>
<td>Operating loss</td>
<td>(77,338)</td>
<td>(15,155)</td>
</tr>
</tbody>
</table>


1. How does the described revenue recognition approach compare to other industry settings?
2. The analysts’ reference to traditional license models in B2B (business-to-business) relate to up-front models in the “new economy,” yet some would argue that tradition in accounting defers revenue to match the earnings process over time. In what sense has the new economy met tradition in the Clarus Company example? Explain, with support from FARS.
3. Do you concur that the recurring revenue recognition will enhance both visibility and predictability of financial results? Why or why not? (Hint: Access the Staff Accounting Bulletin (SAB) 101 on Revenue Recognition at [http://www.sec.gov/interps/account/sab101.htm](http://www.sec.gov/interps/account/sab101.htm)).

Requirement B: Strategy-Related Considerations

Clarus Corporation accords attention to the fact that in October 1999, the Company sold its ERP business. Are there added complications of such an event for the evaluator of the company’s financial performance? Explain.
Hindsight

Access Clarus Corporation’s 10-Q for the quarterly period ended June 30, 2006 from sec.gov. Explain what has happened to the company subsequent to 2000. What is particularly unique about the income statement? Access the 10-K for the fiscal year ended December 31, 2005 to augment the information from the 10-Q and describe the entity’s strategy going forward.

Directed Self-Study

Does Statement of Financial Accounting Standards No. 152 change revenue recognition practices in any manner? Use FARS to explore this question. [Access FASB-OP (amended), click on the Search toolbar, select the option Search Within a Single OP Document Title, type fas 152 into the document title box and in the Query For: box type revenue recognition.]

Key Terms and Glossary

revenue recognition  when revenue is recorded: revenue must be earned and realized or realizable before being recognized—two key criteria for recognition: (1) what constitutes substantive performance by a vendor [i.e., when is the earnings process substantially complete—SFAC No. 5, par. 83(b)]? and (2) how much assurance of collectibility is needed to justify recognition of revenue [i.e., when is revenue realized or realizable]?

subscription revenue  an example might be revenues for a newspaper, which tend to be recorded as earned, pro rata, on a monthly basis, over the life of the subscriptions

“turnkey” packages  reference to off-the-shelf product as distinguished from tailor-made software; the idea is to just “turn the key” to start the ready-made, standardized software

Further Readings


As we all know, profit figures are not reached by a formula. “Proper and appropriate” provisions may be necessary and in thus providing, prudent judgment is needed. It is when judgment is involved with a desire to reach a particular figure that “profit” becomes meaningless, and we are reminded of a company chairman who, in the days when accounts were not as clear as they are now, advised shareholders not to rely too much on the figures before them. Other figures, he said, could have been produced which would equally well have earned a clear [clean] certificate!

[Source: The Accountant (November 8, 1956), p. 571]
Indeed, this point was made before a senate subcommittee when one CPA reported an agency had made a profit of $5,226,000 when another reported a loss of $6,448,000. The dispute concerned the recognition of interest revenue.

[Source: “Two Accountants Disagree on RFC ’Profits,’” The Journal of Accountancy (June 1950), p. 467]
When Would Market to Book Be Less Than One? Does Acquisition by Stock Explain JDS Uniphase Corp.? 

CASE TOPICS OUTLINE
1. JDS Uniphase Corp. 10-Q Filing
   A. Press Release and Media Commentary
   B. SEC Advice Sought and Results Noted
2. Revaluation

*Market to book* is a term applied to the ratio of a company’s market value of equity (capitalization) to the book value of the equity of the company, and descriptive statistics in the literature for empirical samples of thousands of public companies over the past decades report medians (i.e., midway points within the sample, with half of the companies lying above and half lying below) of approximately 2. The 10-Q for March 31, 2001, filed on May 11, 2001, by JDS Uniphase Corp. included the following disclosures:

The Company is currently evaluating the carrying value of certain long-lived assets and acquired equity method investments, consisting primarily of $56.2 billion of goodwill and the Company’s $757 million equity method investment in ADVA (see Note 10) recorded on its balance sheet at March 31, 2001. Pursuant to accounting rules, the majority of the goodwill was recorded based on stock prices at the time merger agreements were executed and announced. The Company’s policy is to assess enterprise level goodwill if the market capitalization of the Company is less than its net assets. Goodwill will be reduced to the extent that net assets are greater than market capitalization. At March 31, 2001, the value of the Company’s net assets, including unamortized goodwill exceeded the Company’s market capitalization by approximately $39.5 billion. The Company also examines the carrying value of equity method investments for recoverability on a regular basis, based on a number of factors including financial condition and business prospects of the investee
and the market value of the investee’s common stock. Downturns in telecommunications equipment and financial markets have created unique circumstances with regard to the assessment of goodwill and equity method investments for recoverability, and the Company has sought the counsel of the Staff of the SEC on the interpretation of generally accepted accounting principles with regard to these matters. The Company anticipates recording additional charges to reduce the carrying value of the unamortized goodwill and acquired equity method investments and such adjustments could represent a substantial portion of their carrying value. Some of these charges may be recorded as an adjustment to the Company’s financial statements at March 31, 2001 and should they be, the Company would restate its March 31, 2001 financial statements in subsequent SEC filings.

... Note 10. Equity Method of Accounting

As of March 31, 2001, the Company had a 29 percent ownership stake in ADVA, a publicly traded German company that develops and manufactures fiber optic components and products and a 40 percent ownership stake in the Photonics Fund ("Photonics Fund"), LLP, a California limited liability partnership (the "Partnership"), which emphasizes privately negotiated venture capital equity investments. The Company accounts for its investments in ADVA and the Photonics Fund under the equity method. Due to the limited availability of timely data, the Company records the adjustments to its equity method investments in the subsequent quarter.

For the three and nine months ended March 31, 2001, the Company recorded $44.5 million and $133.7 million, respectively, in amortization expense related to the difference between the cost of the investment and the underlying equity in the net assets of ADVA. At June 30, 2000, the Company’s cost and estimated fair value of its investment in ADVA was $701.1 million. In the process of completing the E-TEK purchase accounting, the Company increased the cost and estimated fair value of its investment in ADVA to $931.5 million during the first fiscal quarter. The difference between the cost of the investment and the underlying equity in the net assets of ADVA is being amortized over a 5 year period. For the three and nine months ended March 31, 2001, the Company recorded a $0.6 million and $5.7 million net loss in ADVA relating to their three and six months ended December 30, 2000 financial results, respectfly. As of May 7, 2001, ADVA had not announced their financial results for the three months ended March 31, 2000. The Company will record its share of the income or loss of ADVA in the three months ended June 30, 2001.

In the three and nine months ended March 31, 2001, the Company recorded a loss of $0.3 million and a gain of $0.6 million, which represented the Company’s share of the earnings of the Photonics Fund Partnership for the three and six months ended December 30, 2000. The Company’s share of the gain of the Partnership for the three months ended March 31, 2001 was approximately $0.8 million, which will be recorded by the Company during the three months ended June 30, 2001. (Source: 10-Q filed 5/11/01)

The company later issued an 8-K that includes a press release containing the following related discussion:

Goodwill discussion

As we announced in April and reported in our 10-Q, the Company has evaluated the carrying value of certain long-lived assets and acquired equity investments, consisting
When Would Market to Book Be Less Than One? Does Acquisition by Stock Explain JDS Uniphase Corp.?

primarily of goodwill and . . . our investment in ADVA. Pursuant to accounting rules, the majority of the goodwill was recorded based on stock prices at the time merger agreements were executed and announced. The Company’s policy is to assess enterprise level goodwill if the market capitalization of the Company is less than its net assets, with goodwill being reduced to the extent net assets are greater than market capitalization.

Downturns in telecommunications equipment and financial markets have created unique circumstances with regard to the assessment of long-lived assets, and we sought the counsel of the Staff of the Securities and Exchange Commission on the interpretation of generally accepted accounting principles with regard to this matter. We have had communications with the Staff of the SEC, and we will amend our Quarterly Report on Form 10-Q for the quarter ended March 31, 2001 to reduce the carrying value of goodwill by $38.7 billion for that quarter. In addition, we recorded a $6.1 billion reduction for goodwill in the quarter ended June 30 following further declines in our market capitalization. Finally, approximately $300 million in certain amounts paid to SDL executives in connection with the acquisition which were previously recorded as acquisition costs in the quarter ended March 31, 2001 have been reclassified as a one-time charge for that period and we also recorded a $715 million charge for that period to write down the value of our equity investment in ADVA. Because of the significant industry downturn we are in the process of performing a review of our long-lived assets in accordance with GAAP, and this may result in further charges being recorded for the fourth quarter of fiscal 2001 based on the value of such assets.

The largest portion of the Company’s goodwill arose from the merger of JDS FITEL and Uniphase and the subsequent acquisition of SDL, E-TEK, and OCLI. The businesses associated with these business combinations remain significant operations within JDS Uniphase notwithstanding the current business downturn and change in market valuations.

This significant reduction in our goodwill and other assets no doubt will result in press reports or articles about a sizeable loss, so let me explain what it really means. This goodwill resulted from our acquiring good companies when valuations were high. But keep in mind that while we purchased highly valued shares, we were also in effect selling highly valued shares at the same time as none of the transactions resulting in large goodwill amounts were done for cash. Had these transactions been done at different times when valuations were lower with exactly the same share exchange ratios, the goodwill amounts would have been considerably smaller. Of course, these good companies likely would have become parts of other companies and we would not have had the opportunity to acquire them. So by avoiding goodwill we would have foregone many opportunities to strengthen JDS Uniphase. And when you assess these charges, please keep in mind that they were recorded at a time when our cash increased sharply, so these charges in no way impaired our financial health or strength.

We are reporting a pro forma loss of $477 million or $0.36 per share for the fourth quarter and net income of $67 million or $0.06 per share for the year ended June 30, 2001. These results reflect the costs of the Global Realignment Program and charges for the write-down of excess inventory and exclude the costs we have historically excluded, primarily those related to merger and acquisition charges. (Source: 8-K filed 7/26/01)

The media discussed how the pro forma figure of $67.4 million for the fiscal year ended June 30, 2001, contrasted with the $50.6 billion full-year net loss for that period. It was observed that the pro
forma numbers excluded 98 percent of the company’s $52 billion operating expenses, suggesting these were mainly write-offs of assets that had been purchased for inflated prices during the tech bubble. These charges are asserted by JDS to have not impaired either its financial health or strength because the company had purchased them with stock instead of cash. The analysts on Wall Street appear to have embraced the pro forma perspective of the company from the media coverage. Excerpts from the note in the quarterly filing that describes acquisitions completed during the first nine months of fiscal 2001, using the purchase method of accounting, are reported in Table 5.5-1.

**Table 5.5-1** Acquisitions of JDS Uniphase Corp.

<table>
<thead>
<tr>
<th>Note 9</th>
<th>Date</th>
<th>Purchase Price (in millions) (unaudited)</th>
<th>Purchased Intangibles</th>
<th>Net Tangible Assets</th>
<th>In Process Research &amp; Development</th>
<th>Goodwill</th>
</tr>
</thead>
<tbody>
<tr>
<td>SDL</td>
<td>February 2001</td>
<td>$41,514.8</td>
<td>$967.0</td>
<td>$617.4</td>
<td>$380.7</td>
<td>$39,549.7</td>
</tr>
<tr>
<td>OPA</td>
<td>January 2001</td>
<td>168.5</td>
<td>$5.6</td>
<td>$(4.6)</td>
<td>$3.0</td>
<td>$124.5</td>
</tr>
<tr>
<td>Iridian</td>
<td>October 2000</td>
<td>40.3</td>
<td>—</td>
<td>$2.3</td>
<td>—</td>
<td>$38.0</td>
</tr>
<tr>
<td>Epion*</td>
<td>September 2000</td>
<td>184.5</td>
<td>$14.6</td>
<td>$11.0</td>
<td>$8.9</td>
<td>$150.0</td>
</tr>
<tr>
<td>Other</td>
<td>—</td>
<td>10.2</td>
<td>—</td>
<td>$(0.3)</td>
<td>—</td>
<td>$10.5</td>
</tr>
</tbody>
</table>

*The purchase price includes the issuance of contingent consideration based on milestones reached during the nine months ended March 31, 2001, subsequent to the acquisition date. (Source: JDS Uniphase Corporation 10-Q for the quarterly period ended 3/31/01, filed 5/11/01)

**Requirement A: Market-to-Book Ratio**

1. Why is the ratio of market to book an important consideration in evaluating a company’s recorded values? Is it necessarily the case that market to book never drop below a value of 1.0? Why or why not?
2. How important is the fact that the acquisitions were by stock instead of cash? Support your position with appropriate citations from FARS. Do you believe that the reported adjustments are sufficient to achieve a reasonable market to book? How often must goodwill be evaluated for impairment today?
3. Is the equity method being applied acceptable? What seems distinctive about JDS Uniphase Corporation’s practice?

**Requirement B: Strategy-Related Considerations**

Company management determines press-release content, and it is not restricted in the same manner as in 10-Q or 10-K filings, as long as nothing fraudulent is included.

1. Do you believe JDS Uniphase was wise to emphasize a pro forma figure in the press release? Why or why not?
2. Do you believe that actions should be taken by regulators to proscribe disclosures that fail to conform with GAAP in their press releases? Why or why not? Have any such actions been taken subsequent to the period described in the case?
3. As an investor, how would you evaluate the company in light of the materials in this case, as well as subsequent evidence on the performance of JDS Uniphase?
Directed Self-Study

Many press releases have been observed to reference EBITDA. What does this term mean, and does FARS provide any related guidance? Be specific. [Open FASB-OP (amended) and query EBITDA. Then open EITF Abstracts and perform a similar search.]

Key Terms and Glossary

**EBITDA** earnings before interest, taxes, depreciation and amortization is the general definition, but since this is not defined by GAAP, its application in practice has been observed to vary substantially, excluding a wide variety of costs—as examples, some companies exclude start-up costs, in-process research and development, merger-related costs, stock option compensation, and financing costs, among others

**fair value** “the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale” (Appendix F Glossary, FAS 142) [See FAS 157.]

**goodwill** “the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed” (Appendix F, FAS 142)

**pro forma** historically referred to “as if” presentations, associated with two merging companies, to display comparative historical numbers as if the companies had been operating together for years; more recently, the term refers to disclosures in press releases that do not conform with a definition under GAAP but tend to be characterized as earnings without special or one-time charges, as well as charges management contends are unusual or unimportant, in order to communicate core earnings indicative of future operating earnings

Further Readings


Accounting measurement which measures the economic performance of an entity is, therefore, not only a passive representative of real world phenomena, but is also an active agent affecting the real world through its influence upon the decision maker. Thus, we have a situation where two worlds, the real world and the informational world, mutually interact. One is not merely a shadow of the other. The importance of accounting in business should be analyzed within this dual framework.

—Yuji Ijiri

(Source: Theory of Accounting Measurement, Studies in Accounting Research, No. 10 (Sarasota, FL: American Accounting Association, 1975), p. 188)
A Tax Court case involves disputes between the Commissioner of Revenue and various taxpayers, including corporate entities. United Parcel Service was involved in such a case, the decision for which was filed on August 9, 1999. The case caption is: “UNITED PARCEL SERVICE OF AMERICA, INC. ON BEHALF OF ITSELF AND ITS CONSOLIDATED SUBSIDIARIES, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent” No. 15993-95 UNITED STATES TAX COURT T.C. Memo 1999-268; 1999 Tax Ct. Memo LEXIS 304; 78 T.C.M. (CCH) 262; T.C.M. (RIA) 99268 August 9, 1999, Filed. Refer to Chapter 2 of this book for various locations in electronic databases or on the Internet where you can search to obtain a copy of the OPINION: MEMORANDUM FINDINGS OF FACT AND OPINION. Within Tax Court cases, deficiencies are first summarized, then findings of fact are detailed, and finally an opinion is expressed. The actual Tax Court case is 60 pages long; access that case and read it as the first step in completing this assignment. Remember that even if an electronic copy is unavailable, law libraries can be accessed to secure a hard copy of the Tax Court case whereby you can then read through the opinion.

It is useful to become acquainted with the manner in which tax disputes are evaluated and reported; as you review the case, consider the nature of the business, the allegations being analyzed, the defense of the taxpayer, and the position of the court. The background you obtain from reading the case will be used in analyzing the related accounting disclosures.

**Note to Financial Statements**

Access the 10-Q filed August 16, 1999 by United Parcel Service of America, Inc., and Subsidiaries from sec.gov. Particularly read through Note 4 to the unaudited consolidated financial statements.
That note describes its experiences associated with a Tax Court dispute and possible ramifications of the decision.

**Requirement A: Interpreting the 10-Q Disclosures**

You are an intern with the SEC for the summer. Assume that during the course of your internship, this quarterly filing was received from United Parcel Service (UPS), and you are asked to prepare an analysis of the conformance of the accounting treatment and disclosures that relate to the UPS tax environment—known to have been substantially affected by the recent Tax Court decision. Prepare an executive summary (one to two paragraphs) summarizing the tax court holdings. In addition, provide a detailed explanation of what is required by generally accepted accounting principles (GAAP) and compare those requirements to the disclosures reported by UPS. When differences are detected, explain why you believe UPS has provided the information in the filing, rather than the prescriptions by GAAP.

1. Would you propose that additional or different disclosures be requested from UPS? Why or why not?
2. In reading the 10-Q disclosures, you observed that the disclosures related to the tax litigation shown in Figure 5.6-1 seem quite different from the other litigation-related disclosures. Why is this the case, and are both in accordance with GAAP? Support your position with a flowchart that explains how, through consideration of guidance available in FARS, you arrive at your conclusion.

![Figure 5.6-1](image)

**Figure 5.6-1** A number of estimates are disclosed in the 10-Q.

**Requirement B: Cash Flow Implications—Strategy Choices**

1. When UPS refers to cash equivalents in its 10-Q, to what is the company referring? The disclosure specifically refers to the company’s ability to make a deposit with the IRS without affecting foreseeable operating expenses and budgeted capital expenditures. What information sources are relevant to evaluating this representation?
2. The disclosure indicates the company has a choice as to whether to make such a deposit. What other alternatives exist?
3. What strategy would you recommend to UPS regarding its handling of the 1999 tax environment faced by the company and what would be the related cash-flow implications of your suggestions? To facilitate your evaluation of UPS, refer to the Balance Sheet, Income Statement, and Cash Flow Statements, as well as the related Notes.

The Rest of the Story

In its December 31, 2000, 10-K, UPS detailed in its discussion of legal proceedings that it had appealed:

In addition, during the first quarter of 1999, the IRS issued two Notices of Deficiency asserting that we are liable for additional tax for the 1985 through 1987 tax years, and the 1988 through 1990 tax years. The primary assertions by the IRS relate to the reinsurance of excess value package insurance, the issue raised for the 1984 tax year. The IRS has based its assertions on the same theories included in the 1983–1984 Notice of Deficiency. The IRS, in an issued report, has taken similar positions for tax years 1991 through 1994. We expect the IRS to take similar positions for tax years 1995 through 1999. Based on the Tax Court opinion, we currently estimate that our total after-tax exposure for the tax years 1984 through 1999 could be as high as $2.353 billion. We believe that a number of aspects of the Tax Court decision are incorrect, and we have appealed the decision to the U.S. Court of Appeals for the Eleventh Circuit. The Eleventh Circuit has heard oral arguments. We do not know when the court will render a decision. (Source: 10-K for fiscal year ended 12/31/00)

The company explains the basis for its estimates and its action to make deposits without making concessions:

We determined the size of our reserve with respect to these matters in accordance with accounting principles generally accepted in the United States of America based on our estimate of our most likely liability. In making this determination, we concluded that it is more likely that we will be required to pay taxes on income reported by OPL and interest, but that it is not probable that we will be required to pay any penalties and penalty interest. If penalties and penalty interest ultimately are determined to be payable, we would have to record an additional charge of up to $681 million.

On August 31, 1999, we deposited $1.349 billion, and on August 8, 2000, we deposited an additional $91 million, with the IRS related to these matters for the 1984 through 1994 tax years. We included the profit of the excess value package insurance program, using the IRS’s methodology for calculating these amounts, for both 1998 and 1999 in filings we made with the IRS in 1999. In February 2000, we deposited $339 million with the IRS related to these matters for the 1995 through 1997 tax years. These deposits and filings were made in order to stop the accrual of interest, where applicable, on that amount of the IRS’s claim, without conceding the IRS’s positions or giving up our right to appeal the Tax Court’s decision. (Source: 10-K for fiscal year ended 12/31/00)
The company’s “new arrangement” referenced in August of 1999 is likewise described in more details—actions to eliminate the issues considered by the Tax Court post-1999:

After the Tax Court decision, National Union Fire Insurance Company, a subsidiary of American International Group, Inc., notified OPL that effective September 30, 1999, it would terminate the five underlying policies that provide shippers’ risk insurance for UPS customers. The termination of these policies triggered the immediate termination of the reinsurance agreement between National Union and OPL.

UPS, on behalf of our customers, and National Union agreed on a restructuring of this program, which became effective October 1, 1999. Commencing on October 1, 1999, National Union issued five new policies that include coverage for UPS customers. Glenlake Insurance Agency, Inc., a licensed insurance agency formed in 1998 and a wholly owned subsidiary of UPS Capital Corporation, now offers excess value package insurance to be issued under the five new policies.

UPS Re Ltd., a wholly owned subsidiary of UPS, has entered into a reinsurance agreement under which it will reinsure substantially all of the risks underwritten by National Union in exchange for substantially all of the premiums collected. UPS Re Ltd., is a licensed reinsurance company formed in 1999 to reinsure risks related to UPS and its subsidiaries. UPS Re Ltd., which is domiciled in Bermuda, has elected to be taxed on its income as part of UPS’s consolidated income tax return for federal income tax purposes. This revised arrangement should eliminate the issues considered by the Tax Court in the Notices of Deficiency relating to OPL for the periods after September 1999. (Source: 10-K for fiscal year ended 12/31/00)

*When It Rains It Pours*

The IRS additional claims are described:

The IRS has proposed adjustments, unrelated to the OPL matters discussed above, regarding the allowance of deductions and certain losses, the characterization of expenses as capital rather than ordinary, the treatment of certain income, and our entitlement to the investment tax credit and the research tax credit in the 1985 through 1990 tax years. The proposed adjustments would result in $15 million in additional income tax expense. Also, the IRS has issued a report taking a similar position with respect to some of these issues for each of the years from 1991 through 1994. This report proposes adjustments that would result in $155 million in additional income tax expense. For the 1985 through 1994 tax years, unpaid interest on these adjustments through 2000 could aggregate up to $368 million, after the benefit of related tax deductions. We expect that we will prevail on substantially all of these issues. Specifically, we believe that our practice of expensing the items that the IRS alleges should have been capitalized is consistent with the practices of other industry participants. The IRS may take similar positions with respect to some of these issues for each of the years 1995 through 2000. The IRS’s proposed adjustments include penalties and penalty interest. We believe that the possibility that such penalties and penalty interest will be sustained is remote. We believe the eventual resolution of these issues will not result in a material adverse effect on our financial condition, results of operations or liquidity. (Source: 10-K for fiscal year ended 12/31/00)
In addition, the Tax Court decision has spawned related lawsuits:

We have been named as a defendant in 23 lawsuits that seek to hold us (and, in certain cases, other defendants) liable for the collection of premiums for excess value package insurance in connection with package shipments since 1984 (or, in some of the cases, for shorter time periods). These cases generally claim that we acted as an insurer in violation of our shipping contract and without complying with state insurance laws and regulations, and that the price for excess value package insurance was excessive. Eighteen of these cases have been consolidated for pre-trial purposes in a multi-district litigation proceeding (“MDL Proceeding”) before the United States District Court for the Southern District of New York. An amended consolidated complaint in the MDL Proceeding also alleges a violation of the federal RICO statute. Another complaint in the MDL Proceeding alleges violations of federal antitrust laws. We are in the process of seeking to have four of the remaining cases consolidated into the MDL Proceeding. The other remaining case was remanded from federal court to state court in Madison County, Illinois and is proceeding independent of the MDL Proceeding. No class has been certified in any of these cases. These actions all developed after the August 9, 1999 Tax Court opinion was rendered. We believe the allegations in these cases have no merit and intend to continue to defend them vigorously. The ultimate resolution of these matters cannot presently be determined.
(Source: 10-K for fiscal year ended 12/31/00)

Appeals Court

On June 21, 2001, UPS filed Form 8-K containing the following press release:

APPEALS COURT SUPPORTS UPS, REVERSES U.S. TAX COURT ATLANTA, (June 21, 2001)—The 11th U.S. Circuit Court of Appeals, in an important ruling, today overturned a 1999 decision that UPS had improperly tried to avoid federal income taxes when it restructured its program for providing extra package insurance to its customers.

The appeals court said the IRS and Tax Court were wrong to brand UPS as attempting a “sham transaction” to avoid its tax obligations. After reversing the 1999 decision, the appellate court then remanded the case back to the U.S. Tax Court, saying any claims by the IRS should be analyzed under provisions of the Tax Code cited by UPS.

“The sophistication (of the insurance revisions) does not change the fact that there was a real business that served the genuine need for customers to enjoy loss coverage and for UPS to lower its liability exposure,” the court majority wrote in a 16-page opinion. “We therefore conclude that UPS’s restructuring of its excess-value business had both real economic effects and a business purpose, and it therefore under our precedent had sufficient economic substance to merit respect in taxation.”

“For the foregoing reasons, we reverse the judgment against UPS and remand the action to the Tax Court. . . .”

Based on the original Aug. 9, 1999, decision of a Tax Court judge that applied to the 1984 tax year, UPS estimated its potential liability at $1.8 billion for all subsequent years if his ruling were allowed to stand. The company then recorded a special tax assessment on its books of $1.786 billion, reducing its income for the second quarter of 1999 by a net $1.442 billion. Without conceding liability, UPS then paid $1.8 billion into a special
account with the IRS, pending a decision by the 11th Circuit Court of Appeals. The balance will remain in place pending further proceedings on remand.

“This case was much more to us than a dispute over tax regulations and Tax Code interpretations, because we hold nothing more sacred than our reputation,” said UPS Chairman and CEO Jim Kelly. “So we are extremely pleased the original opinion has been reversed.”

The case, known as *UPS vs. Commissioner of Internal Revenue*, was argued before the 11th Circuit on March 7. The case focused on the manner in which UPS decided to exit the excess value coverage business in 1984, creating a new, independent company known as Overseas Partners Ltd., or OPL. OPL subsequently based itself in Bermuda and over the years, grew into one of the largest re-insurance companies in the world.

Prior to 1984, UPS provided excess value coverage itself. After creating and spinning off OPL, UPS engaged another U.S. company, National Union Fire Insurance Co., to provide the insurance purchased by UPS shippers.

The IRS argued in 1997 that UPS had created OPL solely to avoid federal taxes and that UPS must pay federal taxes on OPL’s income. UPS, for its part, adamantly and consistently disputed the IRS’ position, saying it had followed all applicable laws and tax regulations in establishing OPL. The appeals court ruled today “that OPL is an independently taxable entity that is not under UPS’s control.”

Before and after the changes, UPS offered the lowest rates in the industry for excess value coverage. To this day, a package with a value of $300 can be insured at UPS for 70-cents, compared to $4 for the U.S. Postal Service, $2.50 for FedEx and $2.10 for DHL.

UPS is the world’s largest express carrier and largest package delivery company, serving more than 200 countries and territories around the world. Headquartered in Atlanta, Ga., the company is located on the Web at www.ups.com. Earlier this year, UPS was recognized by *Fortune* magazine as “America’s Most Admired” package and mail delivery company for the 18th consecutive year.” (Source: 8-K filed 6/21/01 Item 5. Other Events, Exhibit 99.1)

**Requirement C: Looking Back**

Given the benefit of hindsight, how effective were the contingency-associated disclosures by UPS in 1999 and 2000? Explain. Access the most recent filing by UPS at sec.gov and determine whether the events in this case or related matters continue to be reflected and, if so, how. Describe how this case analysis would be affected had the events followed the issuance of FASB Interpretation (FIN) No. 48 *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*, issued June 2006.

**Directed Self-Study**

the Document Title Box, and then in the Query For: box type change in estimate. The first hit will answer the question.]

Key Terms and Glossary

contingency “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a “gain contingency”) or loss . . . (hereinafter a “loss contingency”) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur” (FAS 5, par. 1).

Internal Revenue Service government agency charged with collection of taxes and enforcement of tax law

investment tax credit an offset to tax bills granted by Congress to encourage investment: The amount has been a function of the life of the asset acquired.

probable “The future event or events are likely to occur” (FAS 5, par. 3). FAS 90, par. 45 observes: “some . . . respondents equated probable with certain. The Board notes that the term probable is defined in Statement 5 and is used in the same sense in this Statement. That definition is not synonymous with certain, a term that connotes a much higher level of assurance than probable.”

reasonably possible “The chance of the future event or events occurring is more than remote but less than likely” (FAS 5, par. 3). [Through analogy, FAS 69, par. 72 distinguishes proved, possible, and probable mineral interests granted by Congress to encourage investment: The amount has been a function of the life of the asset acquired.]

reinsurance the practice of insurance companies selling their insurance policies to another insurance company as a risk management arrangement

remote “The chance of the future event or events occurring is slight” (FAS 5, par. 4).

research tax credit an offset to tax bills granted by Congress to encourage spending on research

U.S. Tax Court specialized courts handling tax disputes

Further Readings


“There’s an unidentified growing object on the right-hand side of the balance sheet,” representatives of Shell Oil told a Financial Accounting Standards Board (FASB) hearing panel in New York City on April 23, “and it’s called ‘deferred taxes.’ That’s the item these hearings are all about.”

“Unidentified growing objects, UGO,” mused FASB Chair Donald J. Kirk in response, “we’re in danger of inventing a new acronym here.”

Halifax Corporation provides installation, maintenance and training for computer, communications, and simulator systems. The corporation provides support to state and local governments as well as to commercial customers that include military bases, prisons, and office complexes. In addition, the company has offered Web site design services, on-site computer repair, and staff outsourcing. The 10-K for March 31, 2001, filed on June 28, 2001, by Halifax Corp. included the following disclosures:

**Embezzlement Matter**

On March 18, 1999, the Company announced that an internal investigation had revealed a material embezzlement by the former controller of one of the Company’s subsidiaries. The embezzlement occurred over a four-year period and aggregated approximately $15.4 million of which approximately $15 million was embezzled from the Company and $400,000 prior to its acquisition by Halifax. After net recoveries through March 31, 2001, as discussed below, the cumulative net embezzlement loss to the Company was approximately $7.7 million.

The embezzlement had a material effect on the Company’s financial statements. During the year ended March 31, 2001, the Company recovered $1,600,000 (net of recovery costs of $1,156,000). During the year ended March 31, 2000, the Company recovered $2,250,000 (net of recovery costs of $250,000) in conjunction with its embezzlement recovery activities. The specific terms and conditions associated with the payments, including the identity of the parties, are subjects of confidentiality agreements.
that preclude disclosure. The embezzlement loss for fiscal 1999 was $6,093,000, offset by $3,500,000 in recoveries (net of recovery costs of $1,000,000), resulting in a net embezzlement loss for fiscal year 1999 of $2,593,000.

Embezzlement Recovery
During the years ended March 31, 2001 and 2000, net embezzlement recoveries were $1.6 million and $2.25 million, respectively (net of recovery costs of $1,156,000 and $250,000, respectively). The loss of approximately $2.6 million in 1999 was net of $3.5 million of total net recoveries realized from certain recovered assets (net of recovery costs) and insurance proceeds. For additional discussion see “Embezzlement Matter” in Item 1 and Note 2 of the consolidated financial statements.

Income Taxes
As a result of the Company’s historical losses (principally from the embezzlement), the Company generated significant loss carryforwards (both federal and state). At March 31, 2001 and 2000, the Company had remaining net operating loss carryforwards amounting to approximately $8.6 million and $10.2 million, respectively. Due to the uncertainty of future realization, the Company has not recorded a net benefit for these operating loss carryforwards in its financial statements.

Net income (loss) from Continuing Operations
The 2001 net loss of $840,000 from continuing operations was due primarily to higher operating expenses offset by embezzlement recoveries of $1.6 million.

The 2000 net income from continuing operations of $1.4 million was principally the result of embezzlement recoveries amounting to $2.25 million.

Net losses from continuing operations in 1999 of $5.3 million were the result of embezzlement losses of $3.6 million and operating loss, in the amount of $3.6 million.

The Company believes that funds generated from operations, bank borrowings, embezzlement recoveries and investing activities should be sufficient to meet its current operating cash requirements through July 1, 2002, although there can be no assurances that all the aforementioned sources of cash can be realized.

2. EMBEZZLEMENT MATTER . . . [same as first two paragraphs, prior page]

Recoveries relating to the embezzlement were as follows:

| Fiscal 2001 | $2,756,000 |
| Fiscal 2000 and prior | 7,000,000 |
| Total recoveries | 9,756,000 |
| Recovery costs | (2,406,000) |
| Net recoveries | $7,350,000 |

The Company continues to pursue recovery activities from certain parties although no assurances can be given as to the timing or extent of such recoveries.

On January 9, 2001, the Securities & Exchange Commission issued a formal order of investigation of the Company and unnamed individuals concerning trading activity in the Company’s securities, periodic reports filed by the Company with the SEC, certain accounting and financial matters and internal accounting controls. The Company is cooperating fully with the SEC. In addition, the Company has received an SEC subpoena
for documents related to these matters. The staff of the SEC has advised that the inquiry is confidential and should not be construed as an indication by the Commission or its staff that any violation of law has occurred, or as an adverse reflection on any person, entity or security. The Company believes the investigation is primarily related to the previously reported embezzlement by one of the Company’s former employees. (Source: 10-K filed 6/28/2001)

The company elsewhere in the 10-K filing states:

Certain statements in this Annual 10-K Report constitute “forward-looking statements” within the meaning of the United States Private Securities Litigation Reform Act of 1995. Such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company, or industry results, to be materially different from any future results, performance, or achievements expressed or implied by such forward-looking statements. Such factors include, among others, the following: general economic and business conditions in the Company’s market area, inflation, continuation of favorable banking arrangements, the availability of capital to finance operations and planned growth, ramifications of the embezzlement referenced herein, changes in government regulations, availability of skilled personnel and competition, which may, among other things impact on the ability of the Company to implement its business strategy.

The embezzlement matter did not involve or affect the Company’s fulfillment of its Government contracts nor its accounting thereof, and it did not trigger any termination provisions under government contracts.

Item 3. Legal Proceedings. . . . There are no material pending legal proceedings to which the Company is a party. The Company is engaged in ordinary routine litigation incidental to the Company’s business to which the Company is a party.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Ernst & Young LLP (the “Former Accountants”) resigned as the independent accountants for Halifax Corporation (the “Company”) on October 19, 1999.

No report prepared by the Former Accountants on the consolidated financial position of Halifax Corporation at March 31, 1999 and 1998, and the consolidated results of operations and its cash flows of each of the three years in the period ended March 31, 1999, contained an adverse opinion or disclaimer of opinion, or was qualified or modified as to uncertainty, audit scope, or accounting principles.

In connection with the audit conducted by the Former Accountants for the fiscal year ended March 31, 1999, which was concluded on September 7, 1999, and which included the consolidated balance sheets of Halifax Corporation as of March 31, 1999 and 1998, and the related consolidated statements of operations, changes in stockholders’ equity (deficit) and cash flows for each of the three years in the period ended March 31, 1999, there were no disagreements between the Company and Ernst & Young LLP on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of Ernst & Young LLP, would have caused them to make reference thereto in their report on the financial statements for those years.
Halifax Corporation reported on its balance sheets total assets of $17,966,000 as of March 31, 2001, and $27,808,000 as of March 31, 2000. Excerpts from Management Discussion and Analysis are included in Tables 5.7-1 and 5.7-2.

Table 5.7-1  Excerpts from Results of Operations

<table>
<thead>
<tr>
<th>Results of Operations</th>
<th>for Years Ended</th>
<th>[dollars in thousands, except per share amounts]</th>
<th>March 31, 2001</th>
<th>March 31, 2000</th>
<th>Change</th>
<th>%</th>
<th>2000</th>
<th>1999</th>
<th>Change</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td></td>
<td></td>
<td>$51,750</td>
<td>$53,530</td>
<td>$(1,780)</td>
<td>–3%</td>
<td>$53,530</td>
<td>$59,071</td>
<td>$(5,541)</td>
<td>–9%</td>
</tr>
<tr>
<td>Operating (loss) income</td>
<td></td>
<td></td>
<td>(1,417)</td>
<td>251</td>
<td>(1,668)</td>
<td>N/M*</td>
<td>251</td>
<td>(1,012)</td>
<td>1,263</td>
<td>N/M</td>
</tr>
<tr>
<td>% of Revenues</td>
<td></td>
<td></td>
<td>–3%</td>
<td>0%</td>
<td>0%</td>
<td>–2%</td>
<td>0%</td>
<td>–2%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Embezzlement (recovery) expense</td>
<td></td>
<td></td>
<td>(1,600)</td>
<td>(2,250)</td>
<td>(650)</td>
<td>–29%</td>
<td>(2,250)</td>
<td>2,593</td>
<td>(4,843)</td>
<td>NM</td>
</tr>
<tr>
<td>Income before taxes and discontinued operations</td>
<td></td>
<td></td>
<td>(817)</td>
<td>1,490</td>
<td>(2,307)</td>
<td>N/M*</td>
<td>1,490</td>
<td>(5,428)</td>
<td>6,918</td>
<td>N/M</td>
</tr>
<tr>
<td>Net income</td>
<td></td>
<td></td>
<td>$1,098</td>
<td>$2,313</td>
<td>($1,215)</td>
<td>–53%</td>
<td>$2,313</td>
<td>$(5,299)</td>
<td>$7,612</td>
<td>N/M</td>
</tr>
<tr>
<td>Earnings (loss) per share—basic Continuing Operations</td>
<td></td>
<td></td>
<td>$(.42)</td>
<td>$.70</td>
<td>$.70</td>
<td>$(2.64)</td>
<td>$.70</td>
<td>$(5.299)</td>
<td>$7,612</td>
<td>N/M</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* N/M = not meaningful (Source: 10-K as of 3/31/01, filed 6/28/01).

Table 5.7-2  Factors that May Affect Future Results

<table>
<thead>
<tr>
<th>Liquidity and Capital Resources</th>
<th>2001</th>
<th>2000</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash balance at March 31, 2001</td>
<td>$231,000</td>
<td>$1,800,000</td>
<td>$0</td>
</tr>
<tr>
<td>Working capital at March 31, 2001</td>
<td>$(102,000)</td>
<td>$3,481,000</td>
<td>$740,000</td>
</tr>
<tr>
<td>Net cash provided by operations before impact of embezzlement</td>
<td>$520,000</td>
<td>$1,641,000</td>
<td>$1,940,000</td>
</tr>
<tr>
<td>Net cash recovered (used) related to embezzlement</td>
<td>$1,600,000</td>
<td>$5,078,000</td>
<td>$(5,421,000)</td>
</tr>
<tr>
<td>Net cash provided by (used in) operating activities</td>
<td>$2,120,000</td>
<td>$6,719,000</td>
<td>$(3,481,000)</td>
</tr>
</tbody>
</table>

(Source: 10-K as of 3/31/01, filed 6/28/01)
Halifax Corporation filed its 10-Q for the quarter ended September 30, 2001, on November 15, 2001, in which it discloses:

Embezzlement Recovery

Embezzlement recoveries (net of settlement costs) for the three and six months ended September 30, 2000 were $2.1 million and $1.8 million, respectively. There were no embezzlement recoveries for the three and six months ended September 30, 2001. . . .

Pursuant to the Company’s credit facility the Company is required to satisfy two financial covenants; funded debt to EBITDA and fixed charge coverage ratio. The Company was not in compliance with the funded debt ratio as of September 30, 2001. The lender has waived the covenant violation at September 30, 2001. The Company and the lender have extended the original maturity date from August 31, 2002 to November 15, 2002. (See Note 4 to the condensed consolidated financial statements.) . . .

Note 4-Debt

On December 8, 2000, the Company entered into a new revolving credit agreement with a financial institution which refinanced the Company’s revolving credit line. Advances under the revolving agreement are collateralized by a first priority security interest on all the Company’s assets as defined in the financing and security agreement.

The agreement also contains certain financial covenants and reporting covenants. Subsequent to September 30, 2001, the agreement, which originally matured on August 31, 2002, was extended to November 15, 2002.

The revolving credit agreement prohibits the payment of dividends or distributions as well as the payment of principal or interest on the Company’s outstanding subordinated debt, which is owned by an affiliate. Interest expense on Subordinated Debt is accrued on a current basis. Pursuant to the terms of a subordination agreement related to the subordinated debt, concurrent with the extension of the revolving credit line discussed above, the due date of the subordinated debt was extended from July 1, 2002 to November 15, 2002.

The Company’s credit facility requires it to satisfy two financial covenants; funded debt to earnings before interest, taxes, depreciation and amortization (“EBITDA”), and fixed charge coverage ratio. The Company was not in compliance with the funded debt to EBITDA ratio at September 30, 2001. Its lender has agreed to an amendment to waive the violations. It is the intention of the lender and the Company to restructure the covenants to assure that compliance can be achieved. (Source: 10-Q as of 9/30/2001, filed on 11/15/2001)

Of interest is a comparison of these disclosures to those made in the 10-Q filed as of September 9, 1999 for the period ended June 30, 1999 by Halifax Corp.:

Note 2—Embezzlement Matter and Restatement of Consolidated Financial Statements

On March 18, 1999, the Company announced that an internal investigation had revealed an apparent material embezzlement by the former controller of one of the Company’s subsidiaries. The embezzlement occurred at, and was confined to, the Company’s Richmond, VA based Halifax Technology Services Company (“HTSC”). At the time of the embezzlement, HTSC was a wholly owned subsidiary of Halifax Corporation, which
resulted from a merger of CMSA (acquired by Halifax on April 1, 1996), and CCI (acquired by Halifax on November 25, 1996). On April 1, 1999, HTSC was merged into Halifax Corporation and is now a division of the Company.

The Company believes that a single individual, the former controller of HTSC, perpetrated the embezzlement. She was immediately terminated, has since been indicted, has pleaded guilty, and currently awaits sentencing. Under the terms of an agreement entered into with the Company, she is cooperating with the Company’s recovery efforts.

The embezzlement occurred over a period of nearly four years and aggregated approximately $15.4 million, of which $15 million was embezzled from the Company and $400,000 from CMSA before it was acquired by Halifax. To conceal the embezzlement in the accounting records, the former controller made fraudulent adjustments totaling more than $21 million. Of the $21 million, the $15 million embezzled was recorded in the Company’s statements of operations and balance sheets after the acquisition, approximately $2.2 million related to amounts reflected in the acquisition date balance sheet, and approximately $3.8 million related to other overstatements of operating results during the three-year period subsequent to the CMSA acquisition.

Under the terms of an agreement with the Company, the embezzler has transferred certain assets back to the Company. Some of the recovered assets have been converted into approximately $1.4 million in cash as of August 31, 1999. With an estimated $1.1 million of assets awaiting conversion to cash, the Company estimates approximately $2.5 million will ultimately be recovered from the embezzler. In addition, the full policy amount of $1 million from each of two separate theft insurance policies, or an aggregate of $2 million, has been received to date.

Therefore, from these sources, the Company expects a total recovery of $4.5 million (excluding recovery costs). The Company estimates that, net of recovery costs, approximately $3.5 million will be recovered. At March 31, 1999, the Company had received approximately $670,000 from its recovery efforts and recorded a $2.83 million recovery receivable to recognize its expectation of receiving the estimated $3.5 million of total net recoveries.

Due to the corresponding overstatement of taxable income, reported by the Company during the period of the embezzlement, the Company will file for a tax refund of approximately $808,000. The receivable is recorded in “Income Taxes Receivable” in the consolidated financial statements.

The embezzlement had a material effect on the Company’s financial statements for fiscal years 1999, 1998 and 1997. In addition to the correction for overstated assets and understated liabilities, the Company recorded an embezzlement loss of approximately $2,593,000, $6,044,000, and $2,892,000 for the fiscal years ended March 31, 1999, 1998 and 1997, respectively. The embezzlement loss recorded in fiscal 1999 is net of the actual and projected net recoveries aggregating $3,500,000.

In addition to the notification and involvement of the appropriate authorities, and the intensive and ongoing investigative efforts, the Company has taken other important steps as a result of the embezzlement. The Board of Directors appointed a special committee of the Board to focus on the recovery of assets taken from the Company and minimization of the damages sustained as a result of the embezzlement.

The employment contract of the HTSC president was not renewed, and he is no longer employed by the Company. Furthermore, new executives have been hired to manage the technology services division and to consolidate the Company’s financial and
administrative activities. The Company has also transferred key accounting and cash management functions of HTSC to Company headquarters.

The Company’s financial statements for the three months ended June 30, 1998 have been restated to reflect corrections due to the embezzlement. The effect of the restatement on results of operations for the three months ended June 30, 1998 is as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Previously Reported</td>
</tr>
<tr>
<td>Revenues</td>
<td>$17,264,000</td>
</tr>
<tr>
<td>Cost of services</td>
<td>15,323,000</td>
</tr>
<tr>
<td>G&amp;A expenses</td>
<td>1,306,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>635,000</td>
</tr>
<tr>
<td>Interest expenses</td>
<td>355,000</td>
</tr>
<tr>
<td>Embezzlement loss</td>
<td>—</td>
</tr>
<tr>
<td>Income (loss) before taxes</td>
<td>280,000</td>
</tr>
<tr>
<td>Income taxes</td>
<td>129,000</td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>$151,000</td>
</tr>
<tr>
<td>Net income (loss) per share—basic</td>
<td>$.08</td>
</tr>
<tr>
<td>Net income (loss) per share—diluted</td>
<td>$.07</td>
</tr>
</tbody>
</table>

(Source: 10-Q as of 6/30/99, filed on 9/9/99)

**Requirement A: Disclosure Practices**

1. Do you find the disclosures in the 2001 10-K and 10-Q to be informative and sufficient as to the nature and extent of effect of the embezzlement matter? Why or why not?
2. What guidance exists to help you evaluate the sufficiency of the disclosures? Support your position with appropriate citations from FARS.
3. Reconcile the disclosures in the 1999 10-Q to those found in the 2001 filings. Do they compare reasonably? Explain.

**Requirement B: Strategy-Related Considerations**

1. What signals does Halifax Corp. include in its 1999 10-Q filing to indicate that it has treated the embezzlement matter seriously?
2. Do you believe this type of disclosure has particular importance to this company? Why?
3. Check the 10-Q for the quarter ended June 30, 2006 to see if any mention is made of the embezzlement. Describe what you find and its implications.

**Directed Self-Study**

Access sec.gov and select the full text search beta version of EDGAR that has two years of filings that can be searched as text. See if you can identify another public filing that discloses an embezzlement and how that disclosure compares and contrasts to the Halifax Corp. setting. [Access National Storm Management, Inc.’s Form 10-SB/A signed by the President and Chief Executive Officer on July
5, 2006, which includes the quarter ended March 31, 2006. Use the Find capability to locate the relevant discussion.]

**Key Terms and Glossary**

**EBITDA** earnings before interest, taxes, depreciation and amortization is the general definition, but since this is not defined by GAAP, its application in practice has been observed to vary substantially.

**involuntary conversions of nonmonetary assets** FIN 30, Summary explains that: “Examples of such conversions are total or partial destruction or theft of insured nonmonetary assets and the condemnation of property in eminent domain proceedings.”

**nonreciprocal transfer** “A transaction in which an entity incurs a liability or transfers an asset to another entity (or receives an asset or cancellation of a liability) without directly receiving (or giving) value in exchange” (FAS 116, par. 209). “In these transfers one of the two entities is often passive, a mere beneficiary or victim of the other’s actions. Examples are gifts, dividends received, taxes, loss of a negligence lawsuit, imposition of fines, and theft” (superseded APS 4, par. 62).

**risk** “refers to any exposure to uncertainty in which the exposure has potential negative consequences” according to CON 7, Par. 64. The FASB describes various risks in FAS 133, par. 408: “The Board recognizes that entities are commonly exposed to a variety of risks in the course of their activities, including interest rate, foreign exchange, market price, credit, liquidity, theft, weather, health, catastrophe, competitive, and business cycle risks. The Exposure Draft did not propose detailed guidance on what risks could be designated as being hedged, other than to note in the basis for conclusions that special hedge accounting for certain risk management transactions, such as hedges of strategic risk, would be precluded. In redeliberating the issue of risk, the Board reaffirmed that hedge accounting cannot be provided for all possible risks and decided to be more specific about the risks for which hedge accounting is available.”

**Further Readings**


SEC. Division of Corporation Finance Office of the Chief Accountant. 2005. Staff statement on management’s report on internal control over financial reporting (May 16).

Turner, Lynn E., then-Chief Accountant of the SEC. 2000. Speech on Audit Committees: A Call to Action [Accounting Irregularities II: What’s an Audit Committee To Do?] New York. (October 5).


Available at: http://www.usdoj.gov/criminal/fraud/fcpa/dojdoch.


effect of firms’ financial disclosure strategies on stock prices.” *Accounting Horizons* (7, 1), pp. 1–11.

The hardest crossword puzzle to solve is the one in which we have penciled in a wrong word and are too stubborn or fixated to erase it; in much the same way, it is often easier to solve a problem when you are merely ignorant than when you are wrong.

—Sidney J. Harris

Case 8

What Constitutes a Subsequent Event? Related Gain Contingency Considerations

Case Topics Outline

1. Subsequent Event for Euronet Worldwide, Inc.
   A. Extinguishment of Debt
   B. Extraordinary Gain
2. Gain Contingency Considerations

Euronet Worldwide, Inc. provides both software and service solutions related to secure electronic financial transactions. A press release was issued by Euronet Worldwide, Inc. on September 10, 2001, in which it announced the appointment of Daniel R. Henry as President, in addition to his Chief Operating Officer (COO) role. The release elaborated on the fact that Mr. Henry co-founded the company with Michael Brown in 1994 and that Mr. Brown would continue as Chairman and Chief Executive Officer—no longer holding the title of President. This same release identifies the realization of a subsequent event reported in its Form 10-Q for the period ended June 30, 2001. Specifically, since that date, the company had exchanged senior discount notes for shares of its common stocks. The release quantifies implications of the exchange as of August 31, 2001 as decreasing the indebtedness since June 30, 2001, thereby resulting in an annual interest expense savings of approximately $2 million per year.

In its quarterly filing, Euronet Worldwide included the following notes among its disclosures:

Euronet Worldwide, Inc. and Subsidiaries
Notes to the Unaudited Consolidated Financial Statements
September 30, 2001 and 2000

Note 1 — Financial Position and Basis of Presentation
The accompanying unaudited consolidated financial statements of Euronet Worldwide, Inc. and subsidiaries (collectively, “Euronet” or the “Company”) (formerly
Euronet Services Inc.), have been prepared from the records of the Company, pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of management, such unaudited consolidated financial statements include all adjustments (consisting only of normal, recurring accruals) necessary to present fairly the financial position of the Company at September 30, 2001, the results of its operations for the three-month periods and nine-month periods ended September 30, 2001 and 2000 and cash flows for the nine-month periods ended September 30, 2001 and 2000.

The unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements of Euronet Worldwide, Inc. and subsidiaries for the year ended December 31, 2000, including the notes thereto, set forth in the Company’s Form 10-K.

The results of operations for the three-month and nine-month periods ended September 30, 2001 are not necessarily indicative of the results to be expected for the full year.

The Company generated an operating loss of $6.2 million for the nine months ended September 30, 2001 primarily due to the significant costs associated with the expansion of its ATM network and investment support and research and development in its software. In addition, the Company generated negative cash flows from operations of $0.3 million for the nine months ended September 30, 2001, as a result of these same factors. Based on the Company’s current business plan and financial projections, the Company expects to reduce operating losses and net cash used in operating activities during the remainder of 2001. In the Processing Services Segment, the Company anticipates that increased transaction levels in its ATM network will result in additional revenues without a corresponding increase in expenses. In addition, the Company expects to further expand its ATM outsourcing services and offer new value-added services, which will provide continued revenue growth without significantly increasing direct operating expenses or capital investments. In the Software Solutions Segment, the Company expects to continue its strategic repositioning of its software business from direct software sales to software-only customers to more integrated solutions combining the strengths of the Company’s electronic financial transaction network system with its software development strengths.

The Company has a $4.0 million credit facility under an unsecured revolving credit agreement (see Note 5). As of September 30, 2001, the Company had drawn $2.0 million against such credit agreement. In addition, the Company holds repurchased notes payable with a face value of DEM 139.7 million ($65.0 million) and a fair value at September 30, 2001 of $52.0 million. The Company believes that cash and cash equivalents at September 30, 2001, and the revolving credit agreement described above, will provide the Company with sufficient cash resources until it achieves positive cash flow. The Company nevertheless has a policy of assessing opportunities for additional debt and equity financing as they arise, and will pursue any such opportunities if the Company considers that they may contribute to fulfilling its financial and strategic business objectives.

Based on the above, management is confident that the Company will be able to continue as a going concern. Accordingly, these consolidated financial statements have been prepared on a going concern basis which contemplates the continuation and expansion of trading activities as well as the realization of assets and liquidation of liabilities in the ordinary course of business...
NOTE 6—EXTINGUISHMENT OF DEBT

During the three months ending March 31, 2001, in a single transaction, the Company exchanged 8,750 Senior Discount Notes (principal face amount of DEM 8.75 million) of its Senior Discount Notes for two new Senior discount notes having an aggregate face amount of $2.9 million (the “New Notes”). The interest, repayment and other terms of the New Notes are identical to those of the Senior Discount Notes for which they were exchanged, except that (i) the principal amount was reduced as indicated in the previous sentence, (ii) the Company has the right to prepay the New Notes at any time at its option by paying the “Accreted Value” of the Notes, and (iii) the new notes are governed by a new Note Purchase Agreement rather than the indenture under which the Senior Discount Notes were issued and the New Notes therefore are not covered by any of the provisions of such indenture relating to action by the trustee, voting or maintenance of listing on a stock exchange. This exchange has been accounted for as an extinguishment of debt and issuance of new debt with a resulting $0.4 million (net of applicable income taxes of $0.3 million) recognized as an extraordinary gain on such extinguishment. The extinguishment gain (pre-tax) represents the difference between the allocated carrying value of the debt extinguished ($3.3 million) and the fair market value of the New Notes issued ($2.5 million), offset by the write-off of the allocated unamortized deferred financing costs ($0.1 million). This transaction was exempt from registration in accordance with Section 3(a)9 of the Act.

During the six months ending June 30, 2001, in eight separate transactions, the Company exchanged 48,600 units (principal amount of DEM 48.6 million) of its Senior Discount Notes and 145,800 warrants for 1,691,000 shares of its common stock, par value $0.02 per share. This exchange has been accounted for as an extinguishment of debt with a resulting $7.0 million (net of applicable income taxes of $1.0 million) recognized as an extraordinary gain on such extinguishment. The extinguishment gain (pre-tax) represents the difference between the allocated carrying value of the debt and any related warrants extinguished ($19.0 million) and the fair market value of the common stock issued ($10.5 million), offset by the write-off of the allocated unamortized deferred financing costs ($0.5 million). These transactions were exempt from registration in accordance with Section 3(a)9 of the Act.

During the three months ending September 30, 2001, in five separate transactions, the Company exchanged 34,000 units (principal amount of DEM 34.0 million) of its Senior Discount Notes and 102,000 warrants for 1,157,000 shares of its common stock, par value $0.02 per share. This exchange has been accounted for as an extinguishment of debt with a resulting $2.1 million (inclusive of an applicable income tax benefit of $1.0 million) recognized as an extraordinary gain on such extinguishment. The extinguishment gain (pre-tax) represents the difference between the allocated carrying value of the debt and any related warrants extinguished ($13.6 million) and the fair market value of the common stock issued ($12.2 million), offset by the write-off of the allocated unamortized deferred financing costs ($0.3 million). These transactions were exempt from registration in accordance with Section 3(a)9 of the Act.

The Senior Discount Notes that were acquired by the Company in the above exchanges have not been retired. The Company will consider additional repurchases of its Senior Discount Notes if opportunities arise to complete such transactions on favorable terms. . . .
NOTE 9—SUBSEQUENT EVENTS
As of November 9, 2001, in a single transaction, the Company exchanged an aggregate of face value DEM 3.0 million of its Senior Discount Notes for 79,500 shares of its common stock, par value $0.02 per share. This exchange will be accounted for as an extinguishment of debt with the resulting extraordinary gain on such extinguishment calculated as the difference between the allocated carrying value of the debt and any related warrants extinguished and the fair market value of the common stock issued, offset by the write-off of the allocated unamortized deferred financing costs. The transaction is exempt from registration in accordance with Section 3(a)9 of the Act. The Senior Discount Notes that were acquired by the Company in the above exchange have not been retired.

As of October 22, 2001, the Hungarian American Enterprise Fund exercised warrants to purchase a total of 102,500 shares of Euronet common stock, par value $0.02 per share, for an aggregate strike price of $598,500. The warrants had been issued under the Credit Agreement referred to in Note 5.

As of November 13, 2001, DST Systems, Inc. exercised warrants to purchase a total of 246,000 shares of Euronet common stock, par value $0.02 per share, for an aggregate strike price of $1,436,520. The warrants had been issued under the Credit Agreement referred to in Note 5.

Total proceeds to the Company of the above warrant exercises were $2,034,520.

(Source: 10-Q/A for the period ended 9/30/01, filed 11/21/01)

Elsewhere in the 10-Q/A filing, financial statements are presented, excerpts from which appear in Table 5.8-1 and Table 5.8-2.

Table 5.8-1 Liabilities and Stockholders’ Deficit Excerpts from Consolidated Balance Sheet (Unaudited)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>LIABILITIES AND STOCKHOLDERS’ DEFICIT</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade accounts payable</td>
<td>$5,009</td>
<td>$5,223</td>
</tr>
<tr>
<td>Current installments of obligations under capital leases</td>
<td>4,295</td>
<td>3,466</td>
</tr>
<tr>
<td>Accrued expenses and other current liabilities</td>
<td>6,201</td>
<td>6,747</td>
</tr>
<tr>
<td>Short-term borrowings</td>
<td>531</td>
<td>—</td>
</tr>
<tr>
<td>Advance payments on contracts</td>
<td>1,838</td>
<td>2,155</td>
</tr>
<tr>
<td>Billings in excess of costs and estimated earnings on software</td>
<td>1,752</td>
<td>2,875</td>
</tr>
<tr>
<td>Installation contracts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>19,626</td>
<td>20,466</td>
</tr>
<tr>
<td>Obligations under capital leases, excluding current installments</td>
<td>7,624</td>
<td>8,034</td>
</tr>
<tr>
<td>Notes payable</td>
<td>46,217</td>
<td>77,191</td>
</tr>
<tr>
<td>Other long-term liabilities</td>
<td>2,000</td>
<td>—</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>75,467</td>
<td>105,691</td>
</tr>
</tbody>
</table>
(In thousands of U.S. Dollars, except share and per share data)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, $0.02 par value, Authorized 60,000,000 shares; issued and outstanding 21,121,448 shares at September 30, 2001 and 17,814,910 at December 31, 2000</td>
<td>422</td>
<td>356</td>
</tr>
<tr>
<td>Additional paid in capital</td>
<td>105,924</td>
<td>81,327</td>
</tr>
<tr>
<td>Treasury stock</td>
<td>(145)</td>
<td>(140)</td>
</tr>
<tr>
<td>Employee loans for stock</td>
<td>(463)</td>
<td>(561)</td>
</tr>
<tr>
<td>Subscription receivable</td>
<td>—</td>
<td>(59)</td>
</tr>
<tr>
<td>Accumulated deficit</td>
<td>(122,566)</td>
<td>(123,811)</td>
</tr>
<tr>
<td>Restricted reserve</td>
<td>779</td>
<td>784</td>
</tr>
<tr>
<td>Accumulated other comprehensive loss</td>
<td>(2,906)</td>
<td>(2,697)</td>
</tr>
<tr>
<td>Total stockholders’ deficit</td>
<td>(18,955)</td>
<td>(44,801)</td>
</tr>
<tr>
<td>Total liabilities and stockholders’ deficit</td>
<td>$ 56,512</td>
<td>$ 60,890</td>
</tr>
</tbody>
</table>

(Source: 10-Q/A for the period ended 9/30/01, filed on 11/21/01)

**Table 5.8-2** Excerpts from Euronet Worldwide, Inc. and Subsidiaries Consolidated Statements of Operations and Comprehensive Income/(Loss) (Unaudited)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenues</td>
<td>$ 15,681</td>
<td>$ 14,026</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>16,619</td>
<td>30,921</td>
</tr>
<tr>
<td>Operating loss</td>
<td>(938)</td>
<td>(16,895)</td>
</tr>
<tr>
<td>Other (expense)/income:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>71</td>
<td>187</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(2,063)</td>
<td>(2,505)</td>
</tr>
<tr>
<td>Foreign exchange gain/(loss), net</td>
<td>(3,560)</td>
<td>4,202</td>
</tr>
<tr>
<td>Loss before income taxes and extraordinary item</td>
<td>(6,490)</td>
<td>(15,011)</td>
</tr>
<tr>
<td>Income taxes</td>
<td>(1,015)</td>
<td>(767)</td>
</tr>
<tr>
<td>Loss before extraordinary item</td>
<td>(7,505)</td>
<td>(15,778)</td>
</tr>
<tr>
<td>Extraordinary gain on extinguishment of debt, net of applicable income taxes</td>
<td>2,097</td>
<td>—</td>
</tr>
<tr>
<td>Net income/(loss)</td>
<td>(5,408)</td>
<td>(15,778)</td>
</tr>
<tr>
<td>Other comprehensive loss:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Translation adjustment</td>
<td>(3)</td>
<td>(65)</td>
</tr>
<tr>
<td>Comprehensive income/(loss)</td>
<td>($ 5,411)</td>
<td>($ 15,843)</td>
</tr>
<tr>
<td>Loss per share—basic and diluted:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss before extraordinary item</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Extraordinary gain on early retirement of debt</td>
<td>0.10</td>
<td>—</td>
</tr>
<tr>
<td>Net income/(loss)</td>
<td>$ (0.27)</td>
<td>$ (0.90)</td>
</tr>
<tr>
<td>Weighted average number of shares outstanding</td>
<td>20,426,648</td>
<td>17,541,079</td>
</tr>
</tbody>
</table>

(Source: 10-Q/A for the period ended 9/30/01, filed on 11/21/01)
Requirement A: Subsequent Events

1. Using FARS, identify guidance that might help a company such as Euronet Worldwide, Inc. determine whether something ought to be disclosed as a subsequent event.
2. Is there any relationship between subsequent event disclosures and gain contingencies? Support your position.
3. Today, would the extinguishment of debt be accounted for as an extraordinary gain? Explain.
4. Check the proxy statement that includes the notice of the Annual Meeting of Stockholders on May 18, 2006 and determine if any reference is made to early retirement of debt. Explain the implications of what you find. In addition, access the 10-K for the fiscal year ended December 31, 2005 from sec.gov and describe its presentations affected by early retirement of debt through year-end 2005.

Requirement B: Strategy-Related Considerations

Company management determines press-release content, which is not restricted in the same manner as either 10-Q or 10-K filings, as long as nothing fraudulent is included.

1. Do you find the disclosure in the press release of Euronet Worldwide, Inc. on September 10, 2001 regarding interest savings resulting from the subsequent event reported in the June 30, 2001 10-Q filing to be of assistance to capital market participants? Why or why not?
2. Should such consequences of subsequent events be included within the note to the financial statement itself? Why or why not? Is such a communication implicit in any case?

Directed Self-Study

What are the subsequent events reported by Microsoft Corporation in its 2006 10-K filing? Describe their implications. Evaluate their relationship to guidance in FARS. Identify other entities’ reported Subsequent Events by using the full text search beta version of EDGAR. [Access sec.gov to locate the 10-K as well as to click on the beta version for the search process. Try the search phrase Subsequent Events Item 304. Then proceed to FARS, open FASB-OP (amended) and search the phrase subsequent event using Query. Perform the same query on EITF Abstracts.]

Does It Matter Where Guidance Is Located?

The FASB expects in early 2007 to deliberate on a project that plans to move guidance on subsequent events into GAAP (Attachment B, International Convergence–Status and Plans, Financial Accounting Standards Advisory Council, December 2006, Appendix 2, p. 12 – retrievable from fasb.org). Comparisons may be drawn to the developments in the area of defining the GAAP Hierarchy within the accounting literature rather than the auditing literature. Do you believe it matters where such guidance is located? Why or why not?
Key Terms and Glossary

Type I subsequent event  “Those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. . . The financial statements should be adjusted for any change in estimates resulting from the use of such evidence” (AU Section 560.06 of SAS No. 1).

Type II subsequent event  “Those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements. Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading” (AU Section 560.06 of SAS No. 1).

Further Readings

New York: AICPA – AU Section 561: “Subsequent discovery of facts existing at the date of the auditor’s report” (June 1).


The basic difference between a technician and a professional person is that the former possess the know-how, while the latter, in addition to the know-how, understands why it should be done.

—Janusz Santocki

[Source: “Educating Tomorrow’s Accountants,” Management Accounting (January 1987), pp. 45–46]
CASE 9

Reconciling International Practices to Those of the FASB: Cash Flow

CASE TOPICS OUTLINE

1. Anglo American plc
   A. Differences in Terminology
   B. Press Release: Interim Results for 2001

2. Cash Flow Comparison

Anglo American plc is a global company, with an investor relations office in London, within the United Kingdom. The company operates in the mining and natural resource sectors—including gold, platinum, diamonds, coal, base and ferrous metals, industrial minerals, and forest products. Its operations are geographically diverse, with operations in Africa, Europe, South and North America, and Australia.

The language found in financial statements varies between the UK and the United States. This is evidenced in Table 5.9-1 which provides a comparison of certain basic terminology. Such financial statement terminology must be mastered to effectively read financial reports from each of these countries.

Table 5.9-1  Financial Statement Terminology

<table>
<thead>
<tr>
<th>United Kingdom (UK)</th>
<th>United States (U.S.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover</td>
<td>Sales</td>
</tr>
<tr>
<td>Operating Costs</td>
<td>Operating Expenses</td>
</tr>
<tr>
<td>Provision for Depreciation</td>
<td>Depreciation Expense</td>
</tr>
<tr>
<td>Profit for the Year</td>
<td>Net Income</td>
</tr>
<tr>
<td>Profit and Loss Account</td>
<td>Retained Earnings</td>
</tr>
<tr>
<td>Depreciation</td>
<td>Accumulated Depreciation</td>
</tr>
<tr>
<td>Stocks</td>
<td>Inventory</td>
</tr>
<tr>
<td>Debtors</td>
<td>Accounts Receivable</td>
</tr>
<tr>
<td>Creditors Due in 1 Year</td>
<td>Accounts Payable</td>
</tr>
<tr>
<td>Other Creditors</td>
<td>Other Liabilities</td>
</tr>
<tr>
<td>Share Capital</td>
<td>Common Stock</td>
</tr>
<tr>
<td>Share Premium Account</td>
<td>Additional Paid-in Capital</td>
</tr>
</tbody>
</table>
Anglo American plc reports interim results for 2001 in a news release on September 7, 2001. Among the disclosures is mention of cash flow:

Cash flow from operations was US$1,506 million compared with US$1,068 million in the prior period. This inflow was after a US$419 million increase in working capital. Purchases of tangible fixed assets amounted to US$772 million, an increase of US$168 million. Tax payments were US$347 million compared with US$180 million. The acquisition of businesses, primarily an additional small interest in Anglo Platinum, resulted in a cash outflow of US$154 million. (Source: News Release on 9/7/2001)

The Consolidated Cash Flow Statement for the six months ended 30 June 2001 is reported in Table 5.9-2. It is followed by the two notes referenced on the face of the statement. The news release indicates that the financial information was prepared in accordance with generally accepted accounting principles (GAAP) in the UK.

Table 5.9-2  Consolidated Cash Flow Statement for the Six Months Ended 30 June 2001

<table>
<thead>
<tr>
<th></th>
<th>US$ million</th>
<th></th>
<th>Note</th>
<th>6 months ended 30.06.01</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net cash inflow from operating activities</td>
<td>8</td>
<td>1,506</td>
<td>(1)</td>
<td></td>
</tr>
<tr>
<td>Expenditure relating to fundamental reorganisations</td>
<td></td>
<td></td>
<td>(20)</td>
<td></td>
</tr>
<tr>
<td>Dividends from joint ventures and associates</td>
<td></td>
<td></td>
<td>223</td>
<td></td>
</tr>
<tr>
<td>Returns on investments and servicing of finance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest received and other financial income</td>
<td></td>
<td></td>
<td>144</td>
<td></td>
</tr>
<tr>
<td>Interest paid</td>
<td></td>
<td></td>
<td>(254)</td>
<td></td>
</tr>
<tr>
<td>Dividends received from fixed asset investments</td>
<td></td>
<td></td>
<td>41</td>
<td></td>
</tr>
<tr>
<td>Dividends paid to minority shareholders</td>
<td></td>
<td></td>
<td>(281)</td>
<td></td>
</tr>
<tr>
<td>Net cash outflow from returns on investments and servicing of finance</td>
<td></td>
<td></td>
<td>(350)</td>
<td></td>
</tr>
<tr>
<td>Taxes paid</td>
<td></td>
<td></td>
<td>(347)</td>
<td></td>
</tr>
<tr>
<td>Capital expenditure and financial investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payments for fixed assets</td>
<td></td>
<td></td>
<td>(772)</td>
<td></td>
</tr>
<tr>
<td>Proceeds from the sale of fixed assets</td>
<td></td>
<td></td>
<td>199</td>
<td></td>
</tr>
<tr>
<td>Payments for other financial assets (1)</td>
<td></td>
<td></td>
<td>(79)</td>
<td></td>
</tr>
<tr>
<td>Proceeds from the sale of other financial assets (1)</td>
<td></td>
<td></td>
<td>1,019</td>
<td></td>
</tr>
<tr>
<td>Net cash inflow/(outflow) for capital expenditure and financial investment</td>
<td></td>
<td></td>
<td>367</td>
<td></td>
</tr>
<tr>
<td>Acquisitions and disposals</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acquisition of subsidiaries (2)</td>
<td></td>
<td></td>
<td>(154)</td>
<td></td>
</tr>
<tr>
<td>Disposal of subsidiaries</td>
<td></td>
<td></td>
<td>135</td>
<td></td>
</tr>
<tr>
<td>Investment in associates</td>
<td></td>
<td></td>
<td>(189)</td>
<td></td>
</tr>
<tr>
<td>Sale of interests in associates</td>
<td></td>
<td></td>
<td>(1,148)</td>
<td></td>
</tr>
<tr>
<td>Investment in proportionally consolidated joint arrangements</td>
<td></td>
<td></td>
<td>(51)</td>
<td></td>
</tr>
<tr>
<td>Investment in joint ventures</td>
<td></td>
<td></td>
<td>(22)</td>
<td></td>
</tr>
<tr>
<td>Net cash inflow/(outflow) from acquisitions and disposals</td>
<td></td>
<td></td>
<td>867</td>
<td></td>
</tr>
<tr>
<td>Equity dividends paid to Anglo American shareholders</td>
<td></td>
<td></td>
<td>(509)</td>
<td></td>
</tr>
<tr>
<td>Cash inflow/(outflow) before use of liquid resources and financing</td>
<td></td>
<td></td>
<td>1,737</td>
<td></td>
</tr>
<tr>
<td>Management of liquid resources (3)</td>
<td></td>
<td></td>
<td>(977)</td>
<td></td>
</tr>
<tr>
<td>Financing</td>
<td></td>
<td></td>
<td>(795)</td>
<td></td>
</tr>
<tr>
<td>Decrease in cash in the period</td>
<td></td>
<td></td>
<td>10</td>
<td>(35)</td>
</tr>
</tbody>
</table>

(1) Disposal and acquisition of other financial assets included in fixed assets.
(2) Net of assets resold of US$709 million in the second half of 2000 in respect of the acquisition of Tarmac plc.
(3) Cash flows in respect of current asset investments.
(Source: Anglo American plc News Release 9/7/01)
Note 8 Reconciliation of group operating profit to net cash flow from operating activities

<table>
<thead>
<tr>
<th>US$ million</th>
<th>6 months ended 30.06.01</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group operating profit–subsidiaries</td>
<td>1,326</td>
</tr>
<tr>
<td>Depreciation and amortisation charges</td>
<td>517</td>
</tr>
<tr>
<td>Decrease/(increase) in stocks</td>
<td>21</td>
</tr>
<tr>
<td>Increase in debtors</td>
<td>(302)</td>
</tr>
<tr>
<td>(Decrease)/increase in creditors</td>
<td>(138)</td>
</tr>
<tr>
<td>Other items</td>
<td>82</td>
</tr>
<tr>
<td>Net cash inflow from operating activities</td>
<td>1,506</td>
</tr>
</tbody>
</table>

Note 10 Reconciliation of net cash flow to movement in net (debt)/funds

<table>
<thead>
<tr>
<th>US$ million</th>
<th>6 months ended 30.06.01</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decrease in cash in the period</td>
<td>(35)</td>
</tr>
<tr>
<td>Cash outflow/(inflow) from debt financing</td>
<td>824</td>
</tr>
<tr>
<td>Cash outflow/(inflow) from management of liquid resources</td>
<td>977</td>
</tr>
<tr>
<td>Change in net debt arising from cash flows</td>
<td>1,766</td>
</tr>
<tr>
<td>Loans and current asset investments acquired with subsidiaries</td>
<td>(42)</td>
</tr>
<tr>
<td>Loans and current asset investments disposed with subsidiaries</td>
<td>11</td>
</tr>
<tr>
<td>Currency translation differences</td>
<td>88</td>
</tr>
<tr>
<td>Movement in net funds/(debt)</td>
<td>1,823</td>
</tr>
<tr>
<td>Net (debt)/funds at start of the period</td>
<td>(3,590)</td>
</tr>
<tr>
<td>Net debt at the end of the period</td>
<td>(1,767)</td>
</tr>
</tbody>
</table>

Requirement A: Reconciliation to GAAP

1. Compare and contrast the presentation of cash flow information by this company operating in the United Kingdom to that required by GAAP in the United States. Specifically, access FAS No. 95 and compare and contrast the examples provided for presentation of cash flow to the contents of Table 5.9-2 and related notes.
2. Within the press release, mention is made of working capital. What is meant by this term and how does it relate, historically, to reporting practices in the United States?
3. Access the Web site for the company (www.angloamerican.co.uk) and download the most recent press release containing quarterly results. Locate the presentations analogous to those in this case and describe how they have changed, if at all. Compare them to the U.S. GAAP.

Requirement B: Strategy-Related Considerations

1. Do you find the content of cash flow-associated disclosures by Anglo American plc to be of more or less use in understanding the strategy of management when compared with the practices common in the U.S.? Explain.
2. The FASB 95 content includes the following phrasing:

   Cash Flow per Share
   FAS95, Par. 33
   Financial statements shall not report an amount of cash flow per share. Neither cash flow nor any component of it is an alternative to net income as an indicator of an enterprise’s performance, as reporting per share amounts might imply.
Do you believe this proscription is in the best interest of financial statement users? Why or why not?

**Directed Self-Study**

Statement of Financial Accounting Standards No. 123(R) entitled *Share-Based Payment* was issued in December 2004. Use FARS to describe how it affected the Statement of Cash Flows. In addition, explain why it is claimed to have resulted in greater international comparability. [Open FASB-OP (amended), click on the toolbar’s Search option, and select Search Within a Single OP Title. Type *FAS 123r* in the Document Title Box and then click twice on the Heading menu, so that the full title appears in the Document Title Box. Move to Query For: and type the phrase *statement of cash flows*. Eleven hits will result, helping you discern the answer to the first question. For the second issue, follow the same steps but use the search phrase *international comparability*. This will be a basis for you to respond to the second query.]

**An International Conundrum**

The editorial page of the *Wall Street Journal* on August 28, 2006 (p. A12) describes a transaction between a foreign bank and a national bank in another country which led to the incarceration of the foreign bank’s staff. Reportedly, legal transactions had resulted in a loss to the national bank, which led to a demand to be “made whole.” What do such developments imply about accounting measurement, international harmonization, and comparability?

**Key Terms and Glossary**

- **cash** “cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty. All charges and credits to those accounts are cash receipts or payments to both the entity owning the account and the bank holding it. For example, a bank’s granting of a loan by crediting the proceeds to a customer’s demand deposit account is a cash payment by the bank and a cash receipt of the customer when the entry is made.” (FAS 95, par. 7, footnote 1).

- **cash equivalents** “cash equivalents are short-term, highly liquid investments that are both:
  a. Readily convertible to known amounts of cash
  b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

  Generally, only investments with original maturities* of three months or less qualify under that definition.

- **financial flexibility** Concept Statement 5, footnote 13 states: “Financial flexibility is the ability of an entity to take effective actions to alter amounts and timing of cash flows so it can respond to unexpected needs and opportunities.”

- **liquidity** Concept Statement 4, par. 54 states: “Financial reporting should provide information about how an organization obtains and spends cash or other liquid resources, about its borrowing and repayment of borrowing, and about other factors that may affect its liquidity. Information about those resource flows may be useful in understanding the operations of an enterprise, evaluating its financing activities, assessing its liquidity, or interpreting performance information provided. Information about performance and economic resources, obligations, and net resources also may be useful in assessing an enterprise’s liquidity.” Concept Statement 5, footnote 13 states: “Liquidity reflects an asset’s or liability’s nearness to cash.”

- **working capital** current assets less current liabilities

  FAS 6, par. 20 notes that Chapter 3A of ARB No. 43, par. 7 defines current liabilities as those whose
*Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months” (FAS 95, par. 8, including footnote 2).

**Further Readings**


“Out of sight, out of mind,” when translated into Russian [by computer], then back again into English became “invisible maniac.”

—Arthur Calder-Marshall
CASE 10

Is the Asset Impaired—or Perhaps a Big Bath?

CASE TOPICS OUTLINE
1. Analyst Expectations for FleetBoston Financial
   A. 8-K Filings for FleetBoston Financial
   B. 10-Q Financial Statements for FleetBoston
2. Asset Impairment or Big Bath?

On December 21, 2001, the *Connecticut Post* reported that a kitchen-sink quarter had been expected by analysts and that FleetBoston Financial indeed was providing such a cleanup of its balance sheet. On December 19, 2001, FleetBoston Financial Corp. filed an 8-K with the SEC which contained the following disclosures:

**FLEETBOSTON TO TAKE A SERIES OF ACTIONS TO STRENGTHEN BALANCE SHEET**

BOSTON, MA (December 19, 2001)—Recognizing the ongoing economic slowdown, FleetBoston Financial (FBF-NYSE) today announced a series of actions to strengthen the company’s balance sheet. These actions will result in an after-tax charge of approximately $650 million ($.62 E.P.S.) to fourth quarter earnings. The Corporation expects to report a net profit of approximately $30 million ($.03 E.P.S.) in the fourth quarter inclusive of these actions and to release complete details of its fourth quarter results on January 16, 2002. “Our financial strength allows us to take actions now that will position FleetBoston to fully realize the benefits of the improved economic conditions we expect to see in the second half of 2002,” said Chad Gifford, FleetBoston’s president and chief operating officer. “It is our practice to address economic uncertainty up front and we are fortunate to have the financial capacity to take action now.” The specific actions and estimated pre-tax charges are summarized as follows:

- **—ARGENTINA** - A charge of approximately $150 million is being taken on our portfolio of Argentine government securities and loans. This brings to $200 million the total impairment charges taken against the Argentine portfolio this year, of which
$75 million will go to bolster loan loss reserves and $125 million relates to the recently announced government sponsored bond swap program. The Corporation has operated in Argentina for 85 years with great success and strong profitability. Its very experienced management team is well equipped to deal with the financial adjustment that is occurring in that country.

• —PRINCIPAL INVESTING - The Corporation has operated in this business for over 40 years and has generated strong returns over that period. The current environment is unprecedented in the confluence of negative factors affecting the principal investing industry. Write-downs of approximately $475 million will be taken to the carrying value of the portfolio in the fourth quarter, primarily in the technology and telecom sectors. This action follows a review of the portfolio in light of the pronounced weakness that has severely impacted market liquidity and the operating performance of the underlying investments, coupled with our intent to maintain a cautious stance on the economy. The principal investing portfolio of $3.6B is currently carried at a discount of approximately 25% of Fleet’s original investment with discounts approaching 50% in the direct technology and telecom portfolio.

• —CREDIT ACTIONS - The current recessionary environment continues to strain a number of our domestic commercial and industrial customers. The Corporation continues to take an aggressive approach to recognizing these pressures and is committed to maintaining its established reserve strength. The Corporation expects to incur incremental credit costs of $175 million to strengthen the loan loss reserve to the $3 billion level and charges of $150 million related to the movement of approximately $350 million of problem credits to accelerated disposition status. During the quarter, write-downs were taken on a number of our larger troubled credits, including a well-publicized energy-related credit. As a result of these actions, the reserve-to-loans ratio is expected to rise to the range of 2.3% to 2.4% at year-end.

• —RESTRUCTURING CHARGE - The Corporation continues to be responsive to the current weak operating environment and wants to ensure that its expense base remains aligned with its revenue expectations, particularly in a weak capital markets environment. Approximately $100 million of charges are being taken to primarily cover severance and related costs for various businesses and is expected to further reduce staff by 700 individuals against our employee base of approximately 55,000 employees. Eugene M. McQuade, FleetBoston’s vice chairman and chief financial officer stated: “The strength of our operating earnings as well as capital and reserves in excess of $20 billion afford us ample capacity to take these actions. We expect to end the year with healthy capital ratios of approximately 7.7% for Tier 1 capital and 6.5% for tangible common equity. Our expectation to achieve the analyst consensus estimate of $3.26 for 2002 earnings per share remains intact.” Mr. Gifford further commented: “We have great confidence in the underlying strength of our franchise and we draw on that strength in taking these actions. Our greatest priority lies in seizing the potential of our extensive customer base and continuing the growth initiatives underway in our mainstream businesses.”

• FleetBoston Financial is the seventh-largest financial holding company in the United States. A $200 billion diversified financial services company, it offers a comprehensive array of innovative financial solutions to 20 million customers in more than 20 countries and territories. FleetBoston Financial is headquartered in Boston and listed
This release contains forward-looking statements that involve risks and uncertainties that could cause actual results to differ materially from estimates. These risks and uncertainties include, among other things, (1) changes in general political and economic conditions, either domestically or internationally, including the economic effects of the September 11, 2001 terrorist attacks against the United States and the response of the United States to those attacks, the continuing weakness in the Latin American economies, particularly Argentina, and a further deterioration in credit quality, including the resultant effect on the level of the Corporation’s nonperforming assets and chargeoffs; (2) interest rate and currency fluctuations, equity and bond market fluctuations and perceptions, including continued weakness in the global capital markets and the impact of such weakness on the Corporation’s Principal Investing and other capital markets businesses; (3) changes in the competitive environment for financial services organizations and the Corporation’s ability to manage those changes; (4) legislative or regulatory developments, including changes in laws concerning taxes, banking, securities, insurance and other aspects of the financial services industry; (5) technological changes, including the impact of the Internet on the Corporation’s businesses; (6) the ability of the Corporation to fully realize expected cost savings and realize those savings within the expected timeframes; and (7) the level of costs related to the integration of acquired businesses. For further information, please refer to the Corporation’s reports filed with the SEC.
(Source: 8-K filed on 12/19/01)

Earlier, the company had issued an 8-K/A that included a press release containing the following related discussion:

FLEETBOSTON REPORTS THIRD QUARTER EARNINGS OF $766 MILLION OR $.70 PER SHARE
COMMON DIVIDEND INCREASED BY 6%

Boston, MA (October 17, 2001)—FleetBoston Financial (FBF-NYSE) today reported third quarter earnings of $766 million, or $.70 per share, compared with $969 million, or $.87 per share in the third quarter of 2000. Earnings from the Corporation’s primary capital markets units—Principal Investing, Robertson Stephens, and Quick & Reilly—fell by $239 million or $.22 per share from their level in the third quarter of last year reflecting continued slowness in the capital markets, exacerbated by the tragic events of September 11.

Offsetting these declines were earnings growth from several business lines including Retail Banking, Latin America, and Small Business; higher cash management fees; merger-related cost savings; and expense reductions from the corporate cost containment program. The current quarter’s results included a gain on the sale of an equity investment, net of merger-related charges, totaling $60 million ($.05 per share), while the third quarter of 2000 included divestiture gains, net of merger related charges, totaling $59 million ($.05 per share).

Return on assets and return on equity for the quarter were 1.47% and 15.56%, respectively, compared with 1.78% and 21.6% a year ago. For the first nine months of
2001, earnings before strategic charges were $2.2 billion, or $1.96 per share, versus $3.02 billion, or $2.72 per share, in the first nine months of 2000.

FleetBoston also announced today a 6% increase in its quarterly common dividend to $.35 per share for shareholders of record on December 3, 2001.

Terrence Murray, Chairman and Chief Executive Officer of FleetBoston commented, “We have all been affected and, in many ways, transformed by the events of September 11. While Fleet was fortunate to not have lost any of our employees from this tragedy, we nonetheless grieve with the rest of the country over the many lives that were lost, including those of friends, relatives and business associates. During the past few weeks, I’ve spent quite a bit of time meeting with employees in many of our businesses, including those in and around New York City who were personally affected by the tragedy. It was truly inspiring to see first hand how incredibly well our employees in the area were handling the adversity and we can all learn a valuable lesson from their courage and determination to serve the customer.”

Murray continued, “These are certainly difficult times for our economy and corporate America. An economic slowdown was well underway prior to September 11 and has now worsened. For Fleet, the biggest impact has been seen in our capital markets businesses, which continued weak throughout the third quarter. Despite the economy’s performance of late, we remain very optimistic that our country will meet the economic challenges that we face and return to a period of growth and prosperity. We also remain enthusiastic about the future of FleetBoston as evidenced by our dividend increase. Our customer service efforts are gaining traction in our consumer businesses and in wholesale banking we are really beginning to leverage our lead relationships. These positive developments, coupled with our expense discipline and balance sheet strength, position us well to capitalize when economic conditions improve.”

Chad Gifford, President and Chief Operating Officer said, “The Corporation moved ahead on a number of fronts during the third quarter. In an effort to support our country’s financial markets and our shareholders in the wake of September 11, we announced a plan to repurchase up to $4 billion of our stock by December 31, 2002 and began executing on this program immediately. We also continued with our efforts to improve the customer experience. Specifically, we announced plans to open 28 new branches and 23 new ATMs in Massachusetts, while upgrading 27 other branches and ATM locations. In addition, we also opened an Investment Access Center in the MetLife building adjacent to Grand Central Station in New York City. This location not only provides our customers with traditional Fleet and Quick & Reilly products and services but also gives our customers self-service on-line access to their accounts. A milestone was reached with the recent enrollment of our two millionth HomeLink on-line banking customer. Finally, work continued during the third quarter on our announced acquisition of Liberty Financial’s Asset Management unit and we expect to close shortly. We remain committed to our top priority of building shareholder value through strengthening our existing business lines and seizing the potential of our extensive customer base. We are intensely focused on execution and customer service-driven revenue growth.

Credit Quality/Balance Sheet

Nonperforming assets were $1.56 billion, or 1.22% of total loans, at September 30, 2001, up 12% from June 30, 2001. The provision for credit losses was $325 million in the current quarter, which matched net chargeoffs. In the third quarter of 2000, the provision
was $325 million and net chargeoffs were $321 million. The reserve for credit losses was $2.73 billion at September 30, 2001, representing 2.14% of total loans and leases.

Total assets at September 30, 2001 were $202 billion, compared with $218 billion at September 30, 2000. The decline from a year ago is due, in part, to the sale/run-off of low-margin assets in connection with the Summit merger, and the sale of our mortgage company in June. Stockholders’ equity amounted to $20 billion at September 30, 2001, with a common equity to assets ratio of 9.6%.

A detailed financial package containing supplemental information on the third quarter financial results can be found by accessing the Corporation’s Web site [http://www.fleet.com](http://www.fleet.com). (Source: 8-K/A filed on 10/17/01)

The Company filed its 10-Q for the period ended September 30, 2001 on November 14, 2001, which contained the following observations:

Decreases in earnings from the prior year in both the three- and nine-month comparisons resulted from a significant drop in capital markets revenue due to the pronounced fallout experienced in U.S. capital markets which began in the second half of 2000. Declines in current-year revenues reflect the continued slowdown in these markets during 2001. These revenue declines were partly offset by improved results in Retail Banking and International Banking, as well as lower operating expenses resulting from a corporate-wide cost containment program and a drop in revenue-related compensation costs.

Although certain branch and other operations were affected by the September 11 terrorist attacks, and some employees were relocated from their New York locations to alternate sites in New Jersey following the attacks, FleetBoston’s overall operations were only modestly impacted, and its consolidated results of operations for the third quarter and its overall financial condition were not materially impacted by these events. These events caused, and may continue to cause, additional weakness in the economy and in general business activities. FleetBoston continues to evaluate the effects of these events on the Corporation’s fourth quarter and future results of operations.

Results for the three and nine months ended September 30, 2001 and 2000 included the following:

**Three months ended September 30, 2001:**

- Gain of $146 million ($91 million after-tax) from the sale of FleetBoston’s investment in the NYCE Corporation.
- Summit merger-related costs of $52 million ($31 million after-tax), composed of $35 million of merger integration costs and $17 million of accelerated depreciation of assets to be disposed of at a later date.

**Three months ended September 30, 2000:**

- Branch divestiture gains of $164 million ($84 million after-tax) associated with the previously disclosed BankBoston merger.
- Merger integration costs of $40 million ($25 million after-tax) incurred in connection with the BankBoston merger.
Nine months ended September 30, 2001:

- Gains of $333 million ($204 million after-tax) from branch divestitures associated with the BankBoston merger and $146 million ($91 million after-tax) from the above-mentioned sale of the investment in the NYCE Corporation.
- Write-downs of $602 million ($370 million after-tax) taken against the carrying value of the Principal Investing portfolio.
- Summit merger-related costs of $863 million ($542 million after-tax), consisting of $463 million ($302 million after-tax) of merger- and restructuring-related charges, $135 million ($82 million after-tax) of merger integration costs and a $265 million ($158 million after-tax) loss from the sale of low-margin securities following the merger.
- Restructuring charges of $79 million ($50 million after-tax) primarily related to a reorganization of capital markets-related businesses.
- An aggregate loss of $428 million ($285 million after-tax) from the sale of the mortgage banking business. (Source: 10-Q filed for the period ended 9/30/01 on 11/14/01)

The Consolidated Statements of Income in the quarterly filing are reported in Table 5.10-1.

**Table 5.10-1** FleetBoston Financial Corp. Consolidated Statements of Income (Unaudited)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Interest income:</td>
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<td></td>
<td></td>
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</tr>
<tr>
<td>Interest and fees on loans and leases</td>
<td>$2,601</td>
<td>$3,323</td>
<td>$8,517</td>
<td>$9,865</td>
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<td>Interest on securities and trading assets</td>
<td>446</td>
<td>658</td>
<td>1,536</td>
<td>1,915</td>
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<tr>
<td>Other</td>
<td>302</td>
<td>128</td>
<td>781</td>
<td>508</td>
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<tr>
<td>Total interest income</td>
<td>3,349</td>
<td>4,109</td>
<td>10,834</td>
<td>12,288</td>
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<tr>
<td>Interest expense:</td>
<td></td>
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<tr>
<td>Deposits of domestic offices</td>
<td>590</td>
<td>817</td>
<td>2,025</td>
<td>2,402</td>
</tr>
<tr>
<td>Deposits of international offices</td>
<td>274</td>
<td>332</td>
<td>849</td>
<td>926</td>
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<tr>
<td>Short-term borrowings</td>
<td>243</td>
<td>406</td>
<td>863</td>
<td>1,216</td>
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<tr>
<td>Long-term debt</td>
<td>363</td>
<td>558</td>
<td>1,300</td>
<td>1,535</td>
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<tr>
<td>Other</td>
<td>32</td>
<td>67</td>
<td>130</td>
<td>208</td>
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<tr>
<td>Total interest expense</td>
<td>1,502</td>
<td>2,180</td>
<td>5,167</td>
<td>6,287</td>
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<tr>
<td>Net interest income</td>
<td>1,847</td>
<td>1,929</td>
<td>5,667</td>
<td>6,001</td>
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<tr>
<td>Provision for credit losses</td>
<td>325</td>
<td>325</td>
<td>955</td>
<td>980</td>
</tr>
<tr>
<td>-----------------------------------------------</td>
<td>---------------------------------------</td>
<td>---------------------------------------</td>
<td>-------------------------------------</td>
<td>-------------------------------------</td>
</tr>
<tr>
<td>Net interest income after provision for credit losses</td>
<td>1,522</td>
<td>1,604</td>
<td>4,712</td>
<td>5,021</td>
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<tr>
<td>Noninterest income:</td>
<td></td>
<td></td>
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<tr>
<td>Capital markets revenue</td>
<td>460</td>
<td>752</td>
<td>455</td>
<td>2,632</td>
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<tr>
<td>Banking fees and commissions</td>
<td>406</td>
<td>400</td>
<td>1,201</td>
<td>1,207</td>
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<tr>
<td>Investment services revenue</td>
<td>348</td>
<td>423</td>
<td>1,099</td>
<td>1,399</td>
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<tr>
<td>Credit card revenue</td>
<td>193</td>
<td>186</td>
<td>520</td>
<td>529</td>
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<tr>
<td>Processing-related revenue</td>
<td>68</td>
<td>154</td>
<td>330</td>
<td>467</td>
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<tr>
<td>Gains on branch divestitures</td>
<td>—</td>
<td>164</td>
<td>353</td>
<td>843</td>
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<tr>
<td>Other</td>
<td>135</td>
<td>185</td>
<td>503</td>
<td>475</td>
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<tr>
<td>Total noninterest income</td>
<td>1,610</td>
<td>2,264</td>
<td>4,461</td>
<td>7,552</td>
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<tr>
<td>Noninterest expense:</td>
<td></td>
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<tr>
<td>Employee compensation and benefits</td>
<td>979</td>
<td>1,178</td>
<td>3,008</td>
<td>3,995</td>
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<tr>
<td>Occupancy and equipment</td>
<td>283</td>
<td>294</td>
<td>847</td>
<td>903</td>
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<tr>
<td>Intangible asset amortization</td>
<td>96</td>
<td>97</td>
<td>294</td>
<td>291</td>
</tr>
<tr>
<td>Marketing and public relations</td>
<td>63</td>
<td>82</td>
<td>184</td>
<td>238</td>
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<tr>
<td>Legal and other professional</td>
<td>51</td>
<td>88</td>
<td>182</td>
<td>266</td>
</tr>
<tr>
<td>Merger- and restructuring-related charges</td>
<td>17</td>
<td>6</td>
<td>542</td>
<td>68</td>
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<tr>
<td>Loss on sale of mortgage banking business</td>
<td>—</td>
<td>—</td>
<td>428</td>
<td>—</td>
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<tr>
<td>Other</td>
<td>408</td>
<td>545</td>
<td>1,324</td>
<td>1,741</td>
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<tr>
<td>Total noninterest expense</td>
<td>1,897</td>
<td>2,290</td>
<td>6,809</td>
<td>7,502</td>
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<tr>
<td>Income before income taxes</td>
<td>1,235</td>
<td>1,578</td>
<td>2,364</td>
<td>5,071</td>
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### Table: Financial Data

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<tbody>
<tr>
<td>Applicable income taxes</td>
<td>469</td>
<td>609</td>
<td>926</td>
<td>2,055</td>
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<tr>
<td>Net income</td>
<td>$766</td>
<td>$969</td>
<td>$969</td>
<td>$3,016</td>
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<tr>
<td>Diluted weighted average common shares outstanding (in millions)</td>
<td>1,091.8</td>
<td>1,101.5</td>
<td>1,094.1</td>
<td>1,099.7</td>
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<tr>
<td>Net income applicable to common shares</td>
<td>$760</td>
<td>$959</td>
<td>$1,415</td>
<td>$2,987</td>
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<tr>
<td>Basic earnings per share</td>
<td>.70</td>
<td>.89</td>
<td>1.31</td>
<td>2.76</td>
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<tr>
<td>Diluted earnings per share</td>
<td>.70</td>
<td>.87</td>
<td>1.29</td>
<td>2.72</td>
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<tr>
<td>Dividends declared</td>
<td>.33</td>
<td>.30</td>
<td>.99</td>
<td>.90</td>
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See accompanying Condensed Notes to Consolidated Financial Statements; Note 6 is reported within this case.
(Source: FleetBoston Financial Corp. 10-Q for quarterly period ended 9/30/01)

### NOTE 6. MERGER- AND RESTRUCTURING-RELATED CHARGES

In the first quarter of 2001, FleetBoston recorded aggregate merger- and restructuring-related charges of $487 million in connection with the Summit merger and a restructuring of its capital markets-related businesses. Of the $487 million, $408 million related to Summit and $79 million primarily related to capital markets. The $408 million charge was composed of $73 million of merger-related charges, $322 million of restructuring-related charges, and $13 million of accelerated depreciation of assets to be disposed of at a later date, which resulted from revisions to the estimated useful lives of assets currently in use that will be disposed when the Summit integration has been completed.

In addition to the merger- and restructuring-related charges, FleetBoston incurred $45 million of merger integration costs in the first quarter. These integration costs, which are expensed as incurred, include the costs of converting duplicate computer systems, training and relocation of employees and departments, consolidation of facilities and customer communications. During the second and third quarters of 2001, aggregate costs of $145 million, composed of $55 million and $90 million of additional accelerated depreciation and integration costs, respectively, were recorded.

In 1999, the Corporation recorded $467 million of restructuring charges in connection with the BankBoston merger. Additional information concerning these 1999 charges is included in Note 14 to the Consolidated Financial Statements included in the Corporation’s Current Report on Form 8-K dated May 4, 2001. During the second quarter of 2001, $14 million of such charges were reversed, primarily related to severance and facilities accruals which were not fully utilized.
Restructuring-Related Charges

Summit

Of the $322 million restructuring-related charge, $150 million related to personnel, $96 million related to asset write-downs and contract cancellations, $60 million related to facilities and $16 million related to other restructuring expenses.

Personnel-related costs of $150 million included severance to be paid in a lump sum or over a defined period, benefit program changes and outplacement services for approximately 2,700 positions identified during the first quarter for elimination in connection with restructuring, principally as a result of the elimination of duplicate functions within the combined company. During the first nine months of 2001, approximately $89 million of personnel-related benefits were paid and approximately 2,500 employees were terminated and left the Corporation.

Asset write-downs and contract cancellation costs of $96 million related to costs to dispose of duplicate or obsolete equipment and computer software, and penalties incurred to cancel leases and other contracts. During the first nine months of 2001, $20 million of costs were paid and $51 million of write-downs were recorded.

Facilities-related charges of $60 million represented minimum lease payments related to duplicate branch and other facilities. During the first nine months of 2001, $1 million of facilities-related charges were paid and $8 million accrued for such charges, which were not fully utilized, was reversed. Other costs of $16 million included expenses and various other costs incurred to merge the two companies. During the first nine months of 2001, $9 million of other costs were paid.

Capital Markets

Of the $79 million charge, $52 million related to severance to be paid in a lump sum or over a defined period, benefit program changes and outplacement services for approximately 750 positions identified during the first quarter for elimination in connection with the restructuring; $23 million of costs related to future lease obligations and write-downs of capitalized assets; and $4 million of other restructuring expenses. During the first nine months of 2001, approximately 740 employees were terminated and left the Corporation, and $43 million of related benefits were paid.

The following table presents activity in restructuring-related accruals during the nine months ended September 30, 2001.

| FleetBoston Financial Corp. Condensed Notes to Consolidated Financial Statements |
| September 30, 2001 |

Restructuring Accrual Activity

<table>
<thead>
<tr>
<th></th>
<th>Summit &amp; Capital Markets</th>
<th>BankBoston</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at December 31, 2000</td>
<td>$ —</td>
<td>$146</td>
</tr>
<tr>
<td>Restructuring accrual</td>
<td>401</td>
<td>—</td>
</tr>
<tr>
<td>Restructuring reversal</td>
<td>(8)</td>
<td>(14)</td>
</tr>
<tr>
<td>Cash payments</td>
<td>(162)</td>
<td>(104)</td>
</tr>
<tr>
<td>Noncash write-downs</td>
<td>(51)</td>
<td>—</td>
</tr>
<tr>
<td>Balance at September 30, 2001</td>
<td>$180</td>
<td>$28</td>
</tr>
</tbody>
</table>
The $104 million of cash payments included in the table above related to the BankBoston merger consisted of $89 million of personnel benefits, $14 million in facilities charges, and $1 million of other restructuring expenses. The remaining accrual at September 30, 2001 is composed primarily of expected cash outlays related to severance and facilities obligations. (Source: FleetBoston Financial Corp. 10-Q for quarterly period ended 9/30/01)

The assets reported on the Consolidated Balance Sheets in the quarterly filing are itemized in Table 5.10-2.

**Table 5.10-2** Excerpt from FleetBoston Financial Corp. Consolidated Balance Sheets (Unaudited)

<table>
<thead>
<tr>
<th>Dollars in Millions, Except per Share Amounts</th>
<th>September 30, 2001</th>
<th>December 31, 2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash, due from banks and interest-bearing</td>
<td>$15,001</td>
<td>$12,826</td>
</tr>
<tr>
<td>deposits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal funds sold and securities purchased</td>
<td>7,500</td>
<td>1,959</td>
</tr>
<tr>
<td>under agreements to resell</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trading assets</td>
<td>6,663</td>
<td>7,108</td>
</tr>
<tr>
<td>Mortgages held for sale</td>
<td>539</td>
<td>2,138</td>
</tr>
<tr>
<td>Securities (market value: $22,255 and $34,932)</td>
<td>22,251</td>
<td>34,964</td>
</tr>
<tr>
<td>Loans and leases</td>
<td>127,820</td>
<td>134,834</td>
</tr>
<tr>
<td>Reserve for credit losses</td>
<td>(2,734)</td>
<td>(2,709)</td>
</tr>
<tr>
<td>Net loans and leases</td>
<td>125,086</td>
<td>132,125</td>
</tr>
<tr>
<td>Due from brokers/dealers</td>
<td>4,059</td>
<td>2,987</td>
</tr>
<tr>
<td>Premises and equipment</td>
<td>2,896</td>
<td>2,867</td>
</tr>
<tr>
<td>Mortgage servicing rights</td>
<td>—</td>
<td>2,695</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>4,198</td>
<td>4,557</td>
</tr>
<tr>
<td>Other assets</td>
<td>13,669</td>
<td>14,859</td>
</tr>
<tr>
<td>Total assets</td>
<td>$201,862</td>
<td>$219,085</td>
</tr>
</tbody>
</table>

(Source: FleetBoston Financial Corp. 10-Q for quarterly period ended 9/30/01)

The derivation of net cash flow provided by operating activities in the FleetBoston Financial Corporation Consolidated Statements of Cash Flows included the line items (in millions): “Depreciation and amortization of premises and equipment” $445 and $437, “Merger- and restructuring-related charges” of $542 and $68, and “Write-downs of principal investing investments” in the amount of $602 and —, for the nine months ended September 30, 2001 and 2000, respectively.

**Requirement A: Impairment of Assets and Write-downs**

1. What accounting guidance applies to the determination of whether an asset is impaired? What guidance applies to quantifying the amount of a write-down, when it is deemed to be appropriate? Does the nature of the asset being written down influence such adjustments? How?
2. Using the disclosures by FleetBoston, write an executive summary as to the nature of the write-downs taken, and the likely implications of these actions for future periods. Provide the basis for your expectations in specific terms, detailing the types of accounts affected and estimated amounts. Support your position with appropriate citations from FARS.

**Requirement B: Strategy-Related Considerations**

Significant effects of write-offs in a single quarter have prompted the business press to dub such practices as “Rumpelstilzchen accounting” (i.e., turning future “straw” into “gold” by hitting current year’s income with a large write-down) or “big bath accounting.”

1. What are the circumstances in which company management may be more likely to take a write-down?
2. Should such a declaration be presumed to be a “big bath”? What differentiates the occasional write-off from a management strategy of a “big bath”?
3. Do you believe such practices result in effective financial reporting? Explain.
4. Access Staff Accounting Bulletin (SAB) 100 at sec.gov. Also find the article in the Wall Street Journal published August 28, 2006 (p. C1) that reports on how an international company’s profit margin is affected by write-downs. In light of such regulation and media coverage, do you view accounting developments to date as leading to fewer or more “big baths”?

**Directed Self-Study**

Access sec.gov and describe what has happened to FleetBoston Financial Corporation since the events described in this case. What are the ramifications of what you find?

**Key Terms and Glossary**

- **big bath** large write-downs of assets
- **capital market transactions hypothesis** drawn from the theory that investors’ perceptions of a firm are of importance to the corporate managers because they expect to issue public debt or equity or to make an acquisition of another company, especially when the latter involves a stock transaction
- **corporate control hypothesis** is a theory motivated by empirical evidence that both boards of directors and investors hold managers accountable for current stock performance
- **impairment** “the condition that exists when the carrying amount of a long-lived asset (asset group) exceeds its fair value” (FAS 144, par. 7)
- **“lemons” problem** information problem that arises from differences in information and conflicts in the incentives between managers and capital providers; signaling is viewed as one approach to addressing the challenge of asymmetric information, whereby managers use voluntary disclosure practices and similar tools to inform the market participants of their expectations and accomplishments to date
Further Readings


Far better an approximate answer to the right question, is often vague, than an exact answer to the wrong question, which can always be made precise.

—John Tukey

CASE TOPICS OUTLINE
1. Enron Corp.
   A. 8-K Filing
   B. Inclusion of Press Release
C. 10-K Filing in 2000
2. Analysis
3. Enron Corp. Files for Chapter 11


Moving backwards in time, consider a sample of the disclosures found in the year-end 10-K filing by Enron Corp. for 2000.

In 2000 and 1999, Enron entered into various transactions with related parties, which resulted in an exchange of assets and an increase in common stock of $171 million in 2000. See Note 16.

In 2000, a partnership in which Enron was a limited partner made a liquidating distribution to Enron resulting in a non-cash increase in current assets of $220 million, a decrease of $20 million in non-current assets and an increase in current liabilities of $160 million. . . .
9 UNCONSOLIDATED EQUITY AFFILIATES

Enron’s investment in and advances to unconsolidated affiliates which are accounted for by the equity method is as follows:

<table>
<thead>
<tr>
<th>Affiliation</th>
<th>Voting Interest(a)</th>
<th>Net December 31, (In millions)</th>
<th>2000</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Azurix Corp.</td>
<td>34%</td>
<td>$325</td>
<td>$762</td>
<td></td>
</tr>
<tr>
<td>Bridgeline Holdings</td>
<td>40%</td>
<td>$229</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Citrus Corp.</td>
<td>50%</td>
<td>$530</td>
<td>$480</td>
<td></td>
</tr>
<tr>
<td>Dabhol Power Company</td>
<td>50%</td>
<td>$693</td>
<td>$466</td>
<td></td>
</tr>
<tr>
<td>Joint Energy Development Investments L.P. (JEDI)(b)</td>
<td>50%</td>
<td>$399</td>
<td>$211</td>
<td></td>
</tr>
<tr>
<td>Joint Energy Development Investments II L.P. (JEDI II)(b)</td>
<td>50%</td>
<td>$220</td>
<td>$162</td>
<td></td>
</tr>
<tr>
<td>SK - Enron Co. Ltd.</td>
<td>50%</td>
<td>$258</td>
<td>$269</td>
<td></td>
</tr>
<tr>
<td>Transportadora de Gas del Sur S.A.</td>
<td>35%</td>
<td>$479</td>
<td>$452</td>
<td></td>
</tr>
<tr>
<td>Whitewing Associates, L.P.(b)</td>
<td>50%</td>
<td>$558</td>
<td>$662</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td>$1,603</td>
<td>$1,572</td>
<td></td>
</tr>
</tbody>
</table>

$5,294(c) $5,036(c)

(a) Certain investments have income sharing ratios which differ from Enron’s voting interests.

(b) JEDI and JEDI II account for their investments at fair value. Whitewing accounts for certain of its investments at fair value. These affiliates held fair value investments totaling $1,823 million and $1,128 million, respectively, at December 31, 2000 and 1999.

(c) At December 31, 2000 and 1999, the unamortized excess of Enron’s investment in unconsolidated affiliates was $182 million and $179 million, respectively, which is being amortized over the expected lives of the investments.

Enron’s equity in earnings (losses) of unconsolidated equity affiliates is as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Azurix Corp.(a)</td>
<td>$(428)</td>
<td>$ 23</td>
<td>$ 6</td>
</tr>
<tr>
<td>Citrus Corp.</td>
<td>50</td>
<td>25</td>
<td>23</td>
</tr>
<tr>
<td>Dabhol Power Company</td>
<td>51</td>
<td>30</td>
<td>-</td>
</tr>
<tr>
<td>Joint Energy Development Investments L.P.</td>
<td>197</td>
<td>11</td>
<td>(45)</td>
</tr>
<tr>
<td>Joint Energy Development Investments II, L.P.</td>
<td>58</td>
<td>92</td>
<td>(4)</td>
</tr>
<tr>
<td>TNPC, Inc. (The New Power Company)</td>
<td>(60)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Transportadora de Gas del Sur S.A.</td>
<td>38</td>
<td>32</td>
<td>36</td>
</tr>
<tr>
<td>Whitewing Associates, L.P.</td>
<td>58</td>
<td>9</td>
<td>-</td>
</tr>
<tr>
<td>Other</td>
<td>123</td>
<td>87</td>
<td>81</td>
</tr>
</tbody>
</table>

$ 87   $ 309  $ 97

(a) During the fourth quarter of 2000, Azurix Corp. (Azurix) impaired the carrying value of its Argentine assets, resulting in a charge of approximately $470 million. Enron’s portion of the charge was $326 million.
Summarized combined financial information of Enron’s unconsolidated affiliates is presented below:

<table>
<thead>
<tr>
<th>December 31,</th>
<th>2000</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>(In millions)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance sheet</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current assets(a)</td>
<td>$5,884</td>
<td>$3,168</td>
</tr>
<tr>
<td>Property, plant and equipment, net</td>
<td>14,786</td>
<td>14,356</td>
</tr>
<tr>
<td>Other noncurrent assets</td>
<td>13,485</td>
<td>9,459</td>
</tr>
<tr>
<td>Current liabilities(a)</td>
<td>4,739</td>
<td>4,401</td>
</tr>
<tr>
<td>Long-term debt(a)</td>
<td>9,717</td>
<td>8,486</td>
</tr>
<tr>
<td>Other noncurrent liabilities</td>
<td>6,148</td>
<td>2,402</td>
</tr>
<tr>
<td>Owners’ equity</td>
<td>13,551</td>
<td>11,694</td>
</tr>
</tbody>
</table>

(a) Includes $410 million and $327 million receivable from Enron and $302 million and $84 million payable to Enron at December 31, 2000 and 1999, respectively.

<table>
<thead>
<tr>
<th>(In millions)</th>
<th>2000</th>
<th>1999</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income statement(a)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating revenues</td>
<td>$15,903</td>
<td>$11,568</td>
<td>$8,508</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>14,710</td>
<td>9,449</td>
<td>7,244</td>
</tr>
<tr>
<td>Net income</td>
<td>586</td>
<td>1,857</td>
<td>142</td>
</tr>
<tr>
<td>Distributions paid to Enron</td>
<td>137</td>
<td>482</td>
<td>87</td>
</tr>
</tbody>
</table>


In 2000 and 1999, Enron sold approximately $632 million and $192 million, respectively, of merchant investments and other assets to Whitewing. Enron recognized no gains or losses in connection with these transactions. Additionally, in 2000, ECT Merchant Investments Corp., a wholly-owned Enron subsidiary, contributed two pools of merchant investments to a limited partnership that is a subsidiary of Enron. Subsequent to the contributions, the partnership issued partnership interests representing 100% of the beneficial, economic interests in the two asset pools, and such interests were sold for a total of $545 million to a limited liability company that is a subsidiary of Whitewing. See Note 3. These entities are separate legal entities from Enron and have separate assets and liabilities. In 2000 and 1999, the Related Party, as described in Note 16, contributed $33 million and $15 million, respectively, of equity to Whitewing. In 2000, Whitewing contributed $7.1 million to a partnership formed by Enron, Whitewing and a third party. Subsequently, Enron sold a portion of its interest in the partnership through a securitization. See Note 3.


From time to time, Enron has entered into various administrative service, management, construction, supply and operating agreements with its unconsolidated equity affiliates. Enron’s management believes that its existing agreements and transactions are reasonable compared to those which could have been obtained from third parties. . . .
Derivative Instruments. At December 31, 2000, Enron had derivative instruments (excluding amounts disclosed in Note 10) on 54.8 million shares of Enron common stock, of which approximately 12 million shares are with JEDI and 22.5 million shares are with related parties (see Note 16), at an average price of $67.92 per share on which Enron was a fixed price payor. Shares potentially deliverable to counterparties under the contracts are assumed to be outstanding in calculating diluted earnings per share unless they are antidilutive. At December 31, 2000, there were outstanding non-employee options to purchase 6.4 million shares of Enron common stock at an exercise price of $19.59 per share.

16 RELATED PARTY TRANSACTIONS

In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner’s managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron. Management believes that the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties.

In 2000, Enron entered into transactions with the Related Party to hedge certain merchant investments and other assets. As part of the transactions, Enron (i) contributed to newly-formed entities (the Entities) assets valued at approximately $1.2 billion, including $150 million in Enron notes payable, 3.7 million restricted shares of outstanding Enron common stock and the right to receive up to 18.0 million shares of outstanding Enron common stock in March 2003 (subject to certain conditions) and (ii) transferred to the Entities assets valued at approximately $309 million, including a $50 million note payable and an investment in an entity that indirectly holds warrants convertible into common stock of an Enron equity method investee. In return, Enron received economic interests in the Entities, $309 million in notes receivable, of which $259 million is recorded at Enron’s carryover basis of zero, and a special distribution from the Entities in the form of $1.2 billion in notes receivable, subject to changes in the principal for amounts payable by Enron in connection with the execution of additional derivative instruments. Cash in these Entities of $172.6 million is invested in Enron demand notes. In addition, Enron paid $123 million to purchase share-settled options from the Entities on 21.7 million shares of Enron common stock. The Entities paid Enron $10.7 million to terminate the share-settled options on 14.6 million shares of Enron common stock outstanding. In late 2000, Enron entered into share-settled collar arrangements with the Entities on 15.4 million shares of Enron common stock. Such arrangements will be accounted for as equity transactions when settled.

In 2000, Enron entered into derivative transactions with the Entities with a combined notional amount of approximately $2.1 billion to hedge certain merchant investments and other assets. Enron’s notes receivable balance was reduced by $36 million as a result of premiums owed on derivative transactions. Enron recognized revenues of approximately $500 million related to the subsequent change in the market value of these derivatives, which offset market value changes of certain merchant investments and price risk management activities. In addition, Enron recognized $44.5 million and $14.1 million of interest income and interest expense, respectively, on the notes receivable from and payable to the Entities.

In 1999, Enron entered into a series of transactions involving a third party and the Related Party. The effect of the transactions was (i) Enron and the third party amended certain forward contracts to purchase shares of Enron common stock, resulting in Enron
having forward contracts to purchase Enron common shares at the market price on that day, (ii) the Related Party received 6.8 million shares of Enron common stock subject to certain restrictions and (iii) Enron received a note receivable, which was repaid in December 1999, and certain financial instruments hedging an investment held by Enron. Enron recorded the assets received and equity issued at estimated fair value. In connection with the transactions, the Related Party agreed that the senior officer of Enron would have no pecuniary interest in such Enron common shares and would be restricted from voting on matters related to such shares. In 2000, Enron and the Related Party entered into an agreement to terminate certain financial instruments that had been entered into during 1999. In connection with this agreement, Enron received approximately 3.1 million shares of Enron common stock held by the Related Party. A put option, which was originally entered into in the first quarter of 2000 and gave the Related Party the right to sell shares of Enron common stock to Enron at a strike price of $71.31 per share, was terminated under this agreement. In return, Enron paid approximately $26.8 million to the Related Party.

In 2000, Enron sold a portion of its dark fiber inventory to the Related Party in exchange for $30 million cash and a $70 million note receivable that was subsequently repaid. Enron recognized gross margin of $67 million on the sale.

In 2000, the Related Party acquired, through securitizations, approximately $35 million of merchant investments from Enron. In addition, Enron and the Related Party formed partnerships in which Enron contributed cash and assets and the Related Party contributed $17.5 million in cash. Subsequently, Enron sold a portion of its interests in the partnerships through securitizations. See Note 3. Also, Enron contributed a put option to a trust in which the Related Party and Whitewing hold equity and debt interests. At December 31, 2000, the fair value of the put option was a $36 million loss to Enron.

In 1999, the Related Party acquired approximately $371 million, merchant assets and investments and other assets from Enron. Enron recognized pre-tax gains of approximately $16 million related to these transactions. The Related Party also entered into an agreement to acquire Enron’s interests in an unconsolidated equity affiliate for approximately $34 million.

18 ACCOUNTING PRONOUNCEMENTS...

Recently Issued Accounting Pronouncements. In 1998, the Financial Accounting Standards Board (FASB) issued SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities,” which was subsequently amended by SFAS No. 137 and SFAS No. 138. SFAS No. 133 must be applied to all derivative instruments and certain derivative instruments embedded in hybrid instruments and requires that such instruments be recorded in the balance sheet either as an asset or liability measured at its fair value through earnings, with special accounting allowed for certain qualifying hedges. Enron will adopt SFAS No. 133 as of January 1, 2001. Due to the adoption of SFAS No. 133, Enron will recognize an after-tax non-cash loss of approximately $5 million in earnings and an after-tax non-cash gain in “Other Comprehensive Income,” a component of shareholders’ equity, of approximately $22 million from the cumulative effect of a change in accounting principle. Enron will also reclassify $532 million from “Long-Term Debt” to “Other Liabilities” due to the adoption.

The total impact of Enron’s adoption of SFAS No. 133 on earnings and on “Other Comprehensive Income” is dependent upon certain pending interpretations, which are currently under consideration, including those related to “normal purchases and normal sales” and inflation escalators included in certain contract payment provisions. The
interpretations of these issues, and others, are currently under consideration by the FASB. While the ultimate conclusions reached on interpretations being considered by the FASB could impact the effects of Enron’s adoption of SFAS No. 133, Enron does not believe that such conclusions would have a material effect on its current estimate of the impact of adoption. *(Source: Enron Corp. 10-K for 12/31/00, filed on 4/2/01)*

**Requirement A: The Relationship of GAAP to Issues in the Restatement**

1. Identify the guidance upon which Enron Corp. relies in its restatement. Using FARS, be specific as to the aspect of each pronouncement that ties to the key determinant of each restatement item.

2. The media noted that Enron’s disclosures in mid-October first indicated a reduction in shareholder equity of $1.2 billion because the corporation had decided to unwind certain transactions with some limited partnerships with which it had done business. However, the elaboration on the situation led to the disclosure that the original accounting for the transactions was not in accordance with GAAP. The media has pointed out that the early 2000 issuance by Enron of shares of its own common stock to four “special-purpose entities” (SPEs) in exchange for a notes receivable would not qualify as an issuance of stock until cash was received. Explain why this is the case.

3. The media has discussed Enron Corp., pre-restatement, as being innovative in tailoring contracts, making new positions valued at over $4 billion each day. The point has been made that trading losses were not the focus of the bad news from the corporation, but rather that the erosion of the equity base of Enron Corp. through the restatement became the issue. Fears among trading partners arose as to Enron Corp.’s ability to finance its trading activity, since counterparties are expected to look to equity base for assurance. The reported rating downgrades—as they reached junk status, due to their below investment grade levels’ effects on various transactions—were expected to force Enron to produce hundreds of millions of dollars in cash or stock. An estimated $3.9B of debt could come due, according to various media discussions, and Enron Corp. was not viewed as sufficiently liquid to meet such demands. Somewhat expected was the 8-K filed by Enron Corp., on December 2, 2001.

**ENRON FILES VOLUNTARY PETITIONS FOR CHAPTER 11 REORGANIZATION; SUES DYNEGY FOR BREACH OF CONTRACT, SEEKING DAMAGES OF AT LEAST $10 BILLION**

FOR IMMEDIATE RELEASE: Sunday, December 2, 2001

- Proceeds of Lawsuit Would Benefit Enron’s Creditors
- Enron Will Downsize Operations and Continue Sales of Non-Core Assets

HOUSTON—Enron Corp. (NYSE: ENE) announced today that it along with certain of its subsidiaries have filed voluntary petitions for Chapter 11 reorganization with the U.S. Bankruptcy Court for the Southern District of New York. As part of the reorganization process, Enron also filed suit against Dynegy Inc. (NYSE: DYN) in the same court, alleging breach of contract in connection with Dynegy’s wrongful termination of its proposed merger with Enron and seeking damages of at least $10 billion. Enron’s lawsuit also seeks the court’s declaration that Dynegy is not entitled to exercise its option to
acquire an Enron subsidiary that indirectly owns Northern Natural Gas Pipeline. Proceeds from the lawsuit would benefit Enron’s creditors.

In a related development aimed at preserving value in its North American wholesale energy trading business, Enron said that it is in active discussions with various leading financial institutions to provide credit support for, recapitalize and revitalize that business under a new ownership structure. It is anticipated that Enron would provide the new entity with traders, back office capabilities and technology from Enron’s North American wholesale energy business, and that the new entity would conduct counterparty transactions through EnronOnline, the company’s existing energy trading platform. Any such arrangement would be subject to the approval of the Bankruptcy Court.

In connection with the company’s Chapter 11 filings, Enron is in active discussions with leading financial institutions for debtor-in-possession (DIP) financing and expects to complete these discussions shortly. Upon the completion and court approval of these arrangements, the new funding will be available immediately on an interim basis to supplement Enron’s existing capital and help the company fulfill obligations associated with operating its business, including its employee payroll and payments to vendors for goods and services provided on or after today’s filing.

Filings for Chapter 11 reorganization have been made for a total of 14 affiliated entities, including Enron Corp.; Enron North America Corp., the company’s wholesale energy trading business; Enron Energy Services, the company’s retail energy marketing operations; Enron Transportation Services, the holding company for Enron’s pipeline operations; Enron Broadband Services, the company’s bandwidth trading operation; and Enron Metals & Commodity Corp.

Enron-related entities not included in the Chapter 11 filing are not affected by the filing. These non-filing entities include Northern Natural Gas Pipeline, Transwestern Pipeline, Florida Gas Transmission, EOTT, Portland General Electric and numerous other Enron international entities.

To conserve capital, Enron will implement a comprehensive cost-saving program that will include substantial workforce reductions. These workforce reductions primarily will affect the company’s operations in Houston, where Enron currently employs approximately 7,500 people.

In addition, the company will continue its accelerated program to divest or wind down non-core assets and operations. Details of the units to be affected will be communicated shortly.

The Dynegy Lawsuit
In its lawsuit filed today in U.S. Bankruptcy Court in New York, Enron alleges, among other things, that Dynegy breached its Merger Agreement with Enron by terminating the agreement when it had no contractual right to do so; and that Dynegy has no right to exercise its option to acquire the entity that indirectly owns the Northern Natural Gas pipeline because that option can only be triggered by a valid termination of the Merger Agreement.

The Chapter 11 Filings
In conjunction with today’s petitions for Chapter 11 reorganization, Enron will ask the Bankruptcy Court to consider a variety of “first day motions” to support its employees, vendors, trading counterparties, customers and other constituents. These include motions seeking court permission to continue payments for employee payroll and health benefits;
obtain interim financing authority and maintain cash management programs; and retain legal, financial and other professionals to support the company’s reorganization actions. In accordance with applicable law and court orders, vendors and suppliers who provided goods or services to Enron Corp. or the subsidiaries that have filed for Chapter 11 protection before today’s filing may have pre-petition claims, which will be frozen pending court authorization of payment or consummation of a plan of reorganization.

The Wholesale Energy Trading Business

The discussions currently underway with various leading financial institutions are aimed at obtaining credit support for, recapitalizing and revitalizing Enron’s North American wholesale energy trading operations under a new ownership structure in which Enron would continue to have a significant ownership interest.

“If these discussions are successful, they could result in the creation of a new trading entity with a strong and unencumbered balance sheet, the industry’s finest trading team, and its leading technology platform, all backed by one or more of the world’s leading financial institutions,” said Greg Whalley, Enron president and chief operating officer.

“We understand that it may take time for counterparties to resume normal trading levels with this entity, but we are confident that this business can be put back on a solid footing. Obviously, our potential partners share our confidence or they would not be at the table with us. We intend to take steps to retain employees who are key to the future success of our wholesale energy trading business and to regain the support and confidence of its trading counterparties.”

Comment by Ken Lay

“From an operational standpoint, our energy businesses—including our pipelines and utilities—are conducting normal operations and will continue to do so,” said Kenneth L. Lay, chairman and CEO of Enron. “While uncertainty during the past few weeks has severely impacted the market’s confidence in Enron and its trading operations, we are taking the steps announced today to help preserve capital, stabilize our businesses, restore the confidence of our trading counterparties, and enhance our ability to pay our creditors.”

Enron’s principal legal advisor with regard to the proposed merger with Dynegy, Enron’s Chapter 11 filings, the Dynegy lawsuit, and related matters is Weil, Gotshal & Manges LLP. Enron’s principal financial advisor with regard to its financial restructuring is The Blackstone Group.

About Enron Corp.

Enron Corp. markets electricity and natural gas, delivers energy and other physical commodities, and provides financial and risk management services to customers around the world. Enron’s Internet address is www.enron.com.

Forward-looking Statements

This press release contains statements that are forward-looking within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Investors are cautioned that any such forward-looking statements are not guarantees of future performance and that actual results could differ materially as a result of known and unknown risks and uncertainties, including: various regulatory issues, the outcome of the Chapter 11 process, the outcome of the litigation discussed above, the outcome of the discussions referred to above, general economic conditions, future trends, and other risks, uncertainties and factors disclosed in the Company’s most recent reports on Forms 10-K, 10-Q and 8-K filed with the Securities and Exchange Commission.

(Source: 8-K filed by Enron Corp. on 12/2/01)
a. What is meant by the term “counterparty”?

b. Why would you expect counterparties to care about the equity of a company such as Enron?

c. What is meant by “unwinding,” and how does this relate to the Enron Corp.’s filing of Chapter 11, if at all?

d. The partnerships attracting attention in the restatement were involved with derivative and hedging transactions. What is it about such transactions that makes the creation of partnerships as discussed in the 10-K of 2000 and in subsequent disclosures desirable? Do unique accounting implications for the recording of financial instrument and hedging transactions arise in this case setting? Explain.

e. The media has pointed out that a decade ago, 80 percent of Enron’s revenues came from the regulated gas-pipeline business, and that by 2000, around 95 percent of its revenues and more than 80 percent of its profits came from trading energy and both buying and selling stakes in energy producers. Commodities trading in gas in 1989, moved to electrons in 1994, and to bandwidth in 1999. Pulp, paper, plastics, metal, and transportation were among its trading operations. Enron traded interest rates, credit risks, and even weather. EnronOnline’s trading floor has been characterized as a sophisticated dot.com, engaged in commodity barter and arbitrage. At one point, Enron was trading at 55 times its earnings. Do these observations influence your analysis of the risk situation, both historical and future for Enron Corp. How?


**Requirement B: Strategy-Related Considerations**

The media has raised issues about the corporate governance structure and decisions made with regard to related party transactions by the Board of Directors. It has been alleged that there was insufficient transparency about potential conflicts of interest. The very idea that dealings with private partnerships run by its own officers may have created half of pretax earnings created questions as to the quality of earnings.

1. Why would a Board of Directors authorize transactions with a related party?
2. Did the Enron Board of Directors create any control structure relative to these transactions?
3. In the wake of the developments detailed in this case, and thereafter, how would you evaluate the actions of the directors?

**Directed Self-Study**

Many credit the Enron events as calling for particular attention to financial accounting and reporting for derivative instruments and special-purpose entities. Identify the standards that have been issued following the 2001 time frame that address issues involved in the debacle. What term has displaced “special-purpose entities” and why? [Go to the FARS Menu, click on Original Pronouncements, and then click on Statements of Financial Accounting Standards. Scroll down and click on FAS 133 to determine its issue date. That can be a reference point for exploring the evolution of standards. Open FASB-OP (amended) and do a query on the term special-purpose entit* to assist in identifying]
relevant guidance. Be certain to consider all types of standards; remember to access the EITF infobase for a complete search.]

**An Oxymoron: “Open Secrets”**

The January 8, 2007 issue of the *New Yorker* published an article by Malcolm Gladwell entitled “Open Secrets – Enron, intelligence, and the perils of too much information.” Read this article and prepare a position paper of your views on the disclosure practices of Enron, the role of GAAP and regulation, and the events since 2001 related to Enron. Also comment on the set of events that have unfolded for Arthur Andersen and its clients, including the verdict first received and that received on appeal. Be prepared to discuss your position.

**Key Terms and Glossary**

*basis swaps*  “are derivative instruments that are used to modify the receipts or payments associated with a recognized, variable-rate asset or liability from one variable amount to another variable amount. They do not eliminate the variability of cash flows; instead, they change the basis or index of variability” (FAS 133, par. 391).

*call options (or put options) on debt instruments* can accelerate the repayment of principal on a debt instrument.

*contractually specified servicing fees*  “All amounts that, per contract, are due to the servicer in exchange for servicing the financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets (or their trustees or agents) were to exercise their actual or potential authority under the contract to shift the servicing to another servicer. Depending on the servicing contract, those fees may include some or all of the difference between the interest rate collectible on the asset being serviced and the rate to be paid to the beneficial owners of those assets” (FAS 140, par. 364).

*credit risk*  the risk that counterparty will not pay what is owed (this can be reduced through use of exchange-traded futures, since the risk becomes distributed throughout the exchange, whereas in a contract, a counterparty’s default or insolvency will result in delay or nonreceipt of the obligation); the risk of counterparty default is said to be more difficult to evaluate when it applies further into the future. The result of this difference in timing of payments is that the credit risk generally is greater for currency forwards than it is judged to be for rate swaps. Current credit risk of an interest rate swap is set at its replacement cost. Future credit risk rises and falls in proportion to the fluctuation in the instruments’ values. A dome-shaped risk curve is typical, rising from origination and falling toward expiration. The idea underlying this shape is that at origination, prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices” (FAS 133, par. 540).

*forward-type derivative*  obligates one party to buy and a counterparty to sell something (i.e., a financial instrument, foreign currency, or commodity) at a future date at an agreed-on price.

*legal risk*  recognizes the possibility of legal responsibilities being altered due to legislative action; since derivatives markets are international, counterparties to the same contract may be expected to have different legal responsibilities toward one another, especially in the case of bankruptcy; this is more threatening due to the fact that many laws governing the over-the-counter (OTC) securities were written prior to the advent of OTC derivatives. In the late 1980s, the London borough of Hammersmith and Fulham used interest-rate swaps to speculate on interest rates’ direction, earning superior returns from volatile derivatives until interest turned against them. At that point, with big losses faced, the local officials declared that they were not allowed to invest in swaps and therefore should not have to bear the losses. The reality of legal risks was highlighted in 1990 when Britain’s highest court, the House of Lords in the United Kingdom ruled for the municipalities, instantly transferring more than $150 million in losses from more than 70 local governments to the dealers. When the House of Lords nullified swap contracts that the municipality of Hammersmith and Fulham had opened, this action was reported to have destroyed contracts between 130 government entities and 75 of the largest banks in the world. Over half of all the realized derivative losses in 1991 were a direct result of this action by the House of Lords.

*LIBOR swap rate*  “the fixed rate on a single-currency, constant-notional interest rate swap that has its floating-rate leg referenced to the London Interbank
interest rate uncertainty is an increasing function of the length of the forecast. Then, as time passes, the contract matures and fewer future payments remain at risk. Hence, the dome shape emerges. In contrast, the currency risk profiles are said to increase steadily, since the primary cash flow arises at the contract’s end. Net arrangements and master agreements, increasingly common, help reduce credit risk. Regulators also have an influence on credit risk. As an example, the Central Banks of several countries including the U.S. Federal Reserve are on record warning that controls are essential before increasing credit. If global standards and policies emerge, the cooperation will no doubt lead to some reduction in both legal and settlement risks.

**currency-sharing agreements** divide foreign currency risk between two counterparties who may have long-term contracting arrangements, such as selling a component between manufacturers located in two different countries. Issues of whether to price in U.S. dollars or, for example, Deutsche marks are common. The resolution can matter substantially in terms of the implications of foreign currency fluctuations. By sharing such risks, both parties effectively reduce risks.

**derivative instrument** “is a financial instrument or other contract with all three of the following characteristics:

a. It has (1) one or more underlyings and (2) one or more notional amounts . . . or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required. . .

b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. Its terms require or permit net settlement, it can readily be settled by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement” (FAS 138, par. 6).

**derivatives transaction** is a contract whose value depends on (or derives from) the value of an underlying asset, reference rate, or index.

**embedded call** “A call option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an offered Rate (LIBOR) with no additional spread over LIBOR on that floating-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equate to the present value of the floating cash flows” (FAS 138, par. 40).

**liquidity risk** reduction of trades, perhaps stemming from turbulence in the markets, that reduces liquidity (i.e., the ability to convert into cash); reduction in liquidity can lead to more price volatility, less certainty, less trading, even less liquidity, continuing in a cycle.

**market risk** any market-related factor that can change the value of the instrument; components that ought to be considered across the term structure include: absolute price or rate change (referred to as delta risk); convexity (gamma risk); change in price volatility (vega risk); time decay (theta); basis or correlation; and discount rate (rho); market risk management should take into account possible abnormal conditions and reduced liquidity.

**monetizing** a financial concept of breaking economic markets into very small pieces that can be sold forward, hedged, borrowed against, and otherwise traded, as a tool for creating competitive markets.

**net arrangements and master agreements** The Group of Thirty suggests a single master agreement rather than multiple master agreements, since the latter can permit “cherry-picking.” In other words, a risk arises that the right to set off amounts due under different master agreements might be delayed. A master agreement should provide for full rather than limited two-way payments. This results in the net amount calculated through the netting provisions being due whether it is to, or from, the defaulting party. The benefits of increasing the certainty about the value of a net position under full two-way payments dominates alternative arrangements, based on the judgments of The Group of Thirty.

**notional amount** “a number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument” (FAS 138, par. 40).

**operating risk** refers to losses stemming from inadequate risk management and internal controls by those firms that use derivatives; if there is incomplete involvement in or understanding of derivative portfolios by management, then operating risks increase. Operating risks involve inadequacies in documentation, credit controls, or position limits, as well as a lack of control over the use of leverage. Trading and exposure limits ought to be strictly applied, and leverage effects should be continuously monitored by considering liability exposures (analyzed by multiplying percentage changes in rates by the leverage factor to get one’s hands around the entire exposure).

**option contract** provides one party with a right, but not an obligation, to buy or sell something at an agreed-on price on or before a set date, which presents one-sided
obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond” (FAS 140, par. 364).

fair value “The amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using discount rates commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring assets and liabilities should be consistent with the objective of measuring fair value. Those techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring forward contracts, such as foreign currency forward contracts, at fair value by discounting estimated future cash flows, an entity should base the estimate of future cash flows on the changes in the forward rate (rather than the spot rate). In measuring financial liabilities and nonfinancial derivatives that are liabilities at fair value by discounting estimated future cash flows (or equivalent outflows of other assets), an objective is to use discount rates at which those liabilities could be settled in an arm’s-length transaction” (FAS 138, par. 40). [See FAS 157.]

financial instrument “Cash, evidence of an ownership interest in an entity, or a contract that both:

- a. Imposes on one entity a contractual obligation* (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity.
- b. Conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

*Contractual obligations encompass both those that are conditioned on the occurrence of a risk. This is an important dimension of option-type instruments which is significant because the counterparty, the writer of the option, has only a potentially unfavorable outcome: at best, it retains the premium paid by the option holder while at worst, its losses could be virtually unlimited.

securitization “the process by which financial assets are transformed into securities” (FAS 140, par. 364)

settlement risk risk that arises when one party settles the contract before the other party does and the latter does not receive what is owed; this is referred to as Herstatt risk, with the namesake of Bank Herstatt which was a German bank closed by German regulators at the close of business on June 26, 1974—since U.S. banks paid the bank German marks specified in forward contracts before the other side of the contract was paid in U.S. dollars, losses resulted. Settlement risks can be sidestepped through the use of transfer agents and escrow agents or through a simple act of simultaneous transfers. Similarly, derivatives transactions such as rate swaps and other contracts that do not involve principal payments reduce Herstatt risk, as do master agreements and netting arrangements. If netting applies, current credit exposure is the sum of negative and positive exposures on transactions in the portfolio. However, for potential credit exposure, simulation of the entire portfolio is necessary because a summation will not effectively treat offsets or give credit for different timing of peak exposures, meaning that the exposure is overstated by a mere summation.

short sales (sales of borrowed securities) “Short sales typically involve the following activities:

1. Selling a security (by the short seller to the purchaser)
2. Borrowing a security (by the short seller from the lender)
3. Delivering the borrowed security (by the short seller to the purchaser)
4. Purchasing a security (by the short seller from the market)
5. Delivering the purchased security (by the short seller to the lender).

Those five activities involve three separate contracts. A contract that distinguishes a short sale involves activities (2) and (5), borrowing a security and replacing it by delivering an identical security” (FAS 133, par. 59).

systemic risk is the risk that any disruption will lead to widespread difficulties in firms, markets, or the financial system as a whole, such as a computer software problem within world financial markets and exchanges. Systemic risks in the derivatives market appear more problematic due to the domination of the market by a few large players; two U.S. banks accounted for 95 percent of the notional amount of derivatives in the U.S. banking system in 1992, whereas such domination is not at this
specified event and those that are not. All contractual obligations that are financial instruments meet the definition of liability set forth in Concepts Statement 6, although some may not be recognized as liabilities in financial statements—may be “off-balance-sheet”—because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is owed to or by a group of entities rather than a single entity.

The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument. Contractual rights encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of asset set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements—may be “off-balance-sheet”—because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from a group of entities rather than a single entity” (FAS 138, par. 40).

firm commitment “agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity’s functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield.

b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable” (FAS 138, par. 40).

floors, caps, and collars “Floors or caps (or collars, which are combinations of caps and floors) on interest rates and the interest rate on a debt instrument are considered to be clearly and closely related, provided the cap is at or above the current market price (or rate) and the floor is at or below the current market price (or rate) at issuance of the instrument” (FAS 133, par. 61). Also, an embedded derivative instrument in which the underlying is an interest rate or interest rate index—examples of which are interest rate cap or an

scale in most other markets. Since derivatives are growing and the market is beginning to get standard-setters’ and regulators’ attention, systemic risk is expected to decline.

**take-or-pay contracts.** “Under a take-or-pay contract, an entity agrees to pay a specified price for a specified quantity of a product whether or not it takes delivery” (FAS 133, par. 59).


**transferor** “An entity that transfers a financial asset, a portion of a financial asset, or a group of financial assets from a transferor” (FAS 140, par. 364).

**transferee** “An entity that receives a financial asset, a portion of a financial asset, or a group of financial assets that it controls to another entity” (FAS 140, par. 364).

**underlying** “a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself” (FAS 138, par. 40). “An underlying usually is one or a combination of the following:

1. A security price or security price index
2. A commodity price or commodity price index
3. An interest rate or interest rate index
4. A credit rating or credit index
5. An exchange rate or exchange rate index
6. An insurance index or catastrophe loss index
7. A climatic or geological condition (such as temperature, earthquake severity, or rainfall), another physical variable, or a related index” (FAS 133, par. 57).

**undivided interest** “Partial legal or beneficial ownership of an asset as a tenant in common with others. The proportion owned may be pro rata, for example, the right to receive 50 percent of all cash flows from a security, or non–pro rata, for example, the right to receive the interest from a security while another has the right to the principal” (FAS 140, par. 364).

**unilateral ability** “A capacity for action not dependent on the actions (or failure to act) of any other party” (FAS 140, par. 364).

**value at risk** is the most commonly recommended method for valuing portfolios. The idea is to determine a portfolio’s change in value due to adverse market movements of any factor, such as volatility or price, for a specified period of time—preferably one day as the time frame for assessing change in value. The Group of Thirty contends that dealers should mark their derivatives positions to market on at least a daily basis for risk management purposes. Intraday or even real-time valuation is cited as potentially helpful in managing market risk of some option portfolios. The
interest rate collar—that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract. **Forecasted transaction** “A transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the

### Further Readings


Brauchli, Marcus W., Nicholas Bray, and Michael R. Sesit. 1995. “Broken bank: Barings PLC officials may have been aware of trader’s position: Investigators say firm knew extent of its exposure, but failed to respond—Leeson was ‘hero to some.” *Wall Street Journal* (March 6), pp. A1, A7.


in August 2003 that identified 78 reforms agreed to by MCI; these reforms involve accounting, cash flow reporting, dividend policy, internal audit, transparency policies, governance, and other topics. The report called “Restoring Trust” is available at: www.ragm.com/library/topics/Breeden_Restoring_Trust_Final-WorldCom082003.pdf.


Credit Suisse Equity Research, First Boston, Research Team David Zion and Bill Carcache. 2003. Accounting & Tax. FIN 46, New Rule Could Surprise Investors (June 24), pp. 1–82.


Emshwiller, John R., and Rebecca Smith. 2001. “Enron did business with a second entity operated by another


company official: No public disclosure was made of deals.” Wall Street Journal (October 26), pp. C1, C14.


Joint Press Release (December 4) [Statement from Big Five CEOs Arthur Andersen, KPMG, Deloitte Touche, PricewaterhouseCoopers, Ernst & Young, Press Release Wires, FACTIVA].


If accounting is important and you change the accounting rules, then the play of the game changes.

— William R. Kinney, Jr.

CASE TOPICS OUTLINE
   A. Board Members’ Rankings
   B. Your Rankings
2. Strategy-Related Considerations

The Financial Accounting Standards Board (FASB) evaluates potential agenda projects by considering the pervasiveness of the issue, alternative solutions, technical feasibility, cost-benefit relationship, and practical consequences. Annually, the Financial Accounting Standards Advisory Council (FASAC) administers a survey to solicit views of FASB members, council members, and their constituencies about future FASB agenda priorities and other matters. This survey is also sent to former members of FASAC. By accessing fasb.org, you can download both the survey form and the summary of responses for annual FASAC survey(s). In October 2005, the FASAC reported the results concerning priorities, future financial reporting issues, simplification, the right level of implementation guidance, and differential accounting standards for certain entities. The 2006 Annual FASAC Survey solicits constituents’ views on the FASB’s current priorities, future financial reporting issues, international convergence, and educational efforts.

Requirement A: Your Ranking

1. The five issues appearing most often as requiring attention on the FASB agenda are revenue recognition, pension accounting and related issues, the conceptual framework, financial performance reporting by business enterprises, and accounting for leases and other contractual obligations; see Section A of the downloadable Summary of Responses to the Annual FASAC Survey—Priorities of the Financial Accounting Standards Board (October 2005, FASAC). How would you rank-order these topics and why?
2. Compare and contrast your assessments relative to those reported for the FASB, as well as the examples of where the board members appear to differ from FASAC members. Do a similar analysis for other surveys available at fasb.org (2006 and later years).

3. Prepare your identification of issues and rankings, apart from the most recent survey results accessible at fasb.org. As background, review the survey results from prior years that are downloadable from the Web site and compare and contrast those with your assessments.

**Requirement B: Strategy-Related Considerations**

The FASB has its stated basis for setting priorities (see “Key terms and Glossary”). Apply those criteria to each topic and determine whether it is possible to assess which criteria took priority in setting the rankings.

Among the instructions to past surveys are reminders to respondents that the FASB always must consider the available resources in making agenda decisions and believes that it is not desirable to have projects on the agenda that are inactive for long periods of time. In addition, the board considers the opportunity to work jointly on projects with the International Accounting Standards Board (IASB) to meet the goal of achieving convergence. Thus, the instructions have advised that the council’s views should be tempered by consideration of all of these factors. Do any of these considerations mitigate the effect of the key criteria set forth for the setting of FASB priorities? Do you believe such mitigation is appropriate and how should these additional considerations influence FASB standard setting, if at all?

**Directed Self-Study**

What was the primary reason the standard-setters issued Statement of Financial Accounting Standards No. 153 entitled *Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29* in December 2004? [Access the FARS Menu, click on Original Pronouncements, click on Statements of Financial Accounting Standards, and then scroll down to FAS 153 and click again. Current standards contain a section within their summary that is entitled “Reasons for Issuing This Statement.” Find that section.] Identify another pronouncement that was issued for similar reasons.

**Are Accounting Rules to Blame?**

The front page of the *Wall Street Journal* on January 20-21, 2007 (Sat/Sun edition) reported that Apple had cited accounting rules as the reason for imposing a fee to download a software enhancement. “Apple Gets a Bruise by Blaming a $1.99 Fee on Accounting Rules” by David Reilly is the companion story on page B3. Read the article, access Apple’s web site to explore its press releases, and then search the media for other coverage of these events. Outline the various points made regarding GAAP and use FARS, as well as the sec.gov site, to evaluate whether accounting rules can indeed be blamed. What are the implications for standard setters and regulators? Explain.
Key Terms and Glossary

**alternative solutions**  
FAS 89, par. 124 explains “The second factor considered is the potential for developing an alternative solution—whether one or more alternatives that will improve the relevance, reliability, and comparability of financial reporting are likely to be developed.”

**cost-benefit relationship**  
FAS 89, par. 117 elaborates on a setting in which this idea of relative costs and benefits is applied: “In addition to those views, the most frequently cited reason for discontinuing the supplementary disclosures was that the benefits derived from presenting that data had not been sufficient to justify the costs incurred.” The Board notes an example of a disclosure considered in isolation as not being “unduly burdensome.”

**equity method of accounting**  
FAS 133, par. 455 states “Under the equity method of accounting, the investor generally records its share of the investee’s earnings or losses from its investment. It does not account for changes in the price of the common stock...”

**going concern concept**  
FIN 39, par. 48 states “as a general rule, accounting should reflect what is expected to occur in the normal course of business and protection in bankruptcy is not pertinent when the probability of bankruptcy is remote.”

**pervasiveness of the issue**  
FAS 89, par. 123 explains “The first factor considered is the pervasiveness of the problem to be addressed. A determination is made concerning (a) the extent to which an issue is troublesome to users, preparers, auditors, or others, (b) the extent to which practice is diverse, and (c) the likely duration of the problem (that is, is it transitory or will it persist).”

**practical consequences**  
FAS 89, par. 126 explains “The last factor considers practical consequences, namely, whether an improved accounting solution is likely to be generally acceptable and whether not addressing a particular subject might cause others to act, that is, the SEC or Congress.”

**technical feasibility**  
FAS 89, par. 125 explains “The third factor addresses the technical feasibility of a project, that is, the extent to which a technically sound solution can be developed or whether the project under consideration should await completion of other projects.”

Further Readings


*The Economist*. 2003. “True and fair is not hard and fast—the future of accounts” (367, 8321, 1, April 26).


—— Yuji Ijiri

“We should not lose the substance by grasping the shadow, but often the shadow helps us grasp the substance. The same may be said of the role of accounting in business. Just as culture affects and is affected by language, business affects and is affected by accounting. In his satirical article on clothes, “Sartor Resartus” (trans. “The Tailor Retailored”), Thomas Carlyle states, “Society is founded upon cloth,” and “... Man’s earthly interests, ‘are all hooked and buttoned together, and held up, by clothes.’” [1834, p. 51]. Indeed, is it not true that business is founded upon accounting? Without accounting how could we hook and button our interests together?