answer. In all cases, assume that the current assets exceed the current liabilities both before and after the event or transaction. Use the following format for your answers:

Effect on Ratio	Reason for Increase, Decrease, or No Effect
1.	
Etc.	

BUILDING YOUR SKILLS

Ethics Challenge [LO3, LO4]

Venice InLine, Inc., was founded by Russ Perez to produce a specialized in-line skate he had designed for doing aerial tricks. Up to this point, Russ has financed the company with his own savings and with cash generated by his business. However, Russ now faces a cash crisis. In the year just ended, an acute shortage of high-impact roller bearings developed just as the company was beginning production for the Christmas season. Russ had been assured by his suppliers that the roller bearings would be delivered in time to make Christmas shipments, but the suppliers had been unable to fully deliver on this promise. As a consequence, Venice InLine had large stocks of unfinished skates at the end of the year and had been unable to fill all of the orders that had come in from retailers for the Christmas season. Consequently, sales were below expectations for the year, and Russ does not have enough cash to pay his creditors.

Well before the accounts payable were due, Russ visited a local bank and inquired about obtaining a loan. The loan officer at the bank assured Russ that there should not be any problem getting a loan to pay off his accounts payable—providing that on his most recent financial statements the current ratio was above 2.0, the acid-test ratio was above 1.0, and net operating income was at least four times the interest on the proposed loan. Russ promised to return later with a copy of his financial statements.

Russ would like to apply for an $80,000 six-month loan bearing an interest rate of 10% per year. The unaudited financial reports of the company appear below:

Venice InLine, Inc.
Comparative Balance Sheet
As of December 31
(dollars in thousands)

	This Year	Last Year
Assets		
Current assets:		
Cash	$ 70	$150
Accounts receivable, net	50	40
Inventory	160	100
Prepaid expenses	10	12
Total current assets	290	302
Property and equipment	270	180
Total assets	$560	$482
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$154	$ 90
Accrued payables	10	10
Total current liabilities	164	100
Long-term liabilities	—	—
Total liabilities	164	100
Stockholders' equity:		
Common stock and additional paid-in capital	100	100
Retained earnings	296	282
Total stockholders' equity	396	382
Total liabilities and stockholders' equity	$560	$482

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See Next Page.

Venice InLine, Inc.
Income Statement
For the Year Ended December 31
(dollars in thousands)

	This Year
Sales (all on account)	$420
Cost of goods sold	290
Gross margin	130
Operating expenses:	
Selling expenses	42
Administrative expenses	68
Total operating expenses	110
Net operating income	20
Interest expense	—
Net income before taxes	20
Income taxes (30%)	6
Net income	$ 14

Required:

1. Based on the above unaudited financial statements and the statement made by the loan officer, would the company qualify for the loan?
2. Last year Russ purchased and installed new, more efficient equipment to replace an older plastic injection molding machine. Russ had originally planned to sell the old machine but found that it is still needed whenever the plastic injection molding process is a bottleneck. When Russ discussed his cash flow problems with his brother-in-law, he suggested to Russ that the old machine be sold or at least reclassified as inventory on the balance sheet because it could be readily sold. At present, the machine is carried in the Property and Equipment account and could be sold for its net book value of $45,000. The bank does not require audited financial statements. What advice would you give to Russ concerning the machine?

Communicating In Practice (LO1, LO2, LO3, LO4)

Typically, the market price of shares of a company's stock takes a beating when the company announces that it has not met analysts' expectations. As a result, many companies are under a lot of pressure to meet analysts' revenue and earnings projections. To manage (that is, to inflate or smooth) earnings, managers sometimes record revenue that has not yet been earned by the company, delay the recognition of expenses that have been incurred or employ other accounting tricks.

A wave of accounting scandals related to earnings management swept over the capital markets in the wake of the collapse of Enron in 2002. Some earlier examples illustrate how companies have attempted to manage their earnings. On March 20, 2000, MicroStrategy announced that it was forced to restate its 1999 earnings; revenue from multiyear contracts had been recorded in the first year instead of being spread over the lives of the related contracts as required by GAAP. On April 3, 2000, Legato Systems Inc. announced that it had restated its earnings; $7 million of revenue had been improperly recorded because customers had been promised that they could return the products purchased. As further discussed in this chapter, America Online overstated its net income during 1994, 1995, and 1996. In May 2000, upon completing its review of the company's accounting practices, the SEC levied a fine of $3.5 million against AOL. Just prior to the announcement of the fine levied on AOL, Helane Morrison, head of the SEC's San Francisco office, reemphasized that the investigation of misleading financial statements is a top priority for the agency. [Sources: Jeff Shuttleworth, "Investors Beware: Dot.Coms Often Use Accounting Tricks," *Business Journal Serving San Jose & Silicon Valley,* April 14, 2000, p. 16; David Henry, "AOL Pays $3.5M to Settle SEC Case," *USA Today,* May 16, 2000, p. 3B.]

Required:

Write a memorandum to your instructor that answers the following questions. Use headings to organize the information presented in the memorandum. Include computations to support your answers, when appropriate.

1. Why would companies be tempted to manage earnings?
2. If the earnings that are reported by a company are misstated, how might this impact business decisions made about that company (such as the acquisition of the company by another business)?
3. What ethical issues, if any, arise when a company manages its earnings?
4. How would investors and financial analysts tend to view the financial statements of a company that has been known to manage its earnings in the past?