1. ABC, Inc., is a calendar-year corporation. Its financial statements for the years 2002 and 2001 contained errors as follows:

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ending Inventory</td>
<td>$1,200 understated</td>
<td>$4,800 overstated</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>$500 understated</td>
<td>$2,000 understated</td>
</tr>
</tbody>
</table>

Required:

a. (10%) Assume that the proper correcting entries were made at December 31, 2001. Determine the amount that 2002 income will be overstated or understated and provide computations. (Assume a corporate income tax rate of 40%.)

b. (10%) Assume that no correcting entries were made at December 31, 2001. Compute the amount by which Retained Earnings will be overstated or understated at December 31, 2002. Also, assume a gross margin of 30%, then how would the account receivable be affected? (Assume a corporate income tax rate of 40% and provide supporting computations.)

c. (10%) Assume that no correcting entries were made at December 31, 2001, nor at December 31 December 31, 2002, and that no additional errors occurred in 2003. Compute the amount by which December 31, 2003, working capital will be overstated or understated. (Assume a corporate income tax rate of 40% and provide supporting computations.)

2. Read the following commentary.

Fortune 500: A Tease

Fortune Magazine has revealed its latest annual ranking of 500 corporations by revenues, and we have joined every other financial media outlet to help make it the magazine's most successful marketing device. Our verdict? Interesting, as always, but unfulfilling.

So, we glanced at the list long enough to note that it was a sleepy year for corporate upsets. Of the 38 companies that joined the august circle, only two did so at No. 200 or higher -- AT&T Wireless at No. 119 and energy provider Reliant Resources at No. 164. Light years away from the boom years, eh, when new entrants zoomed on with a bullet?

And three newbies surprised the heck out of us. Who knew that wireless communications enabler Qualcomm at No. 489, tax giant H&R Block at No. 462, and Starbucks at No. 465 weren't already there?
Indeed, and therein lieth the rub. When we tire of entertainment and put our investing jester caps back on, we prefer numbers like, oh, free cash flow. Call us crazy, but we just happen to think it's more important that Qualcomm converts each dollar of revenues into $0.27 of free cash flow -- a free cash flow margin of 27%! -- compared to Fortune No. 3 company ExxonMobil's $0.05, than whether an ailing business like Ford Motor is No. 4 in revenues. Please. Ford only belongs that high on a list of "Stocks to Avoid Like Michael Jackson."

Don't get us wrong -- we read and enjoy Fortune. We just don't think that revenues make the man, er, company, or that companies suffering under mountains of debt (on or off balance sheet), SEC investigations, or questionable management belong in the top 10 of any allegedly positive list.
(Adapted from an article by Tom Jacobs)

a. (10%) In your own words, briefly explain major points of the article.

b. (20%) According to the article, what accounting number(s) do Fortune use when ranking firms? Which accounting number, in the author's opinion, should be used instead? Why? Do you agree with the author?

c. (20%) This article is related to earnings management. Define earnings management and explain how company managers can achieve it.

3 (20%) The controller of CDE company, your audit client, argues that the refunding of outstanding 10% debt by issuing 8% debt does not materially affect the company's financial position, because the difference between the net amount of debt outstanding is not great (i.e., not material in relation to the other balance sheet items). The controller argues, therefore, that the transaction does not need to be included in the statement of cash flows, particularly since cash is not affected. Do you agree or disagree with the controller? Why?