

S7-4 Ethical Decision Making: A Real-Life Example**LO 7-2, 7-4**

Assume you are on a jury hearing a trial involving a large national drugstore company. Your immediate task is to identify suspicious events in the following evidence that suggest financial fraud may have occurred.

In just seven years, the company grew from 15 to 310 stores, reporting sales of more than \$3 billion. Some retail experts believed the company was going to be the next Walmart. The apparent secret to the company's success was its ability to attract customers to its stores by selling items below cost. Then the company would make it easy for customers to buy other items, particularly pharmaceuticals, which earned a high gross profit. This strategy appeared to be working, so the company's top executives built up massive pharmaceutical inventories at its stores, causing total inventory to increase from \$11 million to \$36 million to \$153 million in the last three years. The company hadn't installed a perpetual inventory system, so inventory had to be physically counted at each store to determine the cost of goods sold. To help its auditors verify the accuracy of these inventory counts, top management agreed to close selected stores on the day inventory was counted. All they asked was that they be given advance notice of which stores' inventory counts the auditors were planning to attend, so that the temporary closures could be conveyed to employees and customers at those stores. The external auditors selected four stores to test each year and informed the company several weeks in advance. To further assist the auditors with counting the inventory, top management reduced the inventory levels at the selected stores by shipping some of their goods to other stores that the auditors weren't attending.

After the inventory was counted and its cost was calculated, the company applied the LCM test. On a store-by-store basis, top management compared the unit cost and market value of inventory items and then prepared journal entries to write down the inventory. Some of the journal entries were large in amount and involved debiting an account called "Cookies" and crediting the inventory account. Management reported that the Cookies account was used to accumulate the required write-downs for all the company's stores. Just before the financial statements were finalized, the Cookies account was emptied by allocating it back to each of the stores. In one instance, \$9,999,999.99 was allocated from Cookies to a store's account called "Accrued Inventory."

Required:

Prepare a list that summarizes the pieces of evidence that indicate that fraud might have occurred and, for each item on the list, explain why it contributes to your suspicion.

Epilogue:

This case is based on a fraud involving **Phar Mor**, as described by David Cottrell and Steven Glover in the July 1997 issue of the *CPA Journal*. Phar Mor's management was collectively fined over \$1 million and two top managers received prison sentences ranging from 33 months to five years. The company's auditors paid over \$300 million in civil judgments for failing to uncover the fraud.

Phar Mor**S7-5 Ethical Decision Making: A Mini-Case****LO 7-3**

David Exler is the CEO of AquaGear Enterprises, a seven-year-old manufacturer of boats. After many long months of debate with the company's board of directors, David obtained the board's approval to expand into water ski sales. David firmly believed that AquaGear could generate significant profits in this market, despite recent increases in the cost of skis. A board meeting will be held later this month for David to present the financial results for the first quarter of ski sales. As AquaGear's corporate controller, you reported to David that the results weren't great. Although sales were better than expected at \$165,000 (3,000 units at \$55 per unit), the cost of goods sold was \$147,500. This left a gross profit of \$17,500. David knew this amount wouldn't please the board. Desperate to save the ski division, David asks you to "take another look at the cost calculations to see if there's any way to reduce the cost of goods sold. I know

you accountants have different methods for figuring things out, so maybe you can do your magic now when I need it most.” You dig out your summary of inventory purchases for the quarter to recheck your calculations, using the LIFO method that has always been used for the company’s inventory of boats.

	Date	Units	Unit Cost	Total Cost
Beginning inventory of water skis	January 1	0	—	—
Purchases	January 15	1,500	\$30	\$45,000
Purchases	February 18	2,000	45	90,000
Purchases	March 29	2,500	50	125,000

Required:

1. Calculate Cost of Goods Sold using the LIFO method. Does this confirm the statement you made to David about the Gross Profit earned on water ski sales in the first quarter?
2. Without doing any calculations, is it likely that any alternative inventory costing method will produce a lower Cost of Goods Sold? Explain.
3. Calculate Cost of Goods Sold using the FIFO method. Would use of this method solve David’s current dilemma?
4. Is it acceptable within GAAP to report the water skis using one inventory costing method and the boats using a different method?
5. Do you see any problems with using the FIFO numbers for purposes of David’s meeting with the board?

LO 7-4 S7-7 Calculating and Recording the Effects of Lower of Cost or Market (LCM) on Ending Inventory

Perfumania



Assume you recently obtained a job in the Miami head office of **Perfumania**, the largest specialty retailer of discounted fragrances in the United States. Your job is to estimate the amount of write-down required to value inventory at the lower of cost or market. The cost of inventory is calculated using the weighted average cost method and, at \$368 million, it represents the company’s biggest and most important asset. Assume the corporate controller asked you to prepare a spreadsheet that can be used to determine the amount of LCM write-down for the current year. The controller provides the following hypothetical numbers for you to use in the spreadsheet.

Product Line	Weighted Average Unit Cost	Replacement Cost (Market) at Year-End	Quantity on Hand
Alfred Sung Shi	\$22	\$20	80
Animale	15	16	75
Azzaro	10	10	50
Mambo	16	17	30
OP Juice	8	7	400

You realize that you’ll need to multiply the quantity of each item by the lower of cost or market per unit. You e-mailed your friend Owen for Excel help.

From: Owentheaccountant@yahoo.com
To: Helpme@hotmail.com
Cc:
Subject: Excel Help

So you don't have a sniff about how to pick the lower of cost or market? You can do this several different ways, but the easiest is to use the MIN command. Set up your spreadsheet similar to the table you sent me, and then add two new columns. In the first new column, enter the command "`= MIN(costcell, marketcell)`" where costcell is the cell containing the cost per unit and marketcell is the cell containing the market value per unit. Next, in the second new column, multiply the quantity by the LCM per unit, and then SUM the column.

Required:

1. Prepare a spreadsheet that calculates total LCM for inventory, applied on an item-by-item basis.
2. Prepare a journal entry to record the inventory LCM write-down.