

# Airplanes and garbage trucks

Business



The three companies could have chosen different useful lives for the same equipment for multiple reasons. One of the reasons would be to manipulate the income statement.

If a company has an idea of when it might want to sell off an asset and approximately how much it will be able to sell said asset, then it could adjust the useful life and choose higher depreciation in order to show a gain on the income statement when the plane is sold. Another reason for choosing different useful lives of the same equipment could be based upon how much and in what capacity each company uses its respective airplanes.

For instance, Northwest has a much shorter useful life than United for its plane because Northwest's planes may spend more hours in the air than United's planes, giving it a shorter useful life. Which set of sale prices (I or II) do you think is more realistic? Why? Choosing the most realistic option of the sales prices is conditional. For instance, if the useful life was determined based upon the actual usage of the airplanes and the usage differed, then it is safe to assume that the sales prices would differ.

If that were the case, then sales price I would be the most realistic option.

If the usage were the same or nearly the same for each plane, the planes should be equal in value and sales price II would be the most reasonable option. Based upon the limited information given in this example, it would be prudent to assume that all the planes are equal in value; therefore, sales price II should be used. Part II: Garbage Trucks Summarize the charges against Waste Management in your own words. The executives of Waste Management, in order to save their jobs and keep/increase their personal

bonuses, manipulated financial records in order to give the appearance to investors that certain earnings targets were being met.

This caused the company's stock to become inflated, and the defendants then sold it to many unsuspecting investors. The defendants accomplished this by altering depreciation expenses, not recording other expenses, improperly capitalizing a variety of expenses and failing to establish sufficient reserves to pay for taxes and certain expenses. When the fraudulent activities were brought to the attention of the investors and the public, the company's stock dropped by 33%, resulting in a \$6 billion loss for the investors.

The charges against the defendants of Waste Management were as follows: securities fraud, filing false periodic reports, falsification of books and records, and lying to auditors. How did management use depreciation expense to manage earnings? A large part of the fraudulent practices instituted by the top executives of Waste Management was the manipulation of depreciation expenses. Essentially, the defendants continually extended the useful life of the company's garbage trucks and at the same time increased the trucks' salvage values.

This made the trucks worth much more on paper than they were in reality. In turn, the company had less expenses to report which made it seem as if there was much more income. Why do you think the managers of Waste Management wanted to manage earnings? There were a few reasons that the managers wanted to manage the earnings. One reason was to simply raise the price of the stock. If earnings were to increase, then stock prices

would increase. Also, the managers of Waste Management made bonuses based on certain earnings targets and even though the earnings were not true representations, the bonuses were still paid out.

What was Arthur Andersen's role in the Waste Management case? What were the terms of its settlement with the SEC? Did Andersen abide by the terms of the settlement? Waste Management's outside auditor, Arthur Andersen, uncovered the manipulation of earnings by the top managers of the company and presented management with proposed adjusting journal entries. The managers refused to adjust the false entries. Arthur Andersen's auditing fees were then capped and the company was told they could earn more in fees by doing "special work." The "special work" ultimately turned out to be producing unqualified opinions for Waste Management even though the auditors were fully aware of the fraudulent activities. Furthermore, the decision was made to write off these errors over a ten-year period, which essentially meant that they would cover up the past fraud with future fraud. When all was said and done, Arthur Andersen settled with the Security Exchange Commission by paying a \$7 million fine and agreeing to be bound to never violate section 10(b) of the Securities Exchange Act of 1934.

Basically, this placed Arthur Andersen on permanent probation with the SEC. Andersen obviously did not abide by the terms of the settlement.

The Enron scandal that came to light only a few years later proved that Andersen could not be trusted as an honest accounting firm, and eventually resulted in the downfall of the firm. Suppose you were working in the accounting department at Waste Management in 1996. You receive instructions to extend the useful lives of certain assets.

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What ethical dilemma would you face? What information would you want to gather to help you evaluate the situation?

If I were instructed to extend the useful lives of certain assets, I would only have one question that would answer whether or not this was ethical. Why should this adjustment be made? If the useful life is being extended due to a change in the usage of the vehicles, such as reducing the amount of daily drive time on the trucks or a new maintenance program was added to extend the life of the vehicle, then the extension could be justified. In order to evaluate the situation, I would gather maintenance records for the trucks, any logistical information that could be of use, and how many fully depreciated trucks are currently still in service.

If the extension was being made just to manage earnings and manipulate income, then there can be no ethical justification for this act and I would not make the adjustments. Part III: Overall Analysis Some accounting systems require all firms to use the same depreciation policies for similar assets.

For example, every firm owning a Boeing 757 would depreciate it over the same period. Do you think GAAP should include such a requirement for financial statements? Why or why not?

Regardless of your position, your answer should include a description of the advantages and disadvantages of the proposal. While there would most likely be instances of unfairness, a uniform depreciation system would have more benefits than negative factors. The main advantage to a uniform depreciation system is that it would keep many companies more honest. Companies could no longer use depreciation to manipulate earnings.

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This would not fully eliminate fraudulent accounting practices concerning depreciation, but it would be much harder to hide this activity from auditors.

It seems that the only down side of this system would be that if there is an actual difference in useful lives due to a physical factor, these differences would not become apparent until after the unit was sold. While keeping stockholders informed on the state of the depreciation of the assets is very important, thousands of people lost a lot of money in the Waste Management and Enron scandals. Some people lost their life's savings, due to the fraudulent management of earnings by a few elite members of management. Keeping something like this from happening again far outweighs any other benefits of not using a uniform depreciation method.