

**A210 - Final Exam
Fall 1997**

- The Stanford Honor Code applies to this exam.
- The Exam is open book and open notes. The exam lasts from 8:00 a.m. – 12:00 p.m.
- Write your name, Stanford ID number, instructor's name, and section number on the top of each page of the exam. Staple all answer sheets together. Failure to do so is at your own risk.

**Turn in your exams to your professor in the lounge above
Arbuckle by noon.**

- We have provided what should be ample space for your answers to each question. Please answer each question in the space provided. If you need more space, use the back of the page that contains the question you are answering.
- Budget your time, including the time required for reading background material.
- Show all your work for full credit. This also helps in granting partial credit. If you can't find a number you need to make a calculation, explain how the calculation you want to perform works. If you can't specify the magnitude of an effect, at least indicate the direction of the effect.
- If you choose to make any assumptions in answering questions, clearly state them as part of the answers you write.
- A faculty member will be in the GSB Communication Center (the upper deck of Arbuckle Lounge) throughout the exam in case you want to ask a question. As a rule, answers will not be provided that give unfair advantages to the questioners.

All questions relate to the excerpts from Philip Morris' 1996 financial statements, except for Part VIII which relates to a footnote from Philip Morris' 1988 financial statements. The point allocation is as follows:

Part I	Receivables	5 points
Part II	Inventories	10 points
Part III	Income Taxes	8 points
Part IV	Long-term Debt	8 points
Part V	Pensions	12 points
Part VI	Stockholders' Equity	5 points
Part VII	Cash Flow Statement	9 points
Part VIII	Acquisitions	13 points
Part IX	Ratios	12 points
Part X	Revenue Recognition	18 points
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		100 points

Part III: Income Taxes (8 points)

3. a. (2 points) What is the amount of taxes deferred by Philip Morris at the end of 1996?

b. (1 point) What is the amount of taxes Philip Morris owes at the end of 1996?

c. (2 points) Explain why the amounts in (a.) and (b.) are the same or different.

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Part VII: Cash Flow Statement (9 points)

1. (1 point) Which method does Philip Morris use in preparing its Statement of Cash Flows?

2. a. (2 points) Why is depreciation added back to net income?

b. (2 points) Explain why the change in Accounts Receivable of \$35 in the Statement of Cash Flows does not equal the change in Accounts Receivable on the balance sheet.

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Part VII: Cash Flow Statement (9 points)

3. (4 points) What are Philip Morris' major sources and uses of cash in 1996? What does this tell you about Philip Morris' business?

Part VIII: Acquisitions (13 points)

3. a. (3 points) What is the amount of goodwill recorded by Philip Morris as a result of the acquisition of Kraft? What does the goodwill likely represent (a non-mechanical answer is required)?

b. (3 points) What amount of goodwill on Philip Morris' balance sheet at the end of 1996 pertains to goodwill from acquisition of Kraft? Is it likely that this asset has a value for Philip Morris greater or less than its book value? Why?

Part VIII: Acquisitions (13 points)

4. a. (2 points) Explain whether Philip Morris' Net Income for 1988 would have been higher or lower if pooling of interests had been used to account for the Kraft acquisition.

b. (2 points) What is your estimate of the effect on Net Income for 1988 of using pooling of interests rather than the purchase method of accounting for the Kraft acquisition? (State any assumptions you feel you need to make.)

Part IX: Ratios (12 points)

2. b. (3 points) What else could explain the difference between market value and book value of equity for Philip Morris?

c. (3 points) Should accounting standards permit these items to be reflected on Philip Morris' balance sheet? Why, or why not?

Part X: Revenue Recognition (18 points)

Philip Morris and other tobacco manufacturers engage in a practice called "Trade Loading" of cigarettes to their wholesale distributors. Exhibit 3 is an April 26, 1993 Business Week article that discusses some of the implications of the practice.

In a Dec 4, 1989 Fortune article criticizing the practice, Carol Loomis writes

"Trade loading is a crazy, uneconomic, insidious practice through which manufacturers – trying to show sales, profits, and market share they don't actually have – induce their wholesale customers, known as the trade, to buy more product than they can promptly resell."

1. (3 points) Is Philip Morris' practice of recognizing revenue on sales to wholesalers consistent with generally accepted accounting principles? Explain.

Part X: Revenue Recognition (18 points)

3. a. (3 points) What benefits does Philip Morris hope to achieve by engaging in trade loading?

b. (3 points) What are the potential drawbacks of following this strategy?