**Question 1**

|  |  |  |  |
| --- | --- | --- | --- |
| Balance Sheet of AMD Co. as of March 31st 2014 | | | |
| Assets |  | Liabilities + OE |  |
| Cash | 500,000 | 9% Bank Loan | 800,000 |
| Acc. Rec. 600,000 |  | Prov. For tax (2012-2013) 100000 |  |
| -Prov. For DD -40,000 | 560,000 | Prov. For tax (2013-2014) 100000 | 200,000 |
| Advance Tax (2012-13) 90,000 |  | Acc. Payables | 400,000 |
| Advance Tax (2013-14) 90,000 | 180,000 | Insurance Payable | 2,000 |
| Raw Material Inventory | 100,000 | Interest Payable | 18,000 |
| W-I-P Inventory | 40,000 | Salary Payable | 80,000 |
| Finished Goods Inventory | 40,000 |  |  |
| Equipment 400,000 |  |  |  |
| Accm. Dep. -40,000 | 360,000 |  |  |
| Building 800,000 |  | Reserves and Surplus | 700,000 |
| Accm. Dep. -80,000 | 720,000 | Common Stock | 300,000 |
|  |  |  |  |
| TOTAL | 2,500,000 | TOTAL | 2,500,000 |
|  |  |  |  |
|  |  |  |  |
|  |  |  |  |

The following transactions took place during the year:

1. We purchased Raw Materials worth 800,000. Out of the purchases, 300,000 were paid for in cash and the remaining were credit purchases. Out of the credit purchases goods costing 20,000 were defective and were returned. At the end of the year our balance in the Raw Material inventory account was 120,000. Ending Balance of W-I-P is 30,000. The ending Finished Goods Inventory is 20,000.

2. We paid 300,000 towards our Accounts Payable. The balance of the accounts payable at the end of the year is 500,000.

3. Our sales for the year were 1,500,000. 600,000 worth of sales were on credit rest were for cash.

4. We collected 800,000 from our debtors. The Bad Debts written off during the year were 50,000 and 10,000 worth of previously written off bad debts were recovered this year. The year-end balance of Accounts Receivables was 300,000. The provision for Doubtful debts is maintained at 5% of closing balance of Accounts Receivables.

5. The bank loan is repaid in semi-annual installments of 50,000 each. The interest and installments are due on 30th June and 31st December.

6. Provision for taxes is created at 30% of Profit before Tax. Assessment for 2012-13 and 2013-14 was completed and the assessed tax was 95,000 and 100,000 respectively for each year. Advance tax paid for the year was 110,000.

7. Cash receipts from Other Income for the year were 180,000 and it was paid to us net of 20,000 TDS. All Fixed Assets have a 10-year useful life. A piece of equipment costing 100,000 was sold on September 30th 2014 for 90,000.

8. Other Payments:

Factory Insurance for 2 years (Paid on 1stJuly): 12,000

Factory Salaries (1/4/14-28/2/15): 300,000 (Outstanding Salary for March 2015: 40,000)

All outstanding expenses payable from the previous year were paid in full in the current year

9. Additional Equipment purchased during the year amounted to 200,000. This equipment was purchased on 31/12/2014 and had a useful life of 10 years.

10. The company received dividend income worth 80,000 during the year. The company declared dividends of 200,000 in March 2015. The company also issued 1000 additional shares with a face value of 10 and market value of 100.

Prepare Income Statement, and Balance Sheet for the year ending 31/3/2015

**Question 2**

**Assume that you are the auditor of ABC Inc, for the fiscal year 2006. No audit procedures have been performed other than general information gathering. Please read all the information given below carefully and then identify any possible material misstatements that exist in the accompanying financial statements and the notes.**

**Brief Description of Operations and Management obtained during general information gathering:**

ABC Inc. is a large publicly held corporation that is involved in manufacturing operations. ABC’s manufacturing operations are spread over 4 states and 2 foreign countries. The net worth of the company is approximately 500 million dollars.

The company has reasonably reliable internal controls. It maintains an in-house internal audit function, which is run by an experienced and well trained group of company employees, who are answerable only to an audit committee comprised of independent directors. The divisional managers of the company decide the timing and scope of all internal audit work. The internal auditors also spend a significant amount of time on consulting work in addition to their usual internal audit compliance work. Due to the large geographical coverage and international operations, the divisional managers have to deal with complex revenue recognition, asset valuation and, transfer pricing issues. This makes it necessary for the divisional managers to use their judgment and discretion to come up with various estimates for some of the company’s complex transactions. The company’s external audit is performed by a Big 4 accounting firm. ABC Inc. is the largest client for the Big 4 accounting firm office, located in the region where the company is incorporated. The company rotates its external auditors at regular intervals.

The divisional managers’ compensation plans consist of a relatively low fixed salary. A significant part of the compensation consists of generous and large bonuses that are dependent on meeting aggressive earnings and performance targets. Through this compensation scheme, the board of directors hopes to encourage the divisional managers to improve ABC’s overall earnings performance. The divisional managers have struggled to meet these earnings targets in the past 3 quarters. The manufacturing industry as a whole has experienced a marginal growth in sales for the last three years amidst increasing competition from local and foreign companies.

**The following are the financial statements, explanations and the notes, as provided by the management of ABC Inc. Please read them carefully and answer all the questions following the financial statements**

# Income Statement (All numbers are in millions unless specified)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Year Ended December 31, | | **2006** | 2005 | 2004 |
| **NET OPERATING REVENUES** | | **$24,088.0** | $ 23,104.0 | $ 21,742.0 |
| Cost of goods sold | | **$ 8,164.0** | $ 8,195.0 | $ 7,674.0 |
| **GROSS PROFIT** | | **$15,924.0** | $14,909.0 | $14,068.0 |
| **GROSS PROFIT MARGIN %** | | **66.1** | 64.5 | 64.7 |
| Selling, general and administrative expenses | | **$ 9,431.0** | $ 8,739.0 | $ 7,890.0 |
| Other operating charges | | **$ 185.0** | $ 85.0 | $ 480.0 |
| **OPERATING INCOME** | | **$ 6,308.0** | $ 6,085.0 | $ 5,698.0 |
| **OPERATING MARGIN %** | | **26.2** | 26.3 | 26.2 |
| Interest income | | **$ 193.0** | $ 235.0 | $ 157.0 |
| Interest expense | | **$ 220.0** | $ 240.0 | $ 196.0 |
| Equity income — net | | **$ 102.0** | $ 680.0 | $ 621.0 |
| Other income (loss) — net | | **$ 195.0** | $ (93.0) | $ (82.0) |
| Gains on issuances of stock by equity investees | | **—** | $ 23.0 | $ 24.0 |
| **INCOME BEFORE INCOME TAXES** | | **$ 6,578.0** | $ 6,690.0 | $ 6,222.0 |
| Income taxes | | **$ 1,498.0** | $ 1,818.0 | $ 1,375.0 |
| Effective tax rate % | | **22.8** | 27.2 | 22.1 |
| **NET INCOME** | | **$   5,080.0** | $    4,872.0 | $    4,847.0 |
| **PERCENTAGE OF NET OPERATING REVENUES %** | | **21.1** | 21.1 | 22.3 |
| **NET INCOME PER SHARE:** | |  |  |  |
|  | Basic | **$      2.16** | $      2.04 | $      2.00 |
|  | Diluted | **$      2.16** | $      2.04 | $      2.00 |

# Gross Profit

        Our gross profit margin increased to 66.1 percent in 2006 from 64.5 percent in 2005. Our gross margin was favorably impacted by improvements in the business model. Specifically, we decided to change the method of recognizing gross profit from a version of the Installment Sales method to a modified version of Point of Sale method. Although the Installment Sales method has been applied consistently in previous years, this change was implemented because the Point of Sale method is considered more appropriate. By changing to the Point of Sale recognition method, we were able to recognize additional gross profits of $585. Our gross margin in 2006 was also impacted favorably by price increases, partially offset by increases in the cost of raw materials and freight, primarily in North America, and by an unfavorable product mix. In 2007, the Company expects the cost of raw materials to increase, primarily in North America. We will attempt to mitigate the overall impact on our business through appropriate pricing and other strategies.

         Gross profit margin in 2006 was favorably impacted by the receipt of approximately $109 million in proceeds related to a class action lawsuit settlement concerning price-fixing in the sale of high fructose corn syrup ("HFCS") purchased by the Company during the years 1991 to 1995. The Company's portion of the settlement was approximately $87 million, which was recorded as a reduction of cost of goods sold.

Our gross profit margin decreased to 64.5 percent in 2005 from 64.7 percent in 2004, primarily due to higher raw material and freight costs driven by rising oil prices. As discussed above, in 2006, this decrease was partially offset by the receipt of net settlement proceeds of approximately $87 million.

# Selling, General and Administrative Expenses

        The following table sets forth the significant components of selling, general and administrative expenses (in millions):

|  |  |  |  |
| --- | --- | --- | --- |
| Year Ended December 31, | **2006** | 2005 | 2004 |
| Selling expenses | **$3,924** | $3,453 | $3,031 |
| Advertising expenses | **$2,553** | $2,475 | $2,165 |
| General and administrative expenses | **$2,630** | $2,487 | $2,349 |
| Stock-based compensation expense | **$ 324** | $ 324 | $ 345 |
| Selling, general and administrative expenses | **$9,431** | $8,739 | $7,890 |

Total selling, general and administrative expenses were approximately 8 percent higher in 2006 versus 2005. The increases in selling and advertising expenses were primarily related to increased investments in marketing activities, combined with new product innovation activities. General and administrative expenses in 2006 also reflected the impact of a $100 million donation made to ABC Inc Foundation. Stock-based compensation expense was flat in 2006 compared to 2005. Stock-based compensation expense in 2005 included approximately $50 million of expense due to a change in our estimated service period for retirement-eligible participants in our plans. This amount was offset primarily by the impact of the timing of stock-based compensation grants in prior years.

As of December 31, 2006, we had approximately $376 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under our plans. This cost is expected to be recognized as stock-based compensation expense over a weighted-average period of 8 years. This amortization of the cost is in accordance with industry practices. This expected cost does not include the impact of any future stock-based compensation awards.

# Other Operating Charges

During 2006, our Company recorded other operating charges of $185 million. Of these charges, approximately $108 million were primarily related to the impairment of assets and investments in our bottling operations, approximately $53 million were for contract termination costs related to production capacity efficiencies and approximately $24 million were related to other restructuring costs. The company decided to capitalize other operating charges worth $96 million, which related to costs of replacement of small value items in its manufacturing facilities. The company will depreciate these assets over a period of 6 years on a straight-line basis.

**Operating Income and Operating Margin**

In 2006, price increases across the majority of operating segments favorably impacted both operating income and operating margins, while increased spending on marketing and innovation activities negatively impacted operating income and operating margins. Although operating margin was at a healthy rate, it was slightly below the industry levels and analysts’ expectations.

# Other Income

Other income indicated a net income of $195 million for 2006 compared to a net loss of $93 million for 2005, a difference of $288 million. In 2006, other income (loss) included a net gain of approximately $175 million resulting from the sale of a portion of our shares held as long-term investments and a gain of approximately $123 million resulting from the sale of a portion of our investment in an IPO of a competitor company. Other income was also significantly affected by the inclusion of gain of $75 million from sale of company’s operational assets, which were damaged in a fire, to some of its own customers.

# Balance Sheet (All numbers are in millions)

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| December 31, | | | | | | **2006** | 2005 |
| **ASSETS** | | | | | |  |  |
|  | **CURRENT ASSETS** | | | | |  |  |
|  |  | Cash and cash equivalents | | | | **$   2,440.0** | $    4,701.0 |
|  |  | Marketable securities | | | | **$ 150.0** | $ 66.0 |
|  |  | Trade accounts receivable, less allowances of $63 and $72, respectively | | | | **$ 2,587.0** | $ 2,281.0 |
|  |  | Inventories | | | | **$ 1,641.0** | $ 1,379.0 |
|  |  | Prepaid expenses and other assets | | | | **$ 1,623.0** | $ 1,778.0 |
|  | **TOTAL CURRENT ASSETS** | | | | | **$ 8,441.0** | $ 10,205.0 |
|  | **INVESTMENTS** | | | | |  |  |
|  |  | | Equity method investments: | | |  |  |
|  |  | |  | ABC Inc. | | **$ 1,312.0** | $ 1,731.0 |
|  |  | |  | XYZ Co. | | **$ 1,251.0** | $ 1,039.0 |
|  |  | |  | PQR Bottlers | | **$ 835.0** | $ 982.0 |
|  |  | |  | BCP Beverage Inc. | | **$ 817.0** | $ 748.0 |
|  |  | |  | Other, principally bottling companies | | **$ 2,095.0** | $ 2,062.0 |
|  |  | | Other Cost method investments | | | **$ 473.0** | $ 360.0 |
|  | **TOTAL INVESTMENTS** | | | | | **$ 6,783.0** | $ 6,922.0 |
|  | **OTHER ASSETS** | | | | | **$ 2,701.0** | $ 2,648.0 |
|  | **PROPERTY, PLANT AND EQUIPMENT — net** | | | | | **$ 6,903.0** | $ 5,831.0 |
|  | **TRADEMARKS WITH INDEFINITE LIVES** | | | | | **$ 2,045.0** | $ 1,946.0 |
|  | **GOODWILL** | | | | | **$ 1,403.0** | $ 1,047.0 |
|  | **OTHER INTANGIBLE ASSETS** | | | | | **$ 1,687.0** | $ 828.0 |
|  |  | |  |  | **TOTAL ASSETS** | **$ 29,963.0** | $ 29,427.0 |
| **LIABILITIES AND SHAREOWNERS' EQUITY** | | | | | |  |  |
|  | **CURRENT LIABILITIES** | | | | |  |  |
|  |  | | Accounts payable and accrued expenses | | | **$   5,055.0** | $  4,493.0 |
|  |  | | Loans and notes payable | | | **$ 3,235.0** | $ 4,518.0 |
|  |  | | Current maturities of long-term debt | | | **$ 33.0** | $ 28.0 |
|  |  | | Accrued income taxes | | | **$ 567.0** | $ 797.0 |
|  | **TOTAL CURRENT LIABILITIES** | | | | | **$ 8,890.0** | $ 9,836.0 |
|  | **LONG-TERM DEBT** | | | | | **$ 1,314.0** | $ 1,154.0 |
|  | **OTHER LIABILITIES** | | | | | **$ 2,231.0** | $ 1,730.0 |
|  | **DEFERRED INCOME TAXES** | | | | | **$ 608.0** | $ 352.0 |
|  | **SHAREOWNERS' EQUITY** | | | | |  |  |
|  |  | | Common stock, $0.25 par value; Authorized — 5,600 shares; | | |  |  |
|  |  | |  | Issued — 3,511 and 3,507 shares, respectively | | **$ 878.0** | $ 877.0 |
|  |  | | Capital surplus | | | **$ 5,983.0** | $ 5,492.0 |
|  |  | | Reinvested earnings | | | **$33,468.0** | $ 31,299.0 |
|  |  | | Accumulated other comprehensive income (loss) | | | **$(1,291.0)** | $ (1,669.0) |
|  |  | | Treasury stock, at cost — 1,193 and 1,138 shares, respectively | | | **$(22,118.0)** | $(19,644.0) |
|  | **TOTAL SHAREOWNERS' EQUITY** | | | | | **$16,920.0** | $ 16,355.0 |
| **TOTAL LIABILITIES AND SHAREOWNERS' EQUITY** | | | | | | **$ 29,963.0** | $  29,427.0 |

**Inventories**

  Inventories consist primarily of raw materials and packaging (which includes ingredients and supplies), finished goods (which includes concentrates and syrups in our concentrate and foodservice operations, and finished beverages in our bottling and canning operations). Inventories are valued at the lower of cost or market. We determine cost on the basis of the average cost or first-in, first-out methods. During 2006 we changed the valuation method for some of our inventory items from average cost to first- in first-out method to ensure that the valuation of all items belonging to a particular inventory category was done using the same method. This change in valuation method increased inventory value by $91 million.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an amendment of Accounting Research Bulletin No. 43, Chapter 4." SFAS No. 151 requires that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) be recorded as current period charges and that the allocation of fixed production overheads to inventory be based on the normal capacity of the production facilities. The Company adopted SFAS No. 151 on January 1, 2006. The adoption of SFAS No. 151 did not have a material impact on our consolidated financial statements and hence we do not report on it.

# Cash Equivalents

        We classify marketable securities that are highly liquid and have maturities of twelve months or less at the date of purchase as cash equivalents. Prior to the current year we classified securities with maturities of three months or less as cash equivalents, this change in classification increased our cash balance by $95 million. We manage our exposure to counterparty credit risk through specific minimum credit standards, diversification of counterparties and procedures to monitor our credit risk concentrations.

# Trade Accounts Receivable

        We record trade accounts receivable at net realizable value. This value includes an appropriate allowance for estimated uncollectible accounts to reflect any loss anticipated on the trade accounts receivable balances and charged to the provision for doubtful accounts. We calculate this allowance based on our history of write-offs, level of past-due accounts based on the contractual terms of the receivables, and our relationships with and the economic status of our bottling partners and customers.

Activity in the allowance for doubtful accounts was as follows (in millions):

|  |  |  |  |
| --- | --- | --- | --- |
| Year Ended December 31, | **2006** | 2005 | 2004 |
| Balance, beginning of year | **$   72.0** | $  69.0 | $   61.0 |
| Net charges to costs and expenses | **$ 2.0** | $ 17.0 | $ 28.0 |
| Write-offs | **$ (12.0)** | $ (12.0) | $ (19.0) |
| Other | **$ 1.0** | $ (2.0) | $ (1.0) |
| Balance, end of year | **$  63.0** | $   72.0 | $    69.0 |

All of ABC Inc.’s sales are made to distributors under agreements allowing right of return. Accounts Receivables include $178 million for goods that were sold in December and it is likely that approximately 70% of these goods will be returned.

# Property Plant and Equipment

Property, plant and equipment are stated at cost. Repair and maintenance costs that do not improve service potential or extend economic life are expensed as incurred. Depreciation is recorded principally by the straight-line method over the estimated useful lives of our assets, which generally have the following ranges: buildings and improvements: 40 years or less; machinery and equipment: 15 years or less; containers: 10 years or less.

The following table summarizes our property, plant and equipment (in millions):

|  |  |  |
| --- | --- | --- |
| December 31, | **2006** | 2005 |
| Land | **$  495.0** | $ 447.0 |
| Buildings and improvements | **$ 3,020.0** | $ 2,692.0 |
| Machinery and equipment | **$ 7,333.0** | $ 6,271.0 |
| Containers | **$ 556.0** | $ 468.0 |
| Construction in progress | **$ 507.0** | $ 306.0 |
|  | **$11,911.0** | $ 10,184.0 |
| Less accumulated depreciation | **$ 5,008.0** | $ 4,353.0 |
| Property, plant and equipment — net | **$ 6,903.0** | $  5,831.0 |

Machinery and equipment contains interest costs of $115 million. These costs were related to the construction of certain infrastructure facilities such as roads and street lighting in the immediate area surrounding the company’s manufacturing plant.

# Goodwill, Trademarks and Other Intangible Assets

         In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," we classify intangible assets into three categories: (1) intangible assets with definite lives subject to amortization, (2) intangible assets with indefinite lives not subject to amortization, and (3) goodwill. We test intangible assets with definite lives for impairment if conditions exist that indicate the carrying value may not be recoverable. Such conditions may include an economic downturn in a geographic market or a change in the assessment of future operations. We record an impairment charge when the carrying value of the definite lived intangible asset is not recoverable by the cash flows generated from the use of the asset.

The following tables set forth information for intangible assets subject to amortization and for intangible assets not subject to amortization (in millions):

|  |  |  |  |
| --- | --- | --- | --- |
| December 31, | | **2006** | 2005 |
| Amortized intangible assets (various, principally trademarks): | |  |  |
|  | Gross carrying amount (1) | **$ 372.0** | $ 314.0 |
|  | Less accumulated amortization | **$ 174.0** | $ 168.0 |
| Amortized intangible assets — net | | **$ 198.0** | $ 146.0 |
| Unamortized intangible assets: | |  |  |
|  | Trademarks (2) | **$2,045.0** | $1,946.0 |
|  | Goodwill (3) | **$1,403.0** | $1,047.0 |
|  | Bottlers' franchise rights (3) | **$1,359.0** | $ 521.0 |
|  | Other | **$ 130.0** | $ 161.0 |
| Unamortized intangible assets | | **$4,937.0** | $3,675.0 |

1. The increase in 2006 is primarily related to business combinations and acquisitions of trademarks with definite lives totaling approximately $75 million and the effect of translation adjustments, which were partially offset by impairment charges of approximately $9 million and disposals.

2. The increase in 2006 is primarily related to business combinations and acquisitions of trademarks and brands totaling approximately $118 million and the effect of translation adjustments, which were partially offset by impairment charges of approximately $32 million.

3. The increase in 2006 is primarily related to the acquisition of certain bottling units in the areas surrounding the company’s manufacturing units, and the effect of translation adjustments.

 In 2006, our Company recorded impairment charges of approximately $41 million primarily related to trademarks. The amount of these impairment charges was determined by comparing the fair values of the intangible assets to their respective carrying values. The fair values were determined using discounted cash flow analyses. Because the fair values were less than the carrying values of the assets, we recorded impairment charges to reduce the carrying values of the assets to their respective fair values. These impairment charges were recorded in the line item other operating charges in the consolidated statement of income.

# Long-Term Debt

        Long-term debt consisted of the following (in millions):

|  |  |  |
| --- | --- | --- |
| December 31, | 2006 | 2005 |
| 5 3/4 % U.S. dollar notes due 2009 | $  399.0 | $  399.0 |
| 5 3/4% U.S. dollar notes due 2011 | $ 499.0 | $ 499.0 |
| 7 3/8% U.S. dollar notes due 2093 | $ 116.0 | $ 116.0 |
| Other, due through 20141 | $ 333.0 | $ 168.0 |
|  | $1,347.0 | $1,182.0 |
| Less current portion | $ (33.0) | $ (28.0) |
| Long-term debt - Net | $ 1,314.0 | $ 1,154.0 |

|  |  |
| --- | --- |
| 1 | The weighted-average interest rate on outstanding balances was 6% for both the years ended December 31, 2006 and 2005. |

The above notes include various restrictions, none of which is presently significant to our Company. The principal amount of our long-term debt that had fixed and variable interest rates, respectively, was $1,346 million and $1 million on December 31, 2006. The principal amount of our long-term debt that had fixed and variable interest rates, respectively, was $1,181 million and $1 million on December 31, 2005. The weighted-average interest rate on the outstanding balances of our Company's long-term debt was 6.0 percent for both the years ended December 31, 2006 and 2005.

        Total interest paid was approximately $212 million, $233 million and $188 million in 2006, 2005 and 2004, respectively.

        Maturities of long-term debt for the five years succeeding December 31, 2006, are as follows (in millions):

|  |  |  |
| --- | --- | --- |
| Year |  | Maturities of Long-Term Debt (in millions) |
| 2007 |  | $33 |
| 2008 |  | $175 |
| 2009 |  | $436 |
| 2010 |  | $54 |
| 2011 |  | $522 |

**Accounts Payables and Accruals:**

Accounts payable and accrued expenses consisted of the following (in millions):

|  |  |  |
| --- | --- | --- |
| December 31, | **2006** | 2005 |
| Other accrued expenses | **$ 1,653.0** | $ 1,413.0 |
| Accrued marketing | **$ 1,348.0** | $ 1,268.0 |
| Trade accounts payable | **$ 929.0** | $ 902.0 |
| Accrued compensation | **$ 550.0** | $ 468.0 |
| Sales, payroll and other taxes | **$ 264.0** | $ 215.0 |
| Container deposits | **$ 264.0** | $ 209.0 |
| Accrued streamlining costs | **$ 47.0** | $ 18.0 |
| Accounts payable and accrued expenses | **$ 5,055.0** | $ 4,493.0 |

Currently the company is involved in a law suit with some of its former employees. If the company loses the lawsuit it could be liable for $165 million worth of compensation and retirement benefits related to 2006. Even though the company has lost similar lawsuits in the past, the company’s legal experts believe that chances of losing the current lawsuit are relatively low. Hence the company has not provided for the liability of $165 million.

# Stock-Based Compensation

        Our Company currently sponsors stock option plans and restricted stock award plans. Prior to January 1, 2006, the Company accounted for these plans under the fair value recognition and measurement provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation." Effective January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), "Share Based Payment" ("SFAS No. 123(R)"). Our Company adopted SFAS No. 123(R) using the modified prospective method. Based on the terms of our plans, our Company did not have a cumulative effect related to our plans. The adoption of SFAS No. 123(R) did not have a material impact on our stock-based compensation expense for the year ended December 31, 2006. Further, we believe the adoption of SFAS No. 123(R) will not have a material impact on our Company's future stock-based compensation expense. The fair values of the stock awards are determined using an estimated expected life. The Company recognizes compensation expense on a straight-line basis over the period the award is earned by the employee.

        Our equity method investees also adopted SFAS No. 123(R) effective January 1, 2006. Our proportionate share of the stock-based compensation expense resulting from the adoption of SFAS No. 123(R) by our equity method investees is recognized as a reduction of equity income. The adoption of SFAS No. 123(R) by our equity method investees did not have a material impact on our consolidated financial statements.

# Statement of Cash Flows (All number are in millions)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Year Ended December 31, | | | **2006** | 2005 | 2004 |
|  | |  |  |  |  |
| **OPERATING ACTIVITIES** | | |
| Net income | | | **$   5,080.0** | $  4,872.0 | $  4,847.0 |
| Depreciation and amortization | | | **$ 938.0** | $ 932.0 | $ 893.0 |
| Stock-based compensation expense | | | **$ 324.0** | $ 324.0 | $ 345.0 |
| Deferred income taxes | | | **$ (35.0)** | $ (88.0) | $ 162.0 |
| Equity income or loss, net of dividends | | | **$ 124.0** | $ (446.0) | $ (476.0) |
| Foreign currency adjustments | | | **$ 52.0** | $ 47.0 | $ (59.0) |
| Gains on issuances of stock by equity investees | | | **—** | $ (23.0) | $ (24.0) |
| Gains on sales of assets, including bottling interests | | | **$ (303.0)** | $ (9.0) | $ (20.0) |
| Other operating charges | | | **$ 159.0** | $ 85.0 | $ 480.0 |
| Other items | | | **$ 233.0** | $ 299.0 | $ 437.0 |
| Net change in operating assets and liabilities | | | **$ (615.0)** | $ 430.0 | $ (617.0) |
|  |  | |  |  |  |
|  | Net cash provided by operating activities | | **$ 5,957.0** | $ 6,423.0 | $ 5,968.0 |
|  |  | |  |  |  |
| **INVESTING ACTIVITIES** | | |  |  |  |
| Acquisitions and investments, principally trademarks and bottling companies | | | **$ (901.0)** | $ (63.0) | $ (267.0) |
| Purchases of other investments | | | **$ (82.0)** | $ (53.0) | $ (46.0) |
| Proceeds from disposals of other investments | | | **$ 640.0** | $ 33.0 | $ 161.0 |
| Purchases of property, plant and equipment | | | **$(1,407.0)** | $ (899.0) | $ (755.0) |
| Proceeds from disposals of property, plant and equipment | | | **$ 112.0** | $ 88.0 | $ 341.0 |
| Other investing activities | | | **$ (62.0)** | $ (28.0) | $ 63.0 |
|  | |  |  |  |  |
|  | | Net cash used in investing activities | **$(1,700.0)** | $(1,496.0) | $ (503.0) |
|  | |  |  |  |  |
| **FINANCING ACTIVITIES** | | |  |  |  |
| Issuances of debt | | | **$ 617.0** | $ 178.0 | $ 3,030.0 |
| Payments of debt | | | **$(2,021.0)** | $(2,460.0) | $(1,316.0) |
| Issuances of stock | | | **$ 148.0** | $ 230.0 | $ 193.0 |
| Purchases of stock for treasury | | | **$(2,416.0)** | $(2,055.0) | $(1,739.0) |
| Dividends | | | **$(2,911.0)** | $(2,678.0) | $(2,429.0) |
|  | |  |  |  |  |
|  | | Net cash used in financing activities | **$(6,583.0)** | $(6,785.0) | $(2,261.0) |
|  | |  |  |  |  |
| **EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS** | | | **$ 65.0** | $ (148.0) | $ 141.0 |
|  | |  |  |  |  |
| **CASH AND CASH EQUIVALENTS** | | |  |  |  |
| Net (decrease) increase during the year | | | **$(2,261.0)** | $(2,006.0) | $ 3,345.0 |
| Balance at beginning of year | | | **$ 4,701.0** | $ 6,707.0 | $ 3,362.0 |
|  | |  |  |  |  |
|  | | Balance at end of year | **$    2,440.0** | $    4,701.0 | $   6,707.0 |
|  | |  |  |  |  |

# Cash Flows from Operating Activities

        Net cash provided by operating activities for the years ended December 31, 2006, 2005 and 2004 was approximately $6.0 billion, $6.4 billion and $6.0 billion, respectively.

        Cash flows from operating activities decreased 7 percent in 2006 compared to 2005. This decrease was primarily the result of payments in 2006 of marketing accruals recorded in 2005 related to increased marketing and innovation activities and increased tax payments made in the first quarter of 2006 related to the 2005 repatriation of foreign earnings under the Jobs Creation Act. This decrease was partially offset by an increase in cash receipts in 2006 from customers, which was driven by a 4 percent growth in net operating revenues and re-pricing of our products. The operating cash flows section also includes insurance proceeds resulting from damage to a company’s manufacturing facility, which was damaged due to fire (total $ 159 million). Another reason for the decrease in cash flows from operating activities in 2006 is a contribution of approximately $216 million to a U.S. Voluntary Employee Beneficiary Association ("VEBA"), a tax-qualified trust to fund retiree medical benefits and a $100 million donation made to The ABC Inc. Foundation.

# Cash Flows from Investing Activities

 Our cash flows used in investing activities are summarized as follows (in millions):

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Year Ended December 31, | | **2006** | 2005 | 2004 |
| Cash flows (used in) provided by investing activities: | |  |  |  |
|  | Acquisitions and investments, principally trademarks and bottling companies | **$ (901.0)** | $ (637.0) | $(267.0) |
|  | Purchases of other investments | **$ (82.0)** | $ (53.0) | $ (46.0) |
|  | Proceeds from disposals of other investments | **$ 640.0** | $ 33.0 | $ 161.0 |
|  | Purchases of property, plant and equipment | **$(1,407.0)** | $ (899.0) | $(755.0) |
|  | Proceeds from disposals of property, plant and equipment | **$ 112.0** | $ 88.0 | $ 341.0 |
|  | Other investing activities | **$ (62.0)** | $ (28.0) | $ 63.0 |
| Net cash used in investing activities | | **$(1,700.0)** | $(1,496.0) | $(503.0) |

Purchases of property, plant and equipment accounted for the most significant cash outlays for investing activities in each of the three years ended December 31, 2006. Our Company currently estimates that purchases of property, plant and equipment in 2007 will be approximately $1.5 billion.

Acquisitions and investments represented the next most significant investing activity, accounting for $901 million in 2006. In 2006, our Company acquired a controlling interest in CCCIL. The remaining amount of cash used for acquisitions and investments was primarily related to the acquisition of various trademarks and brands, none of which were individually significant.

  Investing activities in 2006 also included proceeds of approximately $198 million received from the sale of shares in connection with the public offering of ABC Inc. and proceeds of approximately $427 million received from the sale of a portion of ABC Inc.’s long term investments. The profits from the sale of these investments were included in “other income”.

# Cash Flows from Financing Activities

Our cash flows used in financing activities were as follows (in millions):

|  |  |  |  |
| --- | --- | --- | --- |
| Year Ended December 31, | **2006** | 2005 | 2004 |
| Cash flows provided by (used in) financing activities: |  |  |  |
| Issuances of debt | **$ 617.0** | $ 178.0 | $3,030.0 |
| Payments of debt | **$ (2,021.0)** | $ (2,460.0) | $ (1,316.0) |
| Issuances of stock | **$ 148.0** | $ 230.0 | $ 193.0 |
| Purchases of stock for treasury | **$ (2,416.0)** | $ (2,055.0) | $ (1,739.0) |
| Dividends | **$ (2,911.0)** | $ (2,678.0) | $ (2,429.0) |
| Net cash used in financing activities | **$ (6,583.0)** | $ (6,785.0) | $ (2,261.0) |

Our Company maintains debt levels we consider prudent based on our cash flows, interest coverage ratio and percentage of debt to capital. We use debt financing to lower our overall cost of capital, which increases our return on shareowners' equity.

**Based on your reading of the case, please answer the following questions:**

Based on the reading of only the “**Brief Description of Operations and Management obtained during general information gathering”** list all possible fraud risk factors included in that section. **Do not refer to,** **or base your answer,** on the accompanying financial statements and related notes and management explanations. Please classify the fraud risk factors into pressures and opportunities.

**Pressures:**

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

**Opportunities:**

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Please indicate any **potential material misstatements noted** **during the reading of the financial statements.** You may refer to the case information, and make assumptions, if necessary. (The number of spaces given is not indicative of the actual number of instances of material misstatements).

|  |
| --- |
| **How and where do you believe the client’s financial statements might be susceptible to material misstatement?** |
| 1. |
| 2. |
| 3. |
| 4. |
| 5. |
| 6. |
| 7. |
| 8. |
| 9. |
| 10. |