

NET AND DISCRETIONARY ACCRUALS

Companies that want to manage their reported earnings can do so through real transactions that alter operating cash flows or through accounting gimmicks that change only net income accruals (the noncash revenue and expense components of GAAP earnings). The 2007-2008 balance sheets and 2008 income statement of Runners World follow. The company's operating cash flow for 2008 was (\$ 38,460), a net outflow.

Runners World

Income Statement

For the year ended Dec. 31, 2008

Sales	\$ 120,000
Cost of goods sold	(60,000)
Selling, general, and administrative expenses	(22,000)
Depreciation expense	(14,000)
Operating income	24,000
Interest expense	(6,000)
Interest income	<u>1,000</u>
Income before taxes	\$19,000
Income taxes (@ 34%)	<u>(6,460)</u>
Net income	\$ 12,540

Runners World
Balance Sheet

	Dec. 31, 2008	Dec. 31, 2007
<u>Assets</u>		
Cash	\$100,000	\$80,000
Accounts Receivable (net)	95,000	75,000
Inventories	120,000	90,000
Prepaid expenses	15,000	20,000
Plant, property, and equipment (net)	924,000	850,000
Long-term investments	<u>175,000</u>	<u>232,000</u>
Total assets	<u>\$1,429,000</u>	<u>\$1,347,000</u>
<u>Liabilities and stockholders' equity</u>		
Accounts payable	\$220,000	\$155,000
Accrued payables	195,000	275,000
Interest payable	22,000	10,000
Income tax payable	45,000	62,000
Long-term debt	350,000	270,000
Total liabilities	<u>\$832,000</u>	<u>\$772,000</u>
<u>Stockholders' equity</u>		
Common stock	175,000	145,000
Retained earnings	<u>422,000</u>	<u>430,000</u>
Total stockholders' equity	<u>\$597,000</u>	<u>\$575,000</u>
Total liabilities and stockholders' equity	<u>\$1,429,000</u>	<u>\$1,347,000</u>

Required:

1. Calculate the net accruals (the difference between accrual earnings and operating cash flows) recorded by Runners World in 2008.
2. Identify the individual components of net accruals in requirement 1.
3. Which accruals identified in requirement 2 are subject to the greatest degree of management discretion?
4. Why might managers manipulate the firm's discretionary accruals?