

Holgate Car Wash Systems International

Abstract

The case is based upon the actual financial irregularities of Holgate Car Wash Systems International. This case considers potentially fraudulent financial reporting in the recording and measurement of transactions for Holgate Car Wash Systems, and provides students with the opportunity to integrate accounting, auditing, and business analyses within one case. Integration will help bridge the silo mentality students may hold of the different accounting and business functions. Additionally, by integrating auditing with consideration of financial accounting, auditing issues can be considered earlier in a student's academic education than is now typically done.

The facts of the case are considered from two perspectives: (1) that of the investors attempting to analyze the results reported by previous management, and (2) that of an auditor who is auditing Holgate Car Wash. To consider the case from the investor perspective, the case provides explanations about previous management's recording of specific transactions. These transactions include research and development costs, goodwill impairment, factory labor, warranty, reporting of revenue, and estimation of cost of goods sold. Students will then analyze management's handling of the transactions, determining whether the events, as recorded, faithfully represent the underlying transactions. Measurement discrepancies include both those purposefully misstated by prior management, as well as those in which reasonable differences of proper recognition existed. The case also considers the structuring of the equity position by the owners. This should develop student understanding of general business risks related to liquidity and bankruptcy issues in managing and protecting business assets. To consider the case from the auditor perspective, the effect on the audit from the above transactions is considered.

Students have the opportunity to research relevant generally accepted accounting principles and auditing statements to identify the issues involved in recognition, measurement, and auditing of asset/expense classification, purchase accounting, and goodwill impairment.

Holgate Car Wash Systems International

This case represents information about an actual privately held company. The company provided full access to its records in preparation of this case. While the names and amounts in this case have been changed to protect the privacy of the corporation and individuals, the facts and issues discussed represent the challenges faced by the company.

Background information:

Holgate Car Wash Systems International (HCS) is a privately held manufacturer of conveyor car wash systems that sell at prices ranging from \$100,000 to \$350,000 per system. HCS was once the world's largest conveyor car wash manufacturer, with systems at over 120,000 locations in 70 countries. Recently, however, HCS has lost market share to two competitors, one headquartered in Canada and one in the southeastern part of the United States.

The company is located in a spacious, leased, modern assembly plant. The company maintains a large inventory of raw materials. Since each car wash system is unique, HCS does not begin the manufacture of a system until a specific job order has been obtained and a cash deposit of 30% has been received. Therefore, there is little finished goods inventory, as all completed items are immediately sent to the purchaser.

Approximately 75 employees work at the company. Half of these are employed in the factory. Two different unions represent the employees. Average union wage rate is approximately \$15 per hour, before taxes, medical insurance, and pension benefits paid by the employer. The company maintains a research and development department and holds patents in the United States and in the E.U.

Todd Holgate founded the company in 1954 after he had become intrigued with car wash systems. From the beginnings of owning one car wash, Holgate developed the company into a multi-million dollar operation. He expanded the business into ownership of car wash franchises throughout the United States and created Holgate Acceptance Company, which issued notes to be repaid with the revenue from the business of HCS. HCS became a vertically integrated company that made equipment, produced supplies, built car wash systems, and operated car washes.

Todd Holgate was a colorful individual. Despite running a multi-million dollar corporation, he still continued to wash cars at a franchise location one day a week. He believed in extreme professionalism, and he required that all car wash attendants wear white shirts and ties. He enjoyed acquiring cars and planes. Once, Holgate concurrently owned three Lamborghinis, a BMW, a Cadillac, a Corvette, a Porsche, and a Learjet. He held a speed record for acceleration in a small plane. He raced cars and developed a personal relationship with Paul Newman. This relationship resulted in Newman endorsing HCS in a commercial shown during the Super Bowl.

Holgate was a risk taker. Unfortunately, he took too many risks, and he and the company suffered as a result. His risky behavior resulted in a serious, coma-inducing accident when the tire of his racecar fell from his car, careening his vehicle into a race wall. Likewise, his risky behavior led the business to expand too quickly, when it purchased 25 car wash franchises in the Southern part of the US. This purchase burdened the company with excess debt, resulting in the company declaring bankruptcy in 1990, leaving over 500 investors out at least \$14 million. The investors sued, and a contentious bankruptcy court battle ensued, with some investors eventually receiving repayment from the legal settlement with HCS's auditors, a large international accounting firm.

After bankruptcy, HCS was purchased by a firm from Oklahoma (OK). This company owned HCS for almost 10 years. Todd Holgate and his four sons remained employed by the business. The new owner experienced cash flow difficulties, with vendors demanding cash payment before goods were shipped. The company laid off some employees, and others only worked partial weeks, receiving unemployment from the state for the other days of the week. Additionally, employees were required to take their four-week vacation when the plant closed for part of the winter because of slow sales.

In 2000, OK negotiated to sell the business to a competitor, but OK required short term financing of \$3,000,000 to operate HCS until the sale was complete. IG, an investor group provided these funds. The assets of HCS were designated as collateral for the loan. The competitor ultimately refused to purchase HCS as agreed, and thus HCS did not have cash to repay IG's short-term loan. This left no exit strategy for the new investment group other than to foreclose on the loan. IG acquired the company's assets. In addition, IG elected to assume \$3,800,000 of the liabilities of HCS, including \$3,200,000 of deposits made by customers. The cash from the deposits had previously been used by HCS to cover normal operations. The fair market value of the net identifiable assets received in the foreclosure proceedings was \$4,900,000. With the assets, IG then formed a new entity, Holgate Manufacturing (HM). Like HCS, HM manufactures conveyor car wash systems. The change in name and ownership does not affect the ongoing operations of the business, and most competitors and customers are unaware of any material change in business operations.

IG hired Vale Consulting Corporation, a professional management company, to manage HM. Vale Consulting specialized in workouts of troubled corporations. Additionally Vale Consulting invested \$400,000 in HM to become a 5% equity owner. During the first year, Vale Consulting representatives met monthly with HM's Board of Directors to discuss HM's operating results. But, the meetings became increasingly difficult, as Vale Consulting Corporation would continually miss its own operating projections provided only a month previous. Eventually, the new investment group dismissed Vale Consulting and hired its own manager, Perry Oxman. A timeline of important events in the life of HCS/HM is presented in Exhibit 1.

When Oxman began work, he had no reason to believe any financial shenanigans had occurred under the previous management. However, he began to have his doubts as he found troubling clues. The following discussion represents descriptions of transactions found by the new operations manager in his analysis of the company's financials.

Financial reporting – sales department and revenue recognition

HCS/HM maintains a sales department that markets the products to dealers who resell the products to end-users. Most of the sales personnel have been associated with the company for years, including the founder's sons who work in the sales department.

The company publishes list prices for its products. These prices generally refer to that charged to the end user. A discount of approximately 30% is typically given dealers. Any discount greater than 33% requires management approval. On the financial statements and accompanying detail provided to the Board, prior management only disclosed the net amount of revenue received. New management believed this information too summarized and requested both gross and net numbers for each sale. Exhibit 2 provides this detail for one month.

QUESTIONS:

Financial Accounting

1. Based upon the data provided in Exhibit 2, compute the amount of actual sales discount given. Compare this to the stated authorized rate. What was Vale Consulting's incentive to obscure the true discount rates offered? What was the sales departments' incentive to obscure the true discount rates offered?
2. Review the names of purchasers of conveyor systems. What management concern, if any, do you have about the purchasers of the car wash systems?
3. Discuss the level of detail of the financial information originally provided to the Board of Directors.

Auditing

4. Do related party transactions create any special concerns for an audit? How would an auditor audit related party transactions?
5. What suggestions might the auditor propose to the company regarding the related party transactions?
6. Discuss the internal control function for sales approval. Discuss both the established control and the execution of that control.

Financial reporting – cost of goods sold

A physical inventory is taken once a year; for interim reporting, the company estimates its cost of goods sold based upon the relationship of prior year's cost of goods sold to prior year's sales. In the previous year, actual cost of goods sold as a percentage of net sales averaged 47%. Thus, in the current year cost of goods sold was estimated and recorded as 47% of recorded net sales. However, in prior years, net sales averaged 70% of list. In the current year the sales personnel were transacting sales at a much greater discount, as noted above, yet cost of goods sold continued to be recorded at

47% of net sales. Since actual cost of goods sold does not decrease with a reduction in sales price, the company underreported cost of goods sold on an interim basis.

QUESTIONS:

1. Assuming a list price of \$100,000, discount of 30%, and cost of goods sold allocated at 47%, determine the amount of sales, cost of goods sold, and gross profit recognized for this sale.
2. Now, assuming a list price of \$100,000 a discount of 50%, and cost of goods sold allocated at 47%, determine the amount of sales, cost of goods sold, and gross profit recognized for this sale.
3. For the above example, estimate the understatement of cost of goods sold because of the understatement of the sales discount.
4. Comment about the usage of estimating cost of goods sold for interim reporting.
5. Is the company's reporting of revenues and estimation of cost of goods sold examples of fraudulent financial reporting? Why or why not.

Audit questions:

6. Obtain the recent Statement of Auditing Standard related to fraud. What are the auditors' responsibilities for detecting fraud in the financial statements?

Warranty costs

On all new conveyor systems, the company provides a warranty of two years on parts, and 180 days on labor. Yet, Oxman realized that no warranty costs were reported on the income statement. Upon investigation, he discovered that warranty costs were not accrued at the time of sale. Instead, the company waited until a reported problem occurred. The company would then request that the customer return the faulty part to HCS, and HCS would ship a new item to the customer. The shipment of the new item was recorded as a sale, with a corresponding increase in accounts receivable. When the damaged part was returned to HCS, HCS would increase inventory and decrease accounts receivable for the retail amount of the inventory part received. Experience has found that warranty costs run approximately .7% of net sales.

Assuming sales of \$100,000 and a faulty part for \$15,000, an example of the journal entries is as follows:

1. Time of sale:

Accounts receivable 100,000

Sales 100,000

2. Customer contacts company with a complaint about the product. A new part is sent to the customer. The cost of the new part is \$15,000.

Accounts receivable	15,000	
Sales		15,000
Cost of goods sold	15,000	
Inventory		15,000

3. Customer returns faulty part to Company. Company records item received into inventory at the price of the new part sent to the customer.

Inventory	15,000	
Accounts receivable		15,000

QUESTIONS:

1. Is the company's method of reporting warranty costs an acceptable method for recording such costs?
2. What impact does this method of reporting warranty have upon warranty expense? Net earnings? Valuation of inventory on the financial statement?
3. What would you recommend to the company related to the reporting of warranty costs?

Audit questions

4. How would an auditor uncover the understatement of warranty expense and liability?

Trade Shows

Trade show expenditures represent a significant cost incurred by the company. Each quarter the company sends product and material to trade shows. One quarter, however, the company triples its trade show expenditures for the trade show in Las Vegas. The company can spend 20% of its income on trade shows. Currently the company expenses the entire amount of trade show expenditures in the month of the trade show. The company would prefer, however, to capitalize this cost and expense it over a future period.

QUESTIONS:

1. Research current pronouncements to determine how trade show costs might be reported.

2. Current management is very concerned that expensing trade-show costs in one month would greatly skew that month's results. In particular, management is concerned that the Board of Directors will not understand such large swings in net income. What might you suggest to the manager to address his concerns?

Other expenditures capitalized.

After the first month Oxman had worked at HCS, accounting employees began to ask him whether they could write off some assets that were on the books. Oxman investigated and found that prior management had authorized the capitalization of the following: (1) all research and development costs of \$62,000. (2) \$73,000 of labor costs incurred in a slow month (3) \$55,000 of nuts and bolts for the shop and (4) \$48,000 of costs paid to an engineering firm.

QUESTIONS:

1. Discuss the propriety of recording these transactions as assets.
2. What was the motivation of prior management to capitalize these transactions?
3. What actions should new management have undertaken to discover, on a timely basis, the problems noted?

Financial reporting – generally accepted accounting principles

HCS is a privately held company. It is not required to have an audit. The Board of Directors is provided with operating financials prepared using generally accepted accounting principles. However, senior management is concerned that the magnitude of recent adjustments, necessitated because of poor accounting by the predecessor, creates an appearance that the firm is doing worse than it actually is.

QUESTIONS:

1. Discuss management's concern about using generally accepted accounting principles for reporting the results.
2. Develop an alternative method to generally accepted accounting principles for reporting to the Board of Directors.

Purchase of assets

QUESTIONS:

1. Why would the creditors choose to become equity participants in the carwash business?

2. Why would IG elect to honor customer deposits?
3. How would IG record the purchase of the assets and assumption of some of the liabilities?
4. What is the amount of goodwill recorded from this transaction? Discuss the valuation of goodwill. In this case, does goodwill have an indefinite or definite life? At what amount should goodwill be recorded on the financial statements?
5. During 2002, IG converted part of its equity balance, to debt owed by HM to IGS, an entity related to IG through common ownership. Discuss the owners' reasoning for this transfer of ownership.
6. Optional – Research the proper recognition of IG's purchase of assets and goodwill recognition. Review impairment pronouncements. What guidance do the pronouncements provide about the proper recording of this transaction when the foreclosure occurred? What guidance do the pronouncements provide about the subsequent reporting of goodwill?

Auditor selection

HCS obtains a yearly financial audit of its financial statements. Assume that you are employed by a CPA firm considering bidding for this work. Prepare a risk analysis of this company to determine whether your firm should bid on the audit.

Epilogue: The present owners continue to operate the company, and operating losses have begun to decline as sales activity has increased, although current owners continue to feed cash into the business. The prior sales staff that gave large unauthorized discounts on sales is no longer employed at Holgate. Current management is cleaning up the financial statements. It has expensed and written off over \$1,300,000 of items incorrectly recorded by prior management, including:

Improper recognition of warranty costs - \$64,000
Improper discounting of sales - \$750,000
Understatement of cost of goods sold - \$150,000
Incorrect capitalization of engineering costs - \$48,000
Incorrect capitalization of direct labor - \$73,000
Inventory given free to a former related party - \$40,000
Improper capitalization of R&D - \$62,000
Improper capitalization of shop supplies - \$55,000

In light of these unexpected charges, the current owners are in negotiations with the previous management firm for a refund of the monthly management fee.

The company is seeking a new auditor.

Exhibit 1
Summary of Important Events

- 1954 – company formed
- 1961 – achieved \$1,000,000 of sales
- 1966 – speed record obtained by Holgate
- 1971 – commercial during Super Bowl
- 1988 – expand into Southeast with purchase of car wash company
- 1990 – declared bankruptcy
business sold
- 2000 – contract to sell business
short-term loan made by IG
- 2001 – sale never completed
IG forecloses loan, acquiring assets and assuming some loans
Vale Consulting hired to manage business
- July 2002 – Vale management team replaced with Oxman
- October 2002 – Oxman discovers misstatement of previous financials

Exhibit 2
Net revenue received for the month
January 2002

<u>Job Name</u>	<u>Net Revenue Per Financials</u>	<u>List Price Per published price list</u>	<u>List Price Per invoice</u>
Candy Carwash	\$ 150,000	\$ 225,000	\$225,000
Homer's Clean Cars	280,000	500,000	400,000
Gentle for your Car	250,000	450,000	450,000
Holgate Clean Trucks	350,000	900,000	600,000
Marco Gas and Wash	<u>540,000</u>	<u>800,000</u>	<u>800,000</u>
Total	\$1,570,000	\$2,875,000	\$2,475,000

Instructor Notes

Overview:

This case considers potentially fraudulent financial reporting in the recording and measurement of transactions for Holgate Car Wash Systems International. The case is based upon the actual financial irregularities of Holgate Car Wash Systems. The case provides students with the opportunity to integrate accounting, auditing, and business analyses within one case. Integration will help bridge the silo mentality students may hold of the different accounting and business functions. Additionally, by integrating auditing with consideration of financial accounting issues, auditing issues can be considered earlier in a student's academic education than is now typically done.

The facts of the case are considered from two perspectives: (1) that of the investors attempting to analyze the results reported by previous management, and (2) that of an auditor who is auditing Holgate Car Wash. To consider the case from the investor perspective, the case provides explanations about previous management's recording of specific transactions. These transactions include research and development costs, goodwill impairment, factory labor, warranty, reporting of revenue, and estimation of cost of goods sold. Students will then analyze management's handling of the transactions, determining whether the events, as recorded, faithfully represent the underlying transactions. Measurement discrepancies include both those purposefully misstated by prior management, as well as those in which reasonable differences of proper recognition existed. The case also considers the structuring of the equity position by the owners. This should develop student understanding of general business risks related to liquidity and bankruptcy issues in managing and protecting business assets. To consider the case from the auditor perspective, the effect on the audit from the above transactions is considered.

Students have the opportunity to research relevant generally accepted accounting principles and auditing statements to identify the issues involved in recognition, measurement, and auditing of asset/expense classification, purchase accounting, and goodwill impairment.

The Company:

This case provides a specific example how a multi-million dollar industry leader can suffer from poor accounting expertise and cash flow problems. This case represents information about an actual privately held company. The company provided full access to its records in preparation of this case. While the names and amounts in this case have been changed to protect the privacy of the corporation and individuals, the facts and issues discussed represent the challenges faced by the company.

Class usage:

All or part of the case can be used in Intermediate Accounting. The instructor should use the audit questions along side financial reporting questions, so that the integration of audit and financial accounting occurs. In Intermediate Accounting, original authoritative auditing guidance may be referenced, depending upon the scope of the student expertise and time available for the case. However, when the case is used in an auditing course, students should refer to the original auditing standards.

Time required for case:

This case can be covered in one or several class sessions depending the sections used and advance work required by students before the class. The case lends itself to classroom work, as the description of each section is relatively brief, allowing students to spend class time discussing the issues of each section in depth. Because the case covers several different topics, the case can be used throughout the course, providing a tie-in of various course topics within one case.

Specific research of GAAP can be done during class time if students have access to FARS system through an online university network. If this is not available, research can occur outside of class.

Specific comments on questions in case.

Financial Accounting – sales and revenue recognition:

1. Based upon the data provided in Exhibit 2, compute the amount of actual sales discount given. Compare this to the stated authorized rate. What was Vale Consulting Corporation's incentive to obscure the true discount rates offered? What was the sales departments' incentive to obscure the true discount rates offered?

Discount as a percentage of sales ranged from 30% to 60%, with the average at 45%. The highest discount was given to Holgate Clean Trucks. The company's procedures require written authorization whenever the discount exceeds 33%. Evidence of written authorization for these sales did not exist. Actual discount rates were far in excess of that allowed by company procedures. Additionally, note that for some sales the list price stated on the invoice was significantly lower than the published price list. Thus, the sales invoice showed a discount of 30% of the invoice list price although, with a correct list price, a much greater discount was given.

Vale Consulting Corporation was hired to improve the results of the business. It is presently unclear whether management agreed and/or encouraged the sales at the high discount rates, and if so, why Vale Consulting would purposefully enter into sales at unprofitable rates. It is possible that they did so to increase sales in the short term, hoping that future sales would increase and cover the losses incurred. The lack of detail provided to the board by Vale Consulting does suggest that Vale Consulting either did not want the board to be fully informed, or it was remiss in discerning which information was useful. Vale was held a small interest in the company, making Vale's motivation for a long-term deceit of the owners doubtful.

The motivation for the sales department is clearer. Sales personnel were compensated based upon sales generated, and it was to their advantage to transact as many sales as possible. Since sales personnel negotiated contracts with discounts greater than the standard authorized rate, they had an incentive to hide the true rate for fear the sales would not be approved. The fact that, for some sales, the list price was understated on the invoice suggests that sales personnel wanted to hide the true discount of the sales. It appears that they fraudulently entered into sales at unauthorized rates. However, it is possible that management gave them verbal authorization on the sales. This cannot be

determined with any certainty, as prior management is not willing to discuss this and the sales personnel all left with the change in management.

2. Review the stated purchasers of conveyor systems. What management concern, if any, do you have about any of the purchasers of the conveyors?

One sale was made to Holgate Clean Trucks, a company with a name similar to the founder of the business, Todd Holgate. This suggests a potential related party transaction. Related party transactions should be done at an arm's length transaction, such that the terms of the sale resemble those of sales to outsiders. Yet, this sale generated the greatest discount from list.

3. Discuss the level of detail of the financial statement originally provided to the Board of Directors related to revenue recognition.

Most boards receive summarized financial information. A detailed general ledger would not be expected. Yet, sales price information represents information that any board would find important. Because this company was in financial distress, the board would want detailed information on selling prices to monitor the company's results and the success of new management. By not receiving information about discounts offered, the board was effectively kept ignorant of troubles with sales, profitability, and management's control of these critical areas.

4. Do related party transactions create any special concerns for an audit? How would an auditor audit related party transactions?

Related party transactions are identified in the footnotes to financial statements. Specifically, SFAS No. 57 requires disclosure of the nature of the related party transactions, the description of the transactions, the dollar amounts of the transactions, and any amounts due to/from. SAS 45 governs the auditing of related party transactions. SAS 45 provides guidance on procedures for identifying and testing of material related party transactions.

Since students need frequent opportunities to read the original authoritative sources, students can locate the specific auditing standard and financial accounting statement related to related party transactions. Alternatively, the instructor can provide these to students during class, as they are not lengthy and can be read during the class case discussion.

5. What suggestions might the auditor propose to the company regarding the related party transactions?

All sales should have management approval to ascertain that sales price, terms, and credit worthiness are appropriate. Sales to a related party should require additional management approval to ascertain that the terms of the sale are representative of the sales to other, non-related parties. Unauthorized sales will occur if management is not performing this control. For related party transactions at prices other than market, Board approval should be required.

6. Discuss the internal control function for sales approval. Discuss both the established control and the execution of that control.

In this question students should differentiate between the existence of an internal control and the success of that control. The company had a written policy that required management approval of sales with discounts greater than 33%. It appears that this policy was not followed. Thus, the company had an internal control that was ineffective.

Students might suggest that management be held accountable for all sales made. Students might also suggest other controls that remove the human element of the control. A computerized check could be used prior to production. Because the sales were entered into a computerized system, a computer check of discount rate given could be created, and sales made at unauthorized rates would be rejected, essentially stopping production of the item.

Financial reporting – cost of goods sold

1. Assuming a list price of \$100,000, a sales discount from list of 30%, and cost of goods sold allocated at 47%, determine the amount of sales, cost of goods sold, and gross profit recognized for this sale.

These series of questions are presented so that the students can compute, and understand, the effect from incorrect recognition of cost of goods sold. For this example, the sales price would be \$70,000, the cost of goods sold estimated to be \$32,900, and gross profit would be \$37,100.

2. Now, assuming a list price of \$100,000 a discount of 50%, and cost of goods sold allocated at 47%, determine the amount of sales, cost of goods sold, and gross profit recognized for this sale.

The sales price would be \$50,000, cost of goods sold \$23,500, and gross profit recognized of \$26,500.

3. For the above example, estimate the understatement of cost of goods sold because of the understatement of the sales discount.

Although the sales price has decreased, actual cost of goods sold has not. Thus, for the sale of \$50,000, cost of goods sold should still be estimated at \$32,900, resulting in a gross profit of \$17,300. Cost of goods sold was underestimated (and gross profit overestimated) by \$9,200 for this example. Since sales approximated \$30,000,000 during the year, gross profit was overstated by nearly \$4,000,000. This would, of course, be adjusted at yearend when a physical of inventory was taken, and actual cost of goods sold computed. But, during the year operating results would be greatly miscalculated.

4. Comment about the usage of estimating cost of goods sold for interim reporting.

APB No. 28, Interim Financial Reporting, permits the usage of estimating cost of goods sold for interim reporting purposes. As permitted by APB No. 28, the company used the prior year's relationship between cost of goods sold and sales to estimate current year's cost of goods sold. However, in this case the estimate understated cost of goods sold, as the relationship between sales and cost of goods sold had changed from the prior year. Thus, investors were provided with information that greatly distorted, and overestimated, profit for the period. Since the company had little finished goods, it may be easy to take a physical inventory on a more frequent basis than the once a year that is previous did. Certainly, this would provide more accurate financial information.

5. Is the company's reporting of revenues and estimation of cost of goods sold examples of fraudulent financial reporting? Why or why not.

Net revenues were correctly reported. However, management failed to disclose important information about the prices of those sales. This may not be fraudulent reporting, but it is misleading reporting. Additionally, the company greatly underreported cost of goods sold, so operating results were overly optimistic. It is unclear whether this misstatement occurred because of fraudulent behavior by management who purposefully used an incorrect percentage for cost of goods sold allocation, or whether this was due to sales personnel hiding the true discount rates offered.

6. Obtain the new Statement of Auditing Standard related to fraud. What are the auditors' responsibilities for detecting fraud in the financial statements?

This is an opportunity to have students learn how to obtain original sources, read them, and then report on them, connecting them to the current issue. SAS 99, Consideration of Fraud in a Financial Statement Audit, provides guidance to auditors related to their responsibility for identifying, assessing, and responding to the risks of material misstatement. The new SAS on fraud has increased the auditor responsibilities for fraud detection. However, in this example the auditor would not be at risk. The auditors had not yet begun current year audit procedures, and prior year results related to cost of goods sold were correct.

Warranty costs:

1. Is the company's method of reporting warranty costs an acceptable method for recording such costs?

The company does not record any warranty expense. Clearly this is a departure from the matching principle of matching expenses (warranty) with the revenue recognized.

2. What impact does this method of reporting warranty have upon warranty expense? Reported net earnings? Valuation of inventory on the financial statement?

Warranty expense is understated. Cost of goods sold and sales are both overstated by an equal amount. Net income is overstated by the amount of warranty expense not recorded. Inventory is overstated, as the damaged inventory part is recorded at the price of an undamaged item. In fact, the damaged inventory may be unusable in the future.

3. What would you recommend to the company related to the reporting of warranty costs?

The company should record an estimate of warranty expense at the time of sale. Then, as products are defective and the company incurs costs to repair or replace the item, an estimated warranty liability would be reduced.

4. How would an auditor uncover the understatement of warranty expense and liability?

The auditor needs to understand the business of its clients. In this way, the auditor will anticipate the areas of risk and the types of accounts and transactions that can be expected. In this particular case, the business is primarily a manufacturer of expensive systems. The auditor should obtain an understanding of the expected transactions, the terms of the sales, and warranties provided. Based upon the preliminary risk assessment, the auditor may determine that warranty represents a potential underreported contingent liability that requires some specific audit tests. Even if the auditor determines that specific audit tests are not required, during the analytical review the auditor may notice the absence of the expected warranty expense and warranty liability, which would trigger additional work.

Trade Shows

1. Research current pronouncements to determine how trade show costs might be reported.

There are several ways the instructor might have students prepare this question. The instructor can require students to obtain original authoritative documents and research possible methods for the reporting of trade show costs. These costs are, in many ways, advertising costs, and students will want to focus on this. Alternatively, the instructor may have the students work in groups to discuss among themselves, without authoritative guidance, whether the method is acceptable. Finally, the class can be separated into two sections, with half the class preparing arguments for the method used by HCS, and half preparing arguments against that used by HCS. For these latter two methods, students will not necessarily research authoritative literature but will, instead, be expected to consider the transaction, develop possible ways to record the transaction, present pros and cons for recording the transaction under each scenario developed, and then, based upon their analysis, choose a method.

APB 28, Interim Financial Reporting, permits the deferral of costs within a fiscal year for those costs that benefit more than one quarter. APB 28 specifically states that advertising is a cost that may be deferred. Therefore, the company can defer and expense the cost over several periods within a fiscal year if benefits accrue in future

periods. This, indeed, may be the case when a trade-show increases sales in a subsequent quarter.

2. Current management is very concerned that expensing trade-show costs in one month would greatly skew that month's results. In particular, management is concerned that the Board of Directors will not understand such large swings in net income. What might you suggest to the manager to address his concerns?

In this case, the company is privately held. The owners are less concerned with profit and loss in the short term. They are more concerned with cash flow and assessing the viability of the company's model for the future. One sign of viability is increasing sales with control over expenses. It is understandable that management desires to record the costs as an asset and amortized it over a period of time (before yearend) to smooth out earnings, and it is acceptable to handle the trade show costs. However, more importantly, management should also be prepared to justify its expenditure, for instance, by relating the expenditure to contacts made and sales made from these contacts. Often these types of measures are more helpful for owners and management to fully analyze the results of the business, than an income statement.

Other expenditures capitalized

1. Discuss the propriety of recording these transactions as assets.

Students can be directed to the authoritative literature for the recording of these transactions. Research and development costs (SFAS No. 2) should be expensed when incurred. Excess labor should be expensed. Nuts and bolts are supplies and can be individually controlled with a separate inventory (ARB 43). Engineering costs should be identified as type of item (research, development, or another cost) and then handled appropriately.

2. What was the motivation of prior management to capitalize these transactions?

Prior management had not improved the viability of the company. It may have wanted to reduce the amount of expenses recorded, by capitalizing costs that ordinarily would be expensed. This would have the short-term effect of improving results of operations. However, long-term the company would need to generate much higher revenues to offset the ordinary expenses for the period as well as the expensing of those costs that were improperly capitalized in previous periods.

3. What actions should new management have undertaken to discover, on a timely basis, the problems noted?

At the time of management change, new management should have performed a physical inventory. This would have enabled management to determine actual cost of goods sold, which would have allowed for an earlier discovery of the problems with cost of goods sold recognition and, therefore, the income statement and balance sheet. Additionally, the company's auditors could have been enlisted to help with a review of

the financial statements. Since the auditors presumably are familiar with the company and its operations, a review by them may have uncovered some of the problems noted. However, it should be pointed out that prior auditors might have made errors in prior years, as evidenced by the omission of warranty expense from prior years' financials. Finally, new management should have met earlier with current employees to specifically discuss the financial statements. It appears that some accounting employees did not agree with the recording of previous transactions and discussed with new management their desire to write-off some items recorded as assets. Had new management spoken to the employees sooner to understand the extent of the problems, decisions made in earlier months might have been different

Financial reporting – generally accepted accounting principles

1. Discuss management's concern about using generally accepted accounting principles for reporting the results.

Management wishes to accurately present the financial condition of the company to the owners. While generally accepted accounting principles result in financial statements that reflect the transactions, the financials will include adjustments correcting incorrect accounting treatment by the previous management. These include employee salaries, research and development costs, as well as the recognition of warranty expenses not previously reported. Management was concerned that the corrections would negatively impact the board's analysis of the viability of the company. Some of these corrections represent current year operations but some represent errors to previous years. Comparability is more difficult, as prior year's and prior months' financials do not accurately reflect operations. A restatement of prior year's and prior months' financials should be done, so that any ratio analysis would use the corrected amounts for the appropriate time period. While the changes in previously recorded results may be initially confusing to the owners, they, as a whole, are informed financial statement users who would understand the changes when explained by management in the monthly board meetings.

2. Develop an alternative method to generally accepted accounting principles for reporting to the Board of Directors.

In some respects, cash flow is more critical to the company than accrual financial statements. The company is currently in a negative operating cash position, and cash flow, and projected cash flow, is of particular concern to the owners. The adjustments from prior management accounting errors will not impact the cash flow statement and will be less of a concern for the owners. Thus, detailed cash flow analysis, and projections of future cash flow, should be the focus of management.

In addition to cash flow information, the owners and management may consider concentrating on the costs truly variable, those the company would or could eliminate if it desired, as opposed to considering all the costs including those that the company will incur regardless of operating results. For instance, certain employees may be maintained on the payroll regardless of operations, or the factory may remain operating regardless of volume. Then, the owners should not consider these costs when determining future course of action. Identifying costs that will remain and then reporting

and concentrating only on the discretionary variable costs should help focus owners' and management's attention.

Purchase of assets

1. Why would the creditors choose to become equity partners?

The creditors want to protect their current investment. The creditors used assets of the business as collateral for the loan. Once the loan went into default, the creditors took possession of the assets. However, these assets would not, on their own, generate a return for the creditors' investment. The creditors had the choice to either sell the assets, perhaps at a greatly discounted rate, or use the assets to generate operating income. Creditors will assume the position of owner when they believe that they can recoup more of the investment than from selling the assets outright. In this example, the creditors did not take over the company but formed a new entity. In this way, the company avoided assuming some of the previous firm's liabilities. However, customers were unaware of the changes, as the company continued to operate from the same location and continued to conduct business as it had previously.

2. Why would IG elect to honor customer deposits?

IG elected to honor customer deposits to protect its investment in the company. Had the company defaulted on deposits, thus forgoing the sales connected with these deposits, potential future customers may have been leery of negotiating a contract with HCS.

Typically HCS receives no more than 30% of the purchase price as a deposit. The company could honor the commitments and still have generated cash on the sale. Therefore, the honoring of the deposits was not done at a great financial risk to the owners.

3. How would IG record the purchase of the assets and assumption of some of the liabilities?

IG would reclassify the debt investment as an equity investment. Assumed liabilities would increase the amount of the investment. For year-end reporting purposes, the company should consolidate the results of the business.

4. What is the amount of goodwill recorded from this transaction? Discuss the valuation of goodwill. In this case, does goodwill have an indefinite or definite life? At what amount should goodwill be recorded on the financial statements?

The company received assets worth \$4,900,000 and paid \$3,000,000 in cash and assumed liabilities of \$3,800,000. Thus, implied goodwill from this transaction was \$1,900,000.

Goodwill definitely has a limited future life, and in actuality that life may be zero. There is a very high probability that goodwill is completely impaired. Holgate Manufacturing is in a precarious financial position. It has cash flow problems and has been losing market share. The company must compete against companies that make the products in places much cheaper (Canada and the southern part of the US). The company has been

unsuccessful in finding a purchaser of the business. Thus, the ability of the company to generate excess profits is suspect.

5. During the current year, IG converted part of its equity balance, to debt owed by HM to IGS, an entity related to IG through common ownership. Discuss IG's reasoning for this transfer of ownership.

Debt holders are in a preferred position to investors in bankruptcy. It is likely that IG considered bankruptcy a real possibility and it wanted to be in a position to receive some funds from bankruptcy.

6. Optional – Research the proper recognition of IG's purchase of assets and goodwill recognition. Review impairment pronouncements. What guidance do the pronouncements provide about the proper recording of this transaction when the foreclosure occurred? What guidance do the pronouncements provide about the subsequent reporting of goodwill?

This question provides an opportunity for students to review recent goodwill, business acquisition, and asset impairment standards. Appropriate authoritative literature includes: SFAS No. 144, Accounting for the Impairment or Disposal of Long Lived Assets; SFAS No. 142, Goodwill and Other Intangible Assets; and SFAS No. 141, Business Combinations.

Auditor selection

1. HCS obtains a yearly financial audit of its financial statements. Assume you are employed by a CPA firm considering bidding for this work. Prepare a risk analysis of this company to determine whether your firm should bid on the audit.

Among the items students may discuss:

1. Financial history of company - The company has previously been in bankruptcy. Past owners did not have the financial capital to successfully run the company. Current owners assumed ownership of the business only in foreclosure, and have no experience running a business of this kind. Their track record with hiring management is unproven.
2. Management – previous management appeared to engage in some questionable transactions. But, current management seems honest and very knowledgeable.
3. Turnover of staff – there has been recent turnover of employees, notably in sales and in upper management. While turnover may sometimes be an indicator of problem, in this case it may instead signal a return to good business practices. However, with change there may be some uncertainty of company procedures, resulting in either unauthorized transactions or incorrect recording of transactions
4. Previous errors in financials – some of the previous errors were made by prior management, however current accounting personnel incorrectly recorded transactions as requested by management. These include the reporting of assets that had no future benefit. The ability to trust current accounting

personnel, and to obtain information from them about recorded transactions, must be questioned if they willingly engaged in recording transactions improperly.

5. Adjusting entries – current management is intent upon cleaning up the financials. To do so, it is writing off many items previously recorded as assets. This creates a risk that too many items may be written off in the year of management change, to bolster future years' results.
6. Competition - the company probably has a much higher cost of labor than its competitors. One of the main competitors is located in Canada, the other in the southern part of the US. The US dollar is much stronger than the Canadian dollar, thus it is cheaper to build a product in Canada than in the US. Labor is also cheaper in the southern part of the US. Since two unions operate at the company, financial flexibility is limited. Thus, the company is at a competitive disadvantage to its competitors.
7. Internal controls – internal controls appear to be weak and will probably not be relied upon in the first year of the audit.
8. Going concern – there is an added risk of going concern with this business.
9. Past history of suing auditors – previous owners of HCS successfully sued prior auditors, which may or may not be indicative of a propensity to sue auditors.
10. Past relationship with prior auditors – reasons for termination of the previous auditors should be determined. While it appears that the reason is dissatisfaction with the service and quality of the work provided by past auditors, new auditors should consider whether other items, such as a dispute in the reporting of accounting, is driving the search for the new auditor.