

Case 2-8

Juggyfroot

“I’m sorry, Lucy. That’s the way it is.” Ricardo Rikey said.

“I just don’t know if I can go along with it, Rikey.”

“We have no choice. Juggyfroot is our biggest client, Lucy. They’ve warned us that they will put the engagement up for bid if we refuse to go along with the reclassification of marketable securities.”

“Have you spoken to Fred and Ethel about this?” Lucy asked.

“Are you kidding? They’re the ones who made the decision to go along with Juggyfroot,” Rikey responded.

The previous scene took place in the office of Deziloo LLP, a large CPA firm in Beverly Hills, California. Lucy Spheroid is the partner on the engagement of Juggyfroot, a global manufacturer of pots and pans. Ricardo Rikey is the managing partner of the office. Fred and Ethel are the two members of the firm that make final judgments on difficult accounting issues especially when there is a difference of opinion with the client. All four are CPAs.

Ricardo Rikey is preparing for a meeting with Norman Baitz, the CEO of Juggyfroot. Rikey knows that the company expects to borrow \$5,000,000 next quarter and it wants to put the best face possible on its financial statements to impress the banks. That would explain why the company had reclassified a \$2,000,000 market loss on a trading investment to the available-for-sale category so that the “loss” would now show up in stockholder’s equity and not as a charge against current income. The result was to increase earnings in 2010 earnings by 8 percent. Rikey also knows that without the

change, the earnings would have declined by 2 percent and the company's stock price would have taken a hit.

In the meeting, Rikey points out to Baitz that the investment in question was made in an affiliate company that Juggyfroot had owned for six years. Rikey adds there is no justification under generally accepted accounting principles to change the classification from trading to available-for-sale.

This case shows the auditors resisting pressure from the client to change to a non justified accounting treatment.

Ethical Issues

Rikey is asked by Baitz to classify an investment so that current income will increase; Rikey refused to go along with the reclassification. The ethical theories are discussed below:

Rights Theory: It is not right to mislead the investors by making it look as though the company is doing better than it really is. Any attempt to intentionally misstate the financial statements violates the categorical imperative.

Justice Theory: Stakeholder interests are not fairly represented because the perceived interests of the management are given priority over the interest of all other stakeholders.

Utilitarian Theory: Rule-utilitarianism: It requires that the correct rule should be followed. Act-utilitarianism: Requires that the act that creates the greatest good for the greatest number of stakeholders should be selected. None of the stakeholders benefit from an action that misstates net income. Even Juggyfroot is potentially harmed because the SEC may impose sanctions on it for false and misleading financial statements.

Virtue Theory: Honesty requires that the statements should be truthful and recognize revenue using generally accepted accounting principles. Objectivity requires that the company should approach its decision about the proper asset classification with fair-mindedness and without partially to one set of stakeholders. Trustworthiness means that the accountants should not violate the investors' faith that the statements are accurate and reliable. Integrity requires that Rikey should have the moral courage (which he did) to withstand Baitz's pressure, and not to subordinate judgment.

Questions

1. Explain the rules in accounting to determine whether an investment in a marketable security should be accounted for as trading, available-for-sale, or held-to-maturity. Include in your discussion how such classification affects the financial statements.

Statement of Financial Accounting Standards No. 115 requires that investments be classified in three categories and accounted for as follows:

- Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as *held-to-maturity securities* and reported at amortized cost.
- Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as *trading securities* and reported at fair value, with unrealized gains and losses included in earnings.
- Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as *available-for-sale securities* and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity.

Based upon the facts in the case, Juggyfroot was incorrect in making the reclassification of investment, since the investment did not meet the definition of a trading security.

2. Who are the stakeholders in this case? What expectations should they have and what are the ethical obligations of Deziloo and its CPAs to the stakeholders? Use ethical reasoning to answer this question.

The stakeholders of this case are the bank, the shareholders, creditors, suppliers, employees, and officers of the firm. The stakeholders expect non-misleading financial statements. Deziloo has an obligation to perform the audit with integrity, objectivity, and due professional care. From a rights perspective, it is not right to mislead the investors by making it look as though the company is doing better than it really is. Any attempt to intentionally misstate the financial statements violates the categorical imperative. From a justice perspective, stakeholder interests are not fairly represented because the perceived interests of the management are given priority over the interest of all other stakeholders. From a utilitarian perspective, Rule-utilitarianism requires that the correct rule should be followed. Act-utilitarianism requires that the act that creates the greatest good for the greatest number of stakeholders should be selected. None of the stakeholders benefit from an action that misstates net income. Even Juggyfroot is potentially harmed because the SEC may impose sanctions on it for false and misleading financial statements. From a virtue perspective, honesty requires that the statements should be truthful and recognize revenue using generally accepted accounting principles. Objectivity requires that the company should approach its decision about the proper asset classification with fair-mindedness and without partially to one set of stakeholders. Trustworthiness means that the accountants should not violate the investors' faith that the statements are accurate and reliable.

Integrity requires that Rikey should have the moral courage (which he did) to withstand Baitz's pressure, and not to subordinate judgment.

3. Using the AICPA Code of Professional Conduct as a reference, what ethical issues exist for Rikey, Lucy, Fred and Ethel, and Deziloo LLP in this matter?

What role does auditor virtue play in determining what to do in this case?

Under the AICPA Code, the ethical issues are summarized in the principles of the Code, Articles I (Responsibilities), II (The Public Interest), III (Integrity), IV (Objectivity and Independence) and V (Due Care). If the firm should succumb to pressure from Baitz and Juggyfroot, then the firm has committed an act discreditable to the profession (Rule 501). If the firm should succumb to pressure from Baitz and Juggyfroot, the auditors have subordinated their judgment and have not acted with integrity.

Optional Question*

Refer back to the ethical reflection question in chapter 1. Discuss why the accounting rules for valuing so-called securitized assets that were designed using a basket of outstanding mortgages came under attack in 2008-2009. Explain how the accounting rules for investments in securities changed following criticisms that the accounting rules were, at least in part, responsible for the financial crisis. Do you think accounting rules should be influenced by Congressional pressure as was the case with the changes in accounting for investments? Why or why not?

* Your instructor may want you to conduct additional research into this matter by explaining how the accounting rules changed based as a result of pressure applied on FASB by banks and financial institutions, and indirectly by Congress.

Securitization takes pools of assets such as credit card receivables, mortgage receivables, or car loan receivables, and sells shares in these pools of principal and interest payments.

The FASB concluded that a sale occurs only if the seller surrenders control of the receivable to the buyer. Three conditions must be met before a company can record a sale:

- 1) The transferred asset has been isolated from the transferor.
- 2) The transferees have obtained the right to pledge or exchange either the transferred assets or beneficial interests in the transferred assets.
- 3) The transferor does not maintain effective control over the transferred assets through an agreement to repurchase or redeem them before their maturity.

If the three conditions are met, a sale occurs. Otherwise, it is recorded as a secured borrowing.

In the subprime mortgage crisis, the lenders sold loans to a trust, reported a gain, and earned fees for servicing the debt. The lenders took the loans off the balance sheet and had more flexibility to generate more loans. The trust raised money to buy the loans by selling an interest-bearing security to the investing public.

There were two problems with these arrangements. First, the lender cannot keep control; otherwise it cannot receive gain on the sale treatment. Second, the lenders realized that

lending to subprime borrowers was profitable; lenders received a fee for origination of the loans; sold the loans for a gain; and earned servicing revenue. When the housing market collapsed, the subprime borrowers could not repay their loans and a credit crisis was the result.

The lenders sold the loans and the loans were no longer their responsibility. However, the investors who purchased the securitized loans are not ready to let the lenders off the hook. They argue that the lenders must take back the loans that default unusually fast or contained mistakes or fraud (bogus appraisals, inflated borrower incomes, and other misrepresentations).

If the lender retain control or provided recourse or guarantees against losses, the original sale of the loans were reversed, along with any gains recorded on the sale of the receivables. With the loan receivable on the balance sheet of the lender the lender must measure and report any impairment of loans receivable. An impairment of a loan receivable is when it is probable that all amounts due (principal and interest) are not collectible. The lender may use the expected cash flows discounted at the loan's historical effective interest rate. The value of the loan receivable will change only if the legally contracted cash flows are reduced. The lender may also use the market price of the loan or the fair value of the collateral. The value of the loan receivable based on the historical rate will not be equal to the fair value of the loan in subsequent periods.

An investor in the securitized mortgage bonds accounts as held-to-maturity, trading, or available-for-sale. The held-to-maturity debt securities are valued at the amortized cost; does not recognize unrealized holding gains or losses; interest is realized when earned; and gains and losses are recognized when sold. The trading debt securities are valued at fair value or current market price; unrealized holding gains or losses are recognized in net income; interest income is realized when earned; and gains and losses are recognized when sold. The available-for-sale debt securities are valued at fair value or current market price; unrealized holding gains or losses are recognized as other comprehensive income and as a separate component of stockholders' equity; interest income is realized when earned; and gains and losses are recognized when sold.

Accounting is further complicated if the investor is holding derivatives based upon the securitized debt securities. The accounting treatments for the lender, investor in the securitized bonds and derivatives based on the bonds have enough leeway that each group may be treating the bonds very differently. In the subprime mortgage crisis, all groups seem to keep the instruments off the balance sheet, so that none of the groups were considering the risks of the loans, bonds or derivatives.

Congressional hearings, proposed FDIC new regulations and financial industry regulation are trying to determine the best accounting treatments and safeguards for the public. In the hearings, a utilitarianism approach is the basis for most proposals. Although it hard to be sure that the different interest and lobbying groups are not acting out of egoism. The challenge with Congressional influencing accounting treatments is that the best treatment

may not be the ultimate outcome. The experts of accounting will not be determining the resulting treatment.