**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,” Lucy replied.

“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,” Rikey explained.

“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 publicly owned global manufacturer of pots and pans and other household items. 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 million 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 million 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 2013 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 marketable and in the past the company had sold similar investments in less than one year. Rikey adds there is no justification under generally accepted accounting principles to change the classification from trading to available-for-sale.

**NOTES**

This case shows how the simple miss-classification of an item on the balance sheet can trigger earnings effects even though the equity of the company is unaffected. It also illustrates how alternative treatments under GAAP can be used to manage earnings.

**Ethical Issues**

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. Users (i.e., creditors) have a right to accurate and reliable financial information prior to making loan decisions.

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. Each group has an equal right to accurate and reliable statements to assist in their decision making.

Utilitarian Theory: Rule-utilitarianism: It requires that the correct rule should be followed. The correct rule is to follow GAAP and report financial information honestly. 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. If the loan is made based on false data, it may come back to haunt the company later on.

Virtue Theory: Honesty requires that the statements should be truthful and the statements should be trustworthy and prepared diligently, with objectivity and integrity. Objectivity requires that the company should approach its decision about the proper asset classification with fair-mindedness and without partiality 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 to withstand Baitz’s pressure – not subordinate professional judgment to the client as would a person of integrity.

**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 (i.e., other comprehensive income).

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 accurate and reliable 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. While act utilitarianism might be used to rationalize miss-classifying the securities so that the company’s earnings look better and it gets the loan, the decision is short-sighted and fails to adequately consider the harms on the lenders and potential harm for the company. The auditors also will be harmed if they go along with the false classification.

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 under GAAP. Objectivity requires that the company should approach its decision about the proper asset classification with fair-mindedness and without partiality 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 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 would have placed the client’s interest ahead of the public interest. Virtually all of the ethical principles are violated if the CPA firm goes along with the improper classification; it would be subordinating its judgment and not act with integrity.