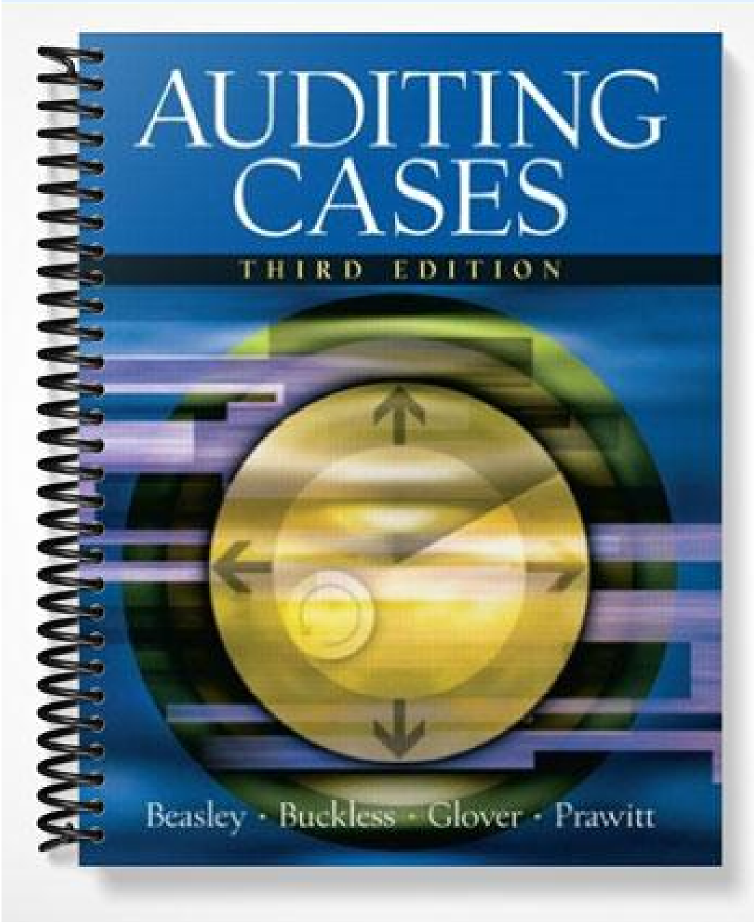
SOLUTIONS MANUAL



Case 2.1
Instructional Notes

Your1040Return.com: Evaluating eBusiness Revenue Recognition, Information Privacy, and Electronic Evidence Issues

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INSTRUCTIONAL OBJECTIVES

- To illustrate business risks for Internet-only business models.
- To help students develop skills related to identifying internal control responses to eBusiness risks.
- To highlight revenue recognition issues related to eBusiness transactions.
- To illustrate unique accounting issues associated with Internet web site banner advertisements.
- To help students identify privacy issues associated with Internet-based business models.
- To illustrate audit implications when transaction audit trails are solely electronic.
- To help students recognize threats to eBusiness strategies.

KEY FACTS

- Your1040Return.com is a leading provider of online income tax preparation and filing services for individual taxpayers.
- The company was founded two years ago by Steven Chicago who realized individuals may be frustrated with the need to purchase tax preparation software upgrades each year to ensure their tax software reflects recent changes in the tax code.
- Your1040Return.com's strategy is to provide up-to-date tax preparation software that can be accessed through the Internet by individuals who pay membership fees for that access.
- In essence, Your1040Return.com's customers "rent" access to tax preparation software packages that are continually kept up-to-date with the latest tax law changes. Customers can also use Your1040Return.com's services to electronically file an already prepared paper-based tax return.
- Customers can use Your1040Return.com to file both state and federal tax returns.
- Your1040Return.com customers select from one of three service packages: Silver, Gold, or Platinum.
- Silver package customers can access electronic copies of tax forms, schedules, and publications and can enter tax return information directly onto those forms and schedules. Your1040Return.com will also file the completed return electronically to the appropriate regulatory agency.

- In addition to the Silver package services, Gold package customers have one-year access to a commercially developed and continually maintained tax preparation software package that assists customers in the preparation of their individual returns.
- Platinum package customers have access to the premium level of services, which allow customers to have multi-year access to the tax preparation software and personalized attention and real-time tax support from qualified income tax specialists.
- Revenue recognition differs for each product offered by Your1040Return.com.
- Your1040Return.com's business is seasonal with its highest demand from early February through April 15th each year. The company experiences peaks in demand during periods surrounding extension deadlines.
- Tax payments and refunds are not funded by Your1040Return.com. Rather, tax refunds are remitted directly from the IRS or state agency to the individual. Tax payments are charged by the IRS or state agency to the individual's credit card account.
- Your1040Return.com also engages in ad swapping with a number of major Internet companies. In exchange for providing electronic advertisements on the Your1040Return.com web site, the company receives free banner ads on other web sites.
- Servers located at Your1040Return.com's offices support the tax preparation software. The servers are in facilities with physical access securities and are protected logically by firewalls and access passwords.
- Two of the founder's nephews who are currently in college oversee the maintenance of the company's information system. The accounting system is maintained by the founder's niece, who is a graduate student seeking her Masters in accounting.
- The company does not have an official customer privacy policy. The company has been approached by marketing executives who are interested in purchasing Your1040Return.com's customer lists.
- As part of a recent line of credit arrangement with the local bank, Your1040Return.com's financial statements must now be audited.

USE OF CASE

This case assignment provides students the opportunity to recognize that while the Internet and related innovative uses of technology offer opportunities for new avenues for conducting business, there are unique risks and related accounting issues that must be considered. This case exposes students to issues associated with a relatively new eBusiness enterprise that provides tax-related services via the Internet. This case explores several issues that arise with an Internet-based business model.

First, the case highlights how the Internet provides innovative ways for businesses to deliver value added services to consumers. As a result, this case exposes students to issues different from those associated with traditional "brick and mortar" businesses. And, because the underlying service relates to tax preparation software for customers, accounting students can easily understand the main components of Your1040Return.com's service offering to consumers.

Second, the structure of the three levels of product service offerings (Silver, Gold, and Platinum) provides a nice opportunity to engage students in an analysis and class discussion of the accounting implications related to revenue recognition. This analysis helps students see how operational decisions about product and service offerings create different accounting issues for each offering. In addition, the use of bartering for the ad banner transactions exposes students to a unique accounting issue for many Internet based businesses.

Third, the case illustrates basic business decisions that start-up companies must make. For example, the case highlights the practical aspects and related implications of attracting and hiring affordable employees with the necessary job skills. It also highlights the difficult realities of maintaining basic business operations with limited resources and talents, such as Your1040Return.com's limited IT system and lack of ideal data and system backups. Finally, the case illustrates tradeoffs business owners must make by highlighting the ethical dilemmas associated with the potential decision to sell private customer information to external marketing agencies.

This case could be used in either an undergraduate or graduate auditing or accounting information systems course to highlight unique business risks, internal controls, and audit evidence issues associated with Internet-based businesses. The questions related to revenue recognition may be effective for use in an undergraduate intermediate accounting course.

Students can complete the case individually or in groups as an in-class or out-of-class assignment. Because the case is relatively short, students can read the case during the class period to prepare for an in-class discussion of several of the questions. Other questions, however, may be better suited as an out-of-class assignment (e.g., see question 1.e and 1.g) that students complete before an in-class discussion is held.

This assignment can be broken down into several sub-assignments that can be completed at various points during a quarter or semester. Students should particularly enjoy this case, given that it exposes them to broader business issues associated with Internet-based businesses.

PROFESSIONAL STANDARDS

Relevant professional standards for this assignment include AU Section 312 "Audit Risk and Materiality in Conducting an Audit," AU Section 319, "The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit," and AU Section 326, "Evidential Matter."

QUESTIONS AND SUGGESTED SOLUTIONS

1. ***You are an audit senior with Gooch & Brown CPA, LLP, a local accounting firm specializing in audits of information systems and financial statements. Your1040Return.com engaged your firm to perform its financial statement audit. You have been asked by the partner to perform the following tasks:***

   a. ***Describe to Stephen Chicago why it is important for your firm to have an understanding of Your1040Return.com's business model.***

   A thorough understanding of the client's business model is essential for doing an adequate audit. The nature of the client's business operations and industry directly affects client business risks and the risk of material misstatements in the financial statements. The auditor uses the knowledge about these risks to determine the appropriate extent of audit evidence. Without an adequate understanding of the underlying client business models, auditors may fail to adequately identify relevant business risks. That failure will likely result in audit procedures inadequately designed to detect material misstatements in the financial statements.

   The auditor should understand factors such as major sources of revenue, key customers and suppliers, sources of financing, and competitors, among other matters, related to the client's core business operations. Through such an understanding, the auditor may be more likely to identify business risks arising from unique incentives and pressures or weaknesses in internal controls created by that business model structure that increase opportunities for misstatements in the financial statements. Additionally, knowledge about core business models gives auditors a better understanding of the client's business and industry to provide value-added services to those clients.

b. Identify Your1040Return.com's major business risks and describe how those risks may increase the likelihood of material misstatements in Your1040Return.com's financial statements.

Because Your1040Return.com's main business model involves the provision of software and other services accessed through the Internet, the company faces different issues from traditional "brick and mortar" businesses. Here is an overview of several business risks that Your1040Return.com faces:

- **Customer Demand.** Because the business model is solely based on services delivered through the Internet, there may be individuals who are uncomfortable using the Internet to use the online tax services. Certain customers may be reluctant to submit personal tax related financial information over the public Internet. As a result, the customer base in the online marketplace may be limited. That may put pressure on management to generate future revenues to maintain profitability goals and targets. That pressure may provide incentives for management to aggressively account for revenue and expense transactions to achieve those profitability goals. In some cases, management may select options that are not in compliance with generally accepted accounting principles.

- **Software Technical Accuracy.** One of the main selling features for Your1040Return.com is access to an up-to-date popular tax software package. There is some risk that the tax preparation software contains errors in the interpretation and application of the complicated federal and state tax codes, which in turn may cause customers to file incorrect returns. If that risk is realized, Your1040Return.com may create contingencies related to potential liabilities associated with litigation claims from customers. In addition, as information about errors in the tax software packages becomes public, customers may be reluctant to continue subscribing to the online services offered, which will lead to decreased revenues. The revenue pressure may lead to incentives to engage in aggressive accounting to maintain profitability goals.

- **Service Availability.** Because Your1040Return.com's core business is based on services delivered via the Internet, the company faces the risk that customers may not be able to access the tax preparation software if there is a failure in the Internet link to the services. Any system failures with Your1040Return.com's computer servers would prevent the company from providing services for its customers, unless reliable and quick backup access is consistently maintained. If the service access is unavailable for a significant amount of time, the company may lose customers, which would create pressures for management to maintain its profitability. In addition, the lack of access to services may create revenue recognition problems given that the company has not fulfilled its service obligations for customers who have already paid for unlimited access to the software services.

- **Inadequate Staff.** Currently, key staff positions related to system support and the accounting functions are held by relatives of the founder who are currently students at local universities. As Your1040Return.com's business continues to grow, the size and complexities associated with company growth may present issues that the current staff is unable to adequately handle. The lack of experience of the current staff may result in errors in judgment that lead to misstatements in the financial statements.

- **Electronic Only Evidence.** Your1040Return.com engages in all transactions electronically, with backups of that data performed daily. There is some risk that the data may be lost or temporarily not accessible, which may increase the difficulty of managing the business and creating (and auditing) accurate financial statements.

- **Customer Privacy.** Because customers access Your1040Return.com's services to complete their individual tax returns, Your1040Return.com has access to highly sensitive personal financial and other demographic data. There is a risk that some of that information might be inadvertently given to or accessed by external parties. If that occurs, Your1040Return.com may face contingencies associated with litigation and other claims filed by customers affected that would need to be disclosed in the financial statements.

c. ***Indicate what Your1040Return.com should do to improve its internal control?***

Below are suggestions designed to strengthen Your1040Return.com's internal controls:

- **Revenue Recognition Controls.** Your1040Return.com should evaluate the adequacy of internal controls surrounding its revenue recognition. Currently, Your1040Return.com recognizes revenue differently for the three levels of service. For the Platinum service, revenue for the first year of service is recognized completely at the point the customer requests the service. Revenue recognition is not spread across the year of service and is not contingent on the filing of a return. However, revenue for the Gold service is treated differently. A portion of the revenue is recognized when service is activated with the remainder not recognized until the customer files the return. Management needs to evaluate internal controls over revenue recognition to ensure that the treatment is consistent with generally accepted accounting principles for all levels of service (For further information regarding revenue recognition see solution to question 1.e).

- **Backup and Contingency Controls.** Your1040Return.com's ability to generate revenues is dependent on the availability of customer access through the Internet to Your1040Return.com's servers and databases. The company needs to evaluate the adequacy of the backup and contingency controls in the event there is a server failure. Backup files should be made frequently (at least daily) and stored off site in secure environments. Alternative servers fully loaded with software and necessary backup data files should be available so that service can be provided in the event of a system failure. These backup and contingency controls should be regularly tested.

- **Privacy Controls.** Because Your1040Return.com has access to highly sensitive customer financial and other demographic information, Your1040Return.com should develop a formal customer privacy policy that identifies how private customer information is maintained and protected. Without a formal policy, sensitive information may be inadvertently released, which may expose Your1040Return.com to significant liabilities. In addition, the company should ensure that policies related to security controls (i.e., firewalls and passwords) are continually evaluated for adequacy.

- **Controls Over Advertising Arrangements.** Because contracts associated with banner advertising can often contain complex revenue provisions (i.e., ad revenues can often be a function of the number of hits to the banner ads and the extent of subsequent drill downs on the advertiser's web site), Your1040Return.com needs to develop controls to ensure the company correctly understands and accounts for revenue transactions generated from offering banner advertisements.

d. ***Explain what audit implications arise if you decide that the controls over electronic records at Your1040Return.com are inadequate to ensure that records have not been altered?***

Given that all transactions are documented solely in electronic form, there is no alternative paper trail to serve as evidence supporting financial statement transactions and accounts. If the auditor is unable to determine that electronic records have not been altered, there may be no reliable evidence for the auditor to examine when evaluating the fair presentation of account balances and transactions. In certain cases, the lack of reliable electronic or other alternative evidence may cause the auditor to conclude that the entity is un-auditable (see AU 326, *Evidential Matter*). In that case, the auditor may be unable to accept the audit engagement or may have to withdraw at a later date. Thus, Your1040Return.com's management needs to establish effective internal controls to ensure that adequate evidence is maintained to support accounts and transactions in the financial statements.

e. ***Authoritative literature provides guidelines for proper revenue recognition policies for transactions such as those discussed in the case. Analyze Your1040Return.com's revenue recognition policies for the three package services. Provide appropriate citations to authoritative literature.***

As summarized in the case materials, Your1040Return.com recognizes revenues differently for each of the three service packages.

Your1040Return.com's Revenue Recognition Policies

For the Silver package, customers pay for access to tax forms, schedules, and publications. And, Silver package customers can submit tax forms electronically. Access is only allowed for one year. Your 1040.com recognizes revenue on the Silver package when the customer submits the tax return to the IRS or state agency.

Gold package customers can access the tax preparation software to complete and submit the return. Access is allowed for one year. Your1040Return.com recognizes a portion of the revenue when the customer accesses the tax software package for the first time. Your1040Return.com recognizes the remaining portion of the revenues when the customer submits the return.

Platinum package customers pay to access the tax software on a multi-year contract basis. Customers can access the tax software package year round to update their tax information and they can receive personalized attention and real-time tax support from qualified income tax specialists. Your1040Return.com recognizes revenues for each year immediately after the customer selects the Platinum service.

At a minimum, Your1040Return.com needs to evaluate their revenue recognition policies to ensure they are applying revenue recognition criteria correctly and consistently across all three products. In addition, Your1040Return.com needs to evaluate implications of their cancellation policy to determine whether they need to record an accrual for the cancellation expense.

Guidance Relevant to Revenue Recognition

FASB Statement of Financial Accounting Concepts (SFAC) No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, states that "an entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues." SFAC No. 5 goes on to note that "the two conditions (being realized or realizable and being earned) are usually met by the time the product or merchandise is delivered or services are rendered to customers." And, SFAC No. 5 notes that "if services are rendered or rights to use assets extend continuously over time, reliable measures based on contractual prices established in advance are commonly available and revenues may be recognized as earned as time passes."

For Your1040Return.com, all three packages (Silver, Gold, and Platinum) grant customers access to the web site for a contracted period of time. For the Silver and Gold memberships, customers have access for a full year. For the Platinum service, customers contract for multiple year service. Because the services allow customers access for a period of time, one may argue that Your1040Return.com should recognize revenues for the Silver and Gold services evenly over the 12-month contractual period. For the Platinum service, revenues should be spread evenly over the number of months contracted in the multi-year package selected.

While all of the revenues for the Silver package and a portion of the revenues for the Gold package are not recognized until the customer files the tax return, one could argue that Your1040Return.com is prematurely recording a portion of the revenue. Even though the tax return has been filed by the customer, both the Silver and Gold packages allow customers access to the web site information to file amendments to their already filed returns. Thus, Your1040Return.com promises access to services beyond the tax return filing date. As a result, Your1040Return.com has an obligation to its customers for the entire one-year period. Thus, revenues are not fully realized until the 12 months expire.

Your1040Return.com's revenue recognition policy appears most aggressive for the Platinum package. Fees for each year's service are recognized as revenue immediately after the customer selects the Platinum option. Because the customer is paying for access to the software and tax specialists for an entire year, revenues from the Platinum service should be earned proportionately over the entire contract period. Thus, Your1040Return.com should modify its revenue recognition policy for the Platinum service to ensure that it is not prematurely recording revenues.

Your1040Return.com needs to evaluate the extent that customers have cancelled previously paid for services during the contract period, as allowed by its cancellation policy. Management needs to perform this evaluation to provide a basis for developing an estimate for the cancellation expense and related liability that should be recorded to reflect this cancellation expense in the financial statements. Your1040Return.com should also determine whether the cancellation policy should be modified to clearly communicate cancellation options for customers during the contract period.

f. ***Explain how you can obtain evidence that ad swapping actually occurred between the Your1040Return.com and Amazon.com? Describe accounting issues that arise when Internet-based companies swap ad services and identify relevant authoritative literature.***

Your1040Return.com and Amazon should have entered into formal contracts regarding the exchange of advertising services on each company's web sites. The auditor would want to obtain copies of the contracts for the audit files to determine the terms of the arrangements and obligations each company has to provide advertisements. Reviews of those contracts would help the auditor determine whether there are underlying accounting issues related to recognizing revenues for advertisements provided on the Your1040Return.com web site or expenses related to Your1040Return.com advertisements at Amazon.com's web site.

The web site systems can be designed to track the time and date advertisements are programmed to appear on the respective web sites. Reports or logs from these systems could be reconciled back to the ad contracts for compliance. Based on information obtained from the review of the ad contracts, the auditor could also visit the respective web sites at those scheduled times to determine if the ads actually appear as stipulated in the contracts.

Because neither Your1040Return.com nor Amazon.com actually pay each other for the advertising services, both companies have actually entered into a non-monetary barter transaction. While currently there is no formal pronouncement from the FASB specifically addressing the accounting for web site advertising arranged on a barter basis, there is relevant guidance for accounting for non-monetary transactions. Paragraph 25 of Accounting Principles Board (APB) Opinion No. 29, *Accounting for Non-Monetary Transactions,* states that the *"Fair value of a non-monetary asset transferred to or from an enterprise in a non-monetary transaction should be determined by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence."* SFAS No. 63, *Financial Reporting for Broadcasters*, contains guidance related to bartering of advertising in the broadcast industry that may be analogous to Your1040Return.com's use of bartering for banner related advertising. Paragraph 8 of SFAS No. 63 states that *"All barter transactions except those involving the exchange of advertising time for network programming shall be reported at the estimated fair market value of the product or service received, in accordance with the provisions of paragraph 25 of APB No. 29, Accounting for Non-Monetary Transactions. Barter revenue shall be reported when commercials are broadcast, and merchandise or services received shall be reported when received or used. If merchandise or services are received prior to the broadcast of the commercial, a liability shall be reported. Likewise, if the commercial is broadcast first, a receivable shall be reported."*

As a result of these accounting provisions, Your1040Return.com needs to gather information to determine the fair market value of the revenues related to advertising it provides for Amazon.com on the Your1040Return.com web site. And, management needs to gather information to determine the fair market value of the expenses related to advertising Your1040Return.com incurs for advertisements on the Amazon.com web site. In addition, information in the contract may provide useful information about the timing of the banner advertisements to determine if there are related receivables and payables that should be reflected in Your1040Return.com's balance sheet.

g. Address a memo to Steven Chicago detailing the appropriate contents for a customer privacy policy. (You may want to visit other company web sites, such as www.cpamoneywatch.com, to see an example of a privacy policy.) Why is it important for Your1040Return.com to have an explicit privacy policy? How might the lack of a policy affect Your1040Return.com's financial statements in the future?

Online privacy policies should focus on protecting the privacy of personal information an organization may collect from its customers through its electronic commerce systems. The AICPA/CICA's *Trust Services Principles and Criteria* provide useful guidance about the importance of online privacy protection for customers engaging in Internet-based businesses that could be pointed out in a memo to Steven Chicago. You could note that the following concepts are commonly used to facilitate the creation and implementation of privacy policies and practices:

- ***Notice.*** An entity should inform customers about its privacy policies and practices at or before the time information is collected or as soon as practicable thereafter. The notice should describe the purpose for which personal information is collected and how it will be used.

- ***Choice and Consent.*** The entity should describe the choices available to individuals and obtain consent from them with respect to the collection, use, disclosure, and retention of personal information.

- ***Collection.*** The entity should limit the collection of personal information to that which is necessary for the purpose described in the notice.

- ***Use and Retention.*** The entity should limit the use of personal information to the purposes described in the notice and for which the individual has provided either implicit or explicit consent. The entity should retain personal information for only as long as necessary for the fulfillment of the stated purposes, or as required by law or regulation.

- ***Access.*** Customers should have access to their own personal or sensitive information for the purposes of correction, update and deletion.

- ***Onward Transfer and Disclosure.*** The entity should only disclose personal information to third parties for purposes described in the notice and for which the individual has provided either implicit or explicit consent, or as permitted by law or regulations. The entity should only disclose personal information to third parties who provide substantially equivalent privacy protection as the entity.

- ***Security.*** The entity that gathers, maintains, or uses personal information must take reasonable precautions to protect the information from loss, misuse, unauthorized access, disclosure, alteration, and destruction.

- ***Integrity.*** The entity should take reasonable care that the information it collects, whether personal or sensitive, be relevant for the purposes for which it is to be used.

- ***Management and Enforcement.*** The entity should provide procedures for assurance of compliance with its own privacy policies and independent recourse procedures to address any unresolved complaints and disputes. The entity should designate one or more individuals who are accountable for the entity's compliance with its privacy policies.

It is important for Your1040Return.com to consider developing an online privacy policy because it is important for consumers to have confidence that an entity takes appropriate steps to protect personal information, especially information as sensitive as that surrounding income and taxation. Because many consumers consider the use of private information about them to be an invasion of their privacy, it is important that entities inform their customers about the kinds of information that are collected about them, the uses of that information, customer options, and related matters. Additionally, some countries have implemented laws and regulations covering the privacy of information obtained through e-commerce.

Failure to develop a formal online privacy policy may lead to future issues that may have an impact on Your1040Return.com's financial statements. First, the lack of a policy may cause some customers to not purchase or renew tax preparation services from Your1040Return.com. Given that customers are using Your1040Return.com's services to prepare and submit highly-sensitive personal tax information, the lack of an adequate privacy policy may be of major concern to potential customers. That reluctance may put pressure on management to generate adequate revenues to be profitable. Second, the lack of an adequately stated privacy policy creates uncertainty as to how Your1040Return.com can use the information it collects from customers ordering tax services online. That lack of uncertainty may lead to inconsistent interpretations about the appropriate uses of the personal information. In some cases, customers may be offended by Your1040Return.com's decision to use the personal information it collects (e.g., decision to sell the customer lists to marketing agencies). Those customers may ultimately enter into litigation against Your1040Return.com to prevent further misuse. Any contingencies that arise related to the litigation may warrant disclosure and recording in the Your1040Return.com financial statements.

Delta Airlines' opening web page at www.delta.com contains an online link to its privacy & security policies. To examine the Delta privacy policy, visit this web site link:

http://www.delta.com/privacy_security/index.jsp

2. Auditing Standard (AU) 326, Evidential Matter, provides guidance for auditors when evaluating electronic evidence. What are the implications for an auditor when a client's accounting system produces and stores transaction evidence only electronically?

Paragraph 14 of AU Section 326, *Evidential Matter*, states the following:

"In entities where significant information is transmitted, processed, maintained, or accessed electronically, the auditor may determine that it is not practical or possible to reduce detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. For example, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is produced, maintained, or accessed only in electronic form. In such circumstances, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk, or consider the effect on his or her report."

Furthermore, paragraph 18 of AU Section 326, *Evidential Matter*, states the following:

"In certain entities, some of the accounting data and corroborating evidential matter are available only in electronic form. Source documents such as purchase orders, bills of lading, invoices, and checks are replaced with electronic messages. For examples, entities may use Electronic Data Interchange (EDI) or image processing systems. In EDI, the entity and its customers or suppliers use communication links to transact business electronically. Purchase, shipping, billing, cash receipt, and cash disbursement transactions are often consummated entirely by the exchange of electronic messages between the parties. In image processing systems, documents are scanned and converted into electronic images to facilitate storage and reference, and the source documents may not be retained after conversion. Certain electronic evidence may exist at a certain point in time. However, such evidence may not be retrievable after a specified period of time if files are changed and if backup files do not exist. Therefore, the auditor should consider the time during which information exists or is available in determining the nature, timing, and extent of his or her substantive tests, and if applicable, tests of controls."

3. Your1040Return.com's main business strategy involves the delivery of services via the Internet. What are some threats to the viability of Your1040Return.com's business strategy?

Because Your1040Return.com's core business strategy involves the delivery of services to customers via the Internet, there are several issues that threaten the viability of successfully continuing this service. Below are examples of some of those threats (note that the answers to this question are similar to those for question 1-b):

- **Customer Demand.** Because the business model is based solely on services delivered through the Internet, there may be individuals who are uncomfortable using the Internet to use the online tax services. Certain customers may be reluctant to submit personal tax related financial information over the public Internet. As a result, the customer base in the online marketplace may be limited. One of Your1040Return.com's comparative advantages is that it provides customers access to the most up-to-date tax preparation software. If providers of traditional tax preparation software purchased in retail stores make available easy access to updated software, there may be less demand for Your1040Return.com's online access to up-to-date software.

- **Software Technical Accuracy.** One of the main selling features for Your1040Return.com is access to an up-to-date popular tax software package. There is some risk that the tax preparation software contains errors in the interpretation and application of the complicated federal and state tax codes, which in turn may cause customers to file incorrect returns. If that risk is realized, Your1040Return.com may lose its customer base.

- **Service Availability.** Because Your1040Return.com's core business is based on services delivered via the Internet, the company faces the risk that customers may not be able to access the tax preparation software if there is a failure in the Internet link to the services. Any system failures with Your1040Return.com's computer servers would prevent the company from providing services for its customers, unless reliable and quick backup access is consistently maintained. If the service access is unavailable for a significant amount of time, the company may lose its core customer base.

- **Customer Privacy.** Certain customers may be reluctant to submit personal tax related financial information over the public Internet because of concerns about the privacy of their highly sensitive tax information. As a result, the customer base in the online marketplace may be limited. Any breaches in customer privacy may cause a deterioration of Your1040Return.com's customer base.

- **Competitors.** Given Your1040Return.com's success of offering online tax preparation software, other established tax preparers may decide to compete directly with Your1040Return.com. Tax preparers, such as H&R Block and national CPA firms, may decide to offer similar online tax preparation software services. To some extent, the IRS already competes with the Silver service package, given that individuals can access electronic copies of tax schedules, forms, and publication via the IRS web site (http://www.irs.gov/.

4. ***When customers register for the Platinum package, they have online access to tax professionals who are paid on a contract basis. If you were in Steven Chicago's shoes, how would you compensate those professionals for their services? What controls could Your1040Return.com implement to ensure that the company does not overpay for those professional services?***

Currently, the tax professionals who provide online tax consulting to Platinum service customers are compensated on a contract basis. Most likely, Steven Chicago would compensate those individuals on an hourly basis for the work they perform. Perhaps a small set of those professionals may be contracted on a retainer basis to perform a minimum number of hours of service each month or quarter of the year for Your1040Return.com customers. Each month (or quarter) the tax professionals could submit a detailed time analysis of the work performed to determine if the minimum number of hours have been worked in accordance with the retainer agreement. In the event the number of hours worked exceed the contracted amount, the tax professionals would be paid for the additional work performed on an hourly rate basis.

Your1040Return.com should design adequate controls to ensure that the tax professionals perform legitimate tax consulting services in exchange for their pay. Perhaps, the Your1040Return.com web site could be designed to capture information when the customer clicks on a link to activate the instant messenger program that allows communication between the Platinum customer and the tax professional service. The web site could be designed such that pertinent information is captured (e.g., time, date, customer number, question asked) automatically by Your1040Return.com's server. The server could also be designed to capture information about the tax professional (e.g., contractor id) who responds to the customer's inquiry. That information captured automatically could then be reconciled to the monthly time analysis submitted by the tax professional that indicates the services performed for the customer. The tax professional's time analysis would be set up to "charge" hours worked to each customer number serviced by that professional. Your1040Return.com could also require the tax professional to retain electronic or paper copies of the responses provided to the customer via the internet messenger program as backup of all services performed. Your1040Return.com could selectively "audit" charges submitted by the tax professionals back to these files on a periodic basis.

Thinking about the issues Your1040Return.com faces in paying its tax consultants is a valuable exercise that will bring students face-to-face with the challenging issues brought about by the unique e-business models made possible by the Internet. Thus, the specific content of student answers to this question is less important than the depth of their thinking and the quality of their insights.

Case 2.2
Instructional Notes

Dell Computer Corporation: Evaluation of Client Business Risk

Mark S. Beasley, Frank A. Buckless,
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INSTRUCTIONAL OBJECTIVES

- To provide experience with obtaining and reading a form 10-K report.
- To provide experience with identifying information relevant for assessing a client's business risks.
- To provide experience with linking business risks to audit implications.
- To provide experience linking an audit client's business risks to risks of material financial misstatement.
- To provide experience with writing a formal business memorandum.

KEY FACTS

- Dell Computer Corporation (Dell) is a publicly traded company (NASDAQ) that had 2,459,003,783 shares of common stock outstanding with a trading price of $40.20 as of February 25, 2005.
- Dell designs, develops, manufactures, markets, services, and supports a wide range of computer systems, including desktops, notebooks, workstations and network servers.
- Dell's products are sold in more than 170, countries and it has manufacturing facilities in Round Rock, Texas; Limerick, Ireland; and Penang, Malaysia.
- Dell's net revenue for fiscal 2005 was $49.2 billion while net income was $3.0 billion. Revenues are normally strongest in the second and third fiscal-year quarters.
- Dell is required to have an annual audit pursuant to the 1934 Securities and Exchange Act.
- An assumption stated in the case materials was that there were no material misstatements detected during the prior year audit of Dell's financial statements (fiscal 2005).

USE OF CASE

Many students will be uncomfortable with this case assignment if they have had no previous experience analyzing a company's business risk. This case assignment will provide students with a structure for evaluating an audit client's business risk. The case assignment is best used in an undergraduate and graduating auditing course when understanding a client's business or audit risk and materiality are discussed.

The approach we recommend for this assignment is to first ask students to review the case assignment materials and conduct a preliminary "in-class" discussion of the business risks to be included in the evaluation memorandum and case requirements. Specifically, it is useful to begin with a discussion of emerging business forces and business strategies related to the personal computer industry. A useful learning activity for the "in-class" assignment is "roundtable." The basic process for this activity is to have students meet in small groups to state aloud and write down on a single sheet of paper their ideas for the external business forces (customers, competitors, suppliers, labor, capital market, and regulations). For example, students could first discuss their ideas concerning customers, then competitors, then suppliers, and so on. Once all students have had an opportunity to state their ideas and arrive at a group consensus, the instructor can randomly call on individual students to share their group's answer with the class. Students often have a difficult time identifying the primary business strategy used by Dell. To help students with this aspect of the assignment we recommend that you give students the selected financial information for Dell and Apple (provided at the end of this document) and ask them to compare and contrast the financial information for the two companies in small groups. This exercise helps bring home the point that Dell's primary strategy is cost leadership while Apple's is product differentiation.

For the "out-of-class" assignment, it is important to discuss the solution with students to maximize their learning experience. Active learning activities can easily be adapted to the "out-of-class" component of this assignment. The learning activity called "homework review" could be used to discuss the students' answers to this assignment. The basic process for this activity is to have the students meet in pairs or small groups to compare and discuss their responses to questions 2a through 2j. The tasks of answering and checking the accuracy of each explanation should be rotated among pairs or group members. After students have had the opportunity to review all their responses the instructor can randomly call on individual students to share their responses with the class. It is important for the instructor to randomly call on individual students to ensure that all students take responsibility for learning the material. Note, if students complete their answers in pairs or groups "out-of-class," it is best to have students discuss their answers with different students "in-class."

If the case assignment is going to be used as an "out-of-class" writing assignment, we recommend discussing the case requirements with the students prior to having them complete the assignment. A useful learning technique to use for the "out-of-class" writing assignment is "peer editing." With this approach students first meet in pairs to develop an outline for their written solutions. Once an outline is developed, students individually draft a written response based on the outline. When the drafts are completed, students exchange draft responses and prepare written suggestions on the grammar, organization, and accuracy of the composition. Students then meet to discuss revisions for each draft. Finally, students revise their responses based on the suggestions provided. To ensure the process is followed, students should attach their final draft to the outline and critiqued drafts when given to the instructor.

When multiple writing projects are assigned during the semester, the above approach can be modified to require students to complete a joint response in place of individual responses. The basic difference is that one student is assigned responsibility to compose and re-write the written response while the other student is assigned responsibility to critique the original draft. Students should still meet to create an outline for the written solution. The responsibilities of writer and reviewer should be alternated for each written assignment.

PROFESSIONAL STANDARDS

Relevant professional standards for this assignment are AU Section 310 "Appointment of the Independent Auditor," AU Section 311 "Planning and Supervision," AU Section 312 "Audit Risk and Materiality in Conducting an Audit," and AU Section 316 "Consideration of Fraud in a Financial Statement Audit."

QUESTIONS AND SUGGESTED SOLUTION

Solution for "In-Class" Discussion

As discussed earlier in the "Use of Case" section, we suggest that you introduce this case by first having an "in-class" discussion of emerging business forces and Dell's business strategy. Here are some suggested points that could be made:

<u>Emerging Business Forces</u>

- Customers – personal computer manufacturers sell their products across a wide spectrum of customers, from large businesses to individuals. The personal computer industry is highly competitive. Dell's personal computers are virtually identical and interchangeable with all other IBM clone manufacturers thus making it very easy for customers to switch suppliers (except for Apple users who are predominately in education or high graphic quality usage fields).
- Competitors – There is very little relative investment required to enter the personal computer industry as evidence by Dell's accidence within the industry. Michael Dell started by assembling personal computers in his dorm room at college. It is estimated that a manufacturing facility to assemble 250,000 personal computers a year can be constructed with as little as a $1 million investment. Additionally, Michael Dell demonstrated that personal computers can be effectively sold directly to the end-users minimizing distribution issues. Needless to say, the personal computer industry is highly competitive.
- Suppliers – Hardware components such as housing, keyboards, memory chips, motherboards, disk drives, monitors, modems, and connectors can be purchased in highly competitive global markets served by many companies. In contrast, microprocessors and software operating systems are supplied by a few companies. Intel is the dominant supplier for microprocessors while Microsoft is the dominant supplier for operating system and application software. The cost of switching suppliers, other than Intel and Microsoft, is relatively low as there is an abundance of contract manufacturers available to provide many of the components included in personal computers.
- Labor – Some estimate that labor is less than one percent of the total cost of assembling a personal computer. Obtaining a sufficient supply of labor is not a major issue in this industry.
- Capital Markets – The personal computer industry is considered a high risk industry. Therefore, there is not an overabundance of long-term investors and creditors available to finance personal computer manufacturers. Individuals seeking to finance a personal computer venture would most likely have to rely on personal connections or angle investors.
- Regulations – Dell must comply with various federal, state and international laws governing product safety (for example, U.S. Consumer Product Safety), radio frequency emission (for example, U.S. Federal Communications Commission), import/export activities (for example, U.S. Department of Commerce), anti-trust activities (for example, U.S. Federal Trade Commission and Department of Justice), environment activities (for example, U.S. Environmental Protection Agency), and labor activities (for example, U.S. Department of Labor Occupational Safety & Health Administration). There are no changes to the regulatory environment suggesting a change to Dell's competitive position.

Business Strategy

- Dell’s personal computers are virtually identical and interchangeable with all other IBM architecture manufacturers suggesting that Dell’s primary mode of competition is cost leadership.
- A review of the financial information provided for Apple and Dell as a percentage of net revenues indicates that Dell has a lower gross margin percent, lower selling, general, and administrative expense percent, lower research and development expense percent and higher asset turnover than Apple. This information is consistent with Apple following a differentiation strategy and Dell following a cost leadership strategy.
- Other interesting insights that can be obtained from the information provided is that long-term operating assets represent less than ten percent of total assets and that less than ten percent of total assets are financed through the use of long-term debt for both companies.

Solution for Case Assignment

1. **Go to Dell’s web site (http://www.dell.com) and click on the “About Dell” link. Review background and investor information provided about Dell. Click on the “Investor” link in the About Dell section and print and read the most recent SEC Form 10-K provided for Dell.**

   Selected information from Dell’s web site is presented below.

   Dell at a Glance

   The Company

   Dell Inc. is a trusted and diversified information-technology supplier and partner, and sells a comprehensive portfolio of products and services directly to customers worldwide. Dell's climb to market leadership is the result of a persistent focus on delivering the best possible customer experience by directly selling standards-based computing products and services. Revenue for the last four quarters totaled $52.8 billion and the company employs approximately 61,400 team members around the globe.

   Dell was founded in 1984 by Michael Dell, the computer industry's longest-tenured chief executive officer, on a simple concept: that by selling computer systems directly to customers, Dell could best understand their needs and efficiently provide the most effective computing solutions to meet those needs. This direct business model eliminates retailers that add unnecessary time and cost, or can diminish Dell's understanding of customer expectations. The direct model allows the company to build every system to order and offer customers powerful, richly-configured systems at competitive prices. Dell also introduces the latest relevant technology much more quickly than companies with slow-moving, indirect distribution channels, turning over inventory every four days on average.

   The Dell Effect

   For more than 20 years, Dell has revolutionized the industry to make computing accessible to customers around the globe, including businesses, institutional organizations and individual consumers. Because of Dell's direct model—and the industry's response to it—information technology is more powerful, easier to use and more affordable, giving customers the opportunity to take advantage of powerful new tools to improve their businesses and personal lives.

Dell has demonstrated this effect time and again as it enters new, standardized product categories, such as network servers, workstations, mobility products, printers and other electronic accessories. Nearly one out of every five standards-based computer system sold in the world today is a Dell. This global reach indicates our direct approach is relevant across product lines, regions and customer segments.

Balancing Liquidity, Profitability and Growth

Dell's high return to shareholders has been the result of a focused effort over time to balance growth with profitability and liquidity. Dell has consistently led its largest competitors in each of those categories.

Dell History

1984 Michael Dell founds Dell Computer Corporation
1985 Company introduces the first computer system of its own design; the Turbo, featuring Intel 8088 processor running at eight megahertz
1987 Dell is first computer systems company to offer next-day, on-site product service
International expansion begins with opening of subsidiary in United Kingdom
1988 Dell conducts initial public offering of company stock, 3.5 million shares at $8.50 each
1989 Company introduces its first notebook computer
1990 Manufacturing center in Limerick, Ireland, opened to serve European, Middle Eastern and African markets
1992 Dell included for first time among Fortune 500 roster of world's largest companies
1993 Dell joins ranks of the top-five computer system makers worldwide

Subsidiaries in Australia and Japan are company's first entries into Asia-Pacific region
1995 $8.50 shares of Dell stock worth $100 on presplit basis
1996 Dell opens original Asia Pacific manufacturing center in Penang, Malaysia

Customers begin buying Dell computers via Internet at www.dell.com
Dell begins major push into network-server market
Company added to Standard & Poor's 500 stock index
1997 Dell ships its 10-millionth computer system
Per-share value of common stock reaches $1,000 on presplit basis
Dell introduces its first workstation systems
1998 Company expands manufacturing facilities in the Americas and Europe, and opens a production and customer center in Xiamen, China
Dell introduces its PowerVault storage products
1999 Dell opens second major U.S. location in Nashville, Tenn.
Dell opens manufacturing facility in Eldorado do Sul, Brazil, to serve Latin America
Dell introduces "E-Support Direct from Dell" online technical support
2000 Company sales via Internet reach $50 million per day
For the first time, Dell is No. 1 in worldwide workstation shipments
Dell introduces PowerApp appliance servers
Dell ships its one millionth PowerEdge server

2001 For the first time, Dell ranks No. 1 in global market share

	Dell is No. 1 in the United States for standard Intel architecture server shipments *Dell introduces PowerConnect network switches*
2002	*Dell names its Austin Manufacturing Campus the Topfer Manufacturing Center* *Dell ships its 2 millionth port in the PowerConnect line of network switches* *U.S. consumers choose Dell as their No. 1 computer systems provider* *Dell ships its first "blade" server, enters the handheld market with the Axim X5, introduces a standards-based point-of-sale offering for retail customers and enters the projector market with the introduction of the 3100MP projector*
2003	*Dell introduces printers for businesses and consumers* *Dell launches Dell Recycling to enable customers to recycle or donate to charity computer equipment from any manufacturer* *The name change to Dell Inc. is official, reflecting the evolution of the company to a diverse supplier of technology products and services* *Dell enters consumer electronics, a natural extension of the company's existing product portfolio that provides customers with a single resSource for consumer technology needs*
2004	*Kevin Rollins becomes Dell's next chief executive officer* *Dell announces third U.S. manufacturing facility in North Carolina*
2005	*Dell tops list of "America's Most Admired Companies" in Fortune Magazine*

Dell’s financial statements from the 2005 form 10-K are provided on the pages that follow this solution.

2. ***Based on the information obtained from the web site and your knowledge of the industry prepare a memo discussing the following items:***

a) ***Dell’s:***

- ***Sales*** - $49,205 million for fiscal year ended 1/28/2005
- ***Net income*** - $3,043 million for fiscal year ended 1/28/2005
- ***Cash flow from operating activities*** - $5,310 million for fiscal year ended 1/28/2005
- ***Total assets*** - $23,215 million for fiscal year ended 1/28/2005
- ***Number of employees*** - Approximately 55,200 regular employees on 1/28/2005

b) ***What are Dell’s products?***

The Company’s primary product offerings include the following items: network servers, network storage devices, network switches, network workstations, notebook computers, and desktop computers. The company also maintains a variety of software, accessory, and service programs to complement its computer systems offerings.

c) ***Who are Dell’s competitors?***

Major competitors for Dell include IBM/Lenovo, Hewlett-Packard, Gateway, and Apple Computers.

d) Who are Dell's customers?

In the computer industry, customers are normally divided into these four categories: large businesses and government units, small businesses and offices, individuals, and educational institutions. While Dell sells its products and services to all customer groups, its traditional customer focus has been with large to midsize businesses and governmental units.

e) Who are Dell's suppliers?

Hardware components such as housing, keyboards, memory chips, motherboards, disk drives, monitors, modems, and connectors can be purchased in highly competitive global markets served by many companies. Microprocessors and software operating systems on the other hand are supplied by a few companies. Intel is the dominant supplier for microprocessors, while Microsoft is the dominant supplier for operating systems and application software.

Dell utilizes a "just-in-time" production system which requires it to work very closely with its suppliers. Many of Dell's suppliers are located near its assembly facilities and are electronically linked to continuously update inventory needs. Dell's production process from order entry to shipping takes less than 12 hours.

f) How does Dell market and distribute its products?

Dell markets and distributes its products using the direct model of taking orders straight from customers. Potential customers are stratified into two broad categories: relationship buyers and transaction buyers. Relationship buyers are large organizations that are expected to have ongoing purchases. For relationship buyers, Dell uses sales personnel in the field to understand customer needs, help customers configure their information systems, and promote Dell products and services. Dell also assigns sales personnel from its call centers to assist relationship customers with their procurements. Transaction buyers are small organizations and individuals. Dell targets these customers via trade journals, business publications, catalogs, direct mailing, and television advertisements. Sales personnel from Dell's call centers assist transaction buyers with their buying needs.

g) What is Dell's basic business strategy (cost leadership or differentiation)?

Dell's basic business strategy is cost leadership. The features and functions of Dell's products are similar to most of its competitors (IBM/Lenovo, Hewlett-Packard, and Gateway). Dell's computers use the same microprocessor and operating system of all competitors (except Apple) forcing it to continuously focus on price. If Dell were to sell its computers at a substantially higher price than its competitors its market acceptance would quickly deteriorate.

h) What are critical business processes for Dell given its basic business strategy (for example, supply chain management)?

- Processes related to supplier relations. The most critical business process for Dell is its supply chain management. Component costs account for approximately 90 percent of the total cost of personal computers. Additionally, technology innovation is pushed by the supplier industry. Dell must have good relations with its suppliers to reduce product costs and continuously introduce reliable products with the latest technology on a timely basis.
- Processes related to customer relations. Demand for personal computers is volatile. Good communications between Dell and its customers can help it properly plan for declines in

demand. Additionally, good communications with customers can help ensure that Dell introduces computers with features most desirable to customers.

i) ***What accounting information is associated with the critical business processes and how does Dell measure-up on that information?***

- Accounting information associated with supplier relations would include cost of sales, inventory, accounts payable, and warranty expense.
- Accounting information associated with customer relations would include revenue, accounts receivable, and selling expenses.

j) ***What accounting method is Dell using to report the accounting information associated with critical business processes and what is the risk of material misstatement?***

- Revenue – recognized on date of shipment which is common practice for industry. Dell does allow customers to return products. The risk of returns for Dell is lower than competitors that sell primarily to third party resellers since Dell sells directly to customers. There is extreme pressure for Dell to show continuous revenue growth. There is some risk of misstatement given Dell's superior revenue performance as compared to competitors.
- Accounts receivable – allowance method for uncollectible accounts. The business economies are weak for Dell's primary markets increasing the likelihood of misstatement.
- Cost of revenues (sales) - method not discussed in notes to financial statements. Cost of revenues are required to be reported when the related sale is recorded. There does not appear to be much risk of misstatement as the numbers are consistent with our understanding of the current business environment.
- Inventory – FIFO. Note that FIFO results in lower net income during periods of declining prices which is the case for the computer industry. There is a low risk of misstatement given that Dell has done an excellent job of minimizing its inventory levels (limiting the risk of obsolescence).
- Accounts payable – method not discussed in notes to financial statements. Accounts payable are required to be recorded when related goods or services are received. Low risk of misstatement as the numbers are consistent with our understanding of the current business environment.
- Warranty expense – estimated and recorded in year of sale. Difficult to assess risk based on information provided.
- Selling, expense – expensed in year incurred. Some risk of misstatement as Dell's expenditures as a percent of revenue are substantially lower than their competitors and they are strategically focused on cost differentiation.

Dell Computer Corporation
Consolidated Statement of Financial Position
(in millions)

	1/28/2005	**1/30/2004**
ASSETS		
Current assets:		
Cash and cash equivalents	$4,747	$4,317
Short-term investments	5,060	835
Accounts receivable, net	4,414	3,635
Inventories	459	327
Other	2,217	1,519
Total current assets	16,897	10,633
Property, plant and equipment, net	1,691	1,517
Investments	4,319	6,770
Other non-current assets	3,008	391
Total assets	$23,215	$19,311
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$8,895	$7,316
Accrued and other	5,241	3,580
Total current liabilities	14,136	10,896
Long-term debt	505	505
Other	2,089	1,630
Total liabilities	16,730	13,031
Commitments and contingent liabilities (Note 8)	--	--
Stockholders' equity:		
Preferred stock and capital in excess of $.01 par value; shares issued and outstanding: none	--	--
Common stock and capital in excess of $.01 par value; shares authorized: 7,000; shares issued: 2,769 and 2,721, respectively	8,195	6,823
Treasury stock, at cost; 284 shares and 165 shares, respectively	(10,758)	(6,539)
Retained earnings	9,174	6,131
Other comprehensive loss	(82)	(83)
Other	(44)	(52)
Total stockholders' equity	6,485	6,280
Total liabilities and stockholders' equity	$23,215	$19,311

Dell Computer Corporation
Consolidated Statement of Income
(in millions, except per share amounts)

	Fiscal Year Ended		
	Jan. 28, 2005	**Jan. 30, 2004**	**Jan. 31, 2003**
Net revenue	$49,205	$41,444	$35,404
Cost of revenue	40,190	33,892	29,055
Gross margin	9,015	7,552	6,349
Operating expenses:			
Selling, general and administrative	4,298	3,544	3,050
Research, development and engineering	463	464	455
Total operating expenses	4,761	4,008	3,505
Operating income	4,254	3,544	2,844
Investment and other income (loss), net	191	180	183
Income before income taxes	4,445	3,724	3,027
Provision for income taxes	1,402	1,079	905
Net income	$3,043	$2,645	$2,122
Earnings per common share:			
Basic	$1.21	$1.03	$0.82
Diluted	$1.18	$1.01	$0.80
Weighted average shares outstanding:			
Basic	2,509	2,565	2,584
Diluted	2,568	2,619	2,644

Dell Computer Corporation
Consolidated Statement of Cash Flows
(in millions)

	Fiscal Year Ended Jan. 28, 2005	Jan. 30, 2004	Jan. 31, 2003
Cash flows from operating activities:			
Net income	3,043	2,645	2,122
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	334	263	211
Tax benefits of employee stock plans	249	181	260
Effects of exchange rate changes on monetary assets and Liabilities denominated in foreign currencies	(602)	(677)	(537)
Other	78	113	60
Changes in:			
Operating working capital	1,755	872	1,210
Non-current assets and liabilities	453	273	212
Net cash provided by operating activities	5,310	3,670	3,538
Cash flows from investing activities:			
Investments:			
Purchases	(12,261)	(12,099)	(8,736)
Maturities and sales	10,469	10,078	7,660
Capital expenditures	525	(329)	(305)
Purchase of assets held in master lease facilities	--	(636)	--
Cash assumed in consolidation of Dell Financial Services L.P.	--	172	--
Net cash used in investing activities	(2,317)	(2,814)	(1,381)
Cash flows from financing activities:			
Repurchase of common stock	(4,219)	(2,000)	(2,290)
Issuance of common stock under employee plans and other	1,091	617	265
Net cash used in financing activities	(3,128)	(1,383)	(2,025)
Effect of exchange rate changes on cash and cash equivalents	565	612	459
Net increase in cash and cash equivalents	430	85	591
Cash and cash equivalents at beginning of period	4,317	4,232	3,641
Cash and cash equivalents at end of period	4,747	4,317	4,232

Dell Computer Corporation

	1/28/2005	1/30/2004	1/31/2003	2/1/2002	2/2/2001
Income Statement Amounts as Percent of Net Revenue:					
Net Revenue	100.00%	100.00%	100.00%	100.00%	100.00%
Cost of Revenue	81.68%	81.78%	82.07%	82.33%	79.79%
Gross Margin	18.32%	18.22%	17.93%	17.67%	20.21%
Selling, General, and Administrative	8.73%	8.55%	8.61%	8.93%	10.01%
Research and Development	0.94%	1.12%	1.29%	1.45%	1.51%
Other Expenses	0.00%	0.00%	0.00%	1.55%	0.33%
Other Income	0.39%	0.43%	0.52%	-0.19%	1.67%
Income Taxes	2.85%	2.60%	2.56%	1.56%	3.00%
Net Income	6.18%	6.38%	5.99%	4.00%	6.83%
Balance Sheet Amounts as Percent of Total Assets:					
Cash	20.45%	22.36%	27.36%	26.90%	35.92%
Marketable Securities	21.80%	4.32%	2.62%	2.02%	3.84%
Accounts Receivable	19.01%	18.82%	16.72%	16.76%	17.73%
Inventory	1.98%	1.69%	1.98%	2.05%	2.93%
Other	9.55%	7.87%	9.01%	10.46%	10.73%
Total Current Assets	72.78%	55.06%	57.69%	58.20%	71.15%
Property, Plant and Equipment	7.28%	7.86%	5.90%	6.10%	7.29%
Investments	18.60%	35.06%	34.05%	32.31%	17.69%
Intangibles	0.00%	0.00%	0.00%	0.00%	0.00%
Other	1.33%	2.02%	2.37%	3.39%	3.88%
Total Assets	100.00%	100.00%	100.00%	100.00%	100.00%
Notes Payable & Current Maturities of Debt	0.00%	0.00%	0.00%	0.00%	0.00%
Accounts Payable	38.32%	37.89%	38.71%	37.50%	31.35%
Accrued Liabilities	22.58%	18.54%	19.03%	18.06%	18.23%
Other Current Liabilities	0.00%	0.00%	0.00%	0.00%	0.00%
Total Current Liabilities	60.89%	56.42%	57.74%	55.55%	49.58%
Long-term Debt	2.18%	2.62%	3.27%	3.84%	3.72%
Other Liabilities	9.00%	8.44%	7.49%	5.93%	5.57%
Total Liabilities	72.07%	67.48%	68.50%	65.32%	58.87%
Total Stockholders' Equity	27.93%	32.52%	31.50%	34.68%	41.13%
Total Liabilities and Stockholders' Equity	100.00%	100.00%	100.00%	100.00%	100.00%
Selected Ratios:					
Return on Assets	14.31%	15.21%	14.63%	9.16%	17.32%
Return on Stockholders' Equity	231.41%	238.31%	244.12%	229.13%	253.67%
Asset Turnover Ratio	333.15%	311.85%	303.18%	263.72%	230.02%
Financial Leverage Ratio	47.68%	47.43%	44.36%	24.16%	39.84%
Accounts Receivable Turnover	12.23	13.32	14.58	13.28	12.67
Inventory Turnover	102.26	107.08	99.50	75.70	64.34
Accounts Payable Turnover	4.96	5.09	5.25	5.48	6.50
Current Ratio	1.20	0.98	1.00	1.05	1.43
Quick Ratio	1.01	0.81	0.81	0.82	1.16
Liabilities to Equity Ratio	2.58	2.08	2.17	1.88	1.43

Apple Computer, Inc.

	9/252004	9/27/2003	9/28/2002	9/29/2001	9/30/2000
Income Statement Amounts as Percent of Net Revenue:					
Net Revenue	100.00%	100.00%	100.00%	100.00%	100.00%
Cost of Revenue	72.71%	72.48%	72.08%	76.97%	72.87%
Gross Margin	27.29%	27.52%	27.92%	23.03%	27.13%
Selling, General, and Administrative	17.16%	19.53%	19.31%	21.22%	14.61%
Research and Development	5.91%	7.59%	7.77%	8.02%	4.76%
Other Expenses	0.28%	0.42%	0.54%	0.21%	1.23%
Other Income	0.69%	1.50%	1.22%	5.44%	7.14%
Income Taxes	1.29%	0.39%	0.38%	-0.28%	3.83%
Net Income	3.33%	1.10%	1.13%	-0.47%	9.85%
Balance Sheet Amounts as Percent of Total Assets:					
Cash	36.88%	49.83%	35.76%	38.37%	17.51%
Marketable Securities	30.99%	17.17%	33.11%	33.65%	41.69%
Accounts Receivable	9.61%	11.24%	8.97%	7.74%	14.01%
Inventory	1.25%	0.82%	0.71%	0.18%	0.49%
Other	8.89%	7.32%	7.00%	5.48%	6.09%
Total Current Assets	87.64%	86.38%	85.55%	85.42%	79.77%
Property, Plant and Equipment	8.78%	9.82%	9.86%	9.37%	6.16%
Investments	0.00%	0.00%	0.62%	2.13%	11.55%
Intangibles	1.20%	1.60%	1.89%	1.26%	0.51%
Other	2.37%	2.20%	2.08%	1.83%	2.00%
Total Assets	100.00%	100.00%	100.00%	100.00%	100.00%
Notes Payable & Current Maturities of Debt	0.00%	4.46%	0.00%	0.00%	0.00%
Accounts Payable	18.02%	16.93%	14.46%	13.30%	17.01%
Accrued Liabilities	15.27%	13.19%	11.86%	11.91%	11.41%
Other Current Liabilities	0.00%	0.00%	0.00%	0.00%	0.00%
Total Current Liabilities	33.29%	34.59%	26.33%	25.21%	28.41%
Long-term Debt	0.00%	0.00%	5.02%	5.26%	4.41%
Other Liabilities	3.65%	3.45%	3.64%	4.42%	6.81%
Total Liabilities	36.94%	38.03%	34.98%	34.89%	39.63%
Total Stockholders' Equity	63.06%	61.97%	65.02%	65.11%	60.37%
Total Liabilities and Stockholders' Equity	100.00%	100.00%	100.00%	100.00%	100.00%
Selected Ratios					
Return on Assets	3.71%	1.04%	1.06%	-0.39%	13.52%
Return on Stockholders' Equity	5.94%	1.64%	1.62%	-0.62%	21.80%
Asset Turnover Ratio	111.39%	94.67%	93.22%	83.64%	137.34%
Financial Leverage Ratio	159.86%	157.65%	153.70%	159.76%	161.21%
Accounts Receivable Turnover	10.75	9.33	11.14	7.56	9.77
Inventory Turnover	76.69	89.09	147.82	187.64	219.51
Accounts Payable Turnover	4.62	4.36	4.84	4.22	5.91
Current Ratio	2.63	2.50	3.25	3.39	2.81
Quick Ratio	2.33	2.26	2.96	3.16	2.58
Liabilities to Equity Ratio	0.59	0.61	0.54	0.54	0.66

Case 2.3

Instructional Notes

Flash Technologies, Inc.: Risk Analysis and Resolution of Client Issues

Group Assignment

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INSTRUCTIONAL OBJECTIVES

- To provide students with an opportunity to learn (by doing) how auditors identify various client and audit risks. The case also provides students with insight into how a risk analysis ties in to the strategic audit planning process.
- To provide students with hands-on experience responding to client concerns and issues. Often auditing students do not realize the extent to which clients request interpretations of standards and financial statement reporting and disclosure issues.
- This case requires students to comprehend Flash's business as well as apply their broader business knowledge. The case also requires students to apply writing and team building skills (if the case is completed in groups).
- This case helps students integrate a number of concepts including client acceptance, inherent risk, analytical procedures, acceptable audit risk, audit planning, fraud red flags, risk assessment and financial reporting research.
- Flash Technology is based on an actual company (Centennial Technologies, Inc.) that committed a large accounting fraud from 1996 to 1998. When the instructor outlines the details of the fraud the students can compare the risks they identified with the areas containing fraud.
- To illustrate that "incredible" intentional accounting manipulations that still take place today (many famous high profile accounting frauds included in well-known audit cases took place before the average audit student was born).

KEY FACTS

- Flash is a rapidly growing high-tech firm primarily in the PC card business.
- Flash is in the process of changing auditors. The company believes they need a larger international professional services firm to manage their growing international business.

- The students are asked to assume the role of team members from the new audit firm. While there is a tentative agreement with respect to the December 2005 audit, the students' "firm" is conducting additional analyses.
- Flash has asked the new audit team to make recommendations regarding a few financial reporting issues (subsequent event, pending litigation, and derivatives).
- The case provides students with audit memos written to the planning files, Flash's draft financial statements, industry ratios, and industry articles.
- Flash faces a number of important business risks (e.g., intense competition, rapidly changing technology, and foreign operations). There are also a number of firm characteristics that increase auditor business risk (e.g., public company, management integrity) and inherent risks (e.g., related party transactions, nature of business, initial engagement, and likelihood of fraud).
- The company has been acquiring ownership interests in other companies. The company recently began selling a new product, "Flash 2005" that is alleged to have a cost of less than $20 but a sales price of $200. In the actual case, "Flash 98" was claimed to have a cost of 10 cents and a sales price of over $500.
- Manny Schwimez is the CEO and Chairman of the Board. Students are provided with background information that is similar to Emanuel Pinez, who was the actual CEO of Centennial. Pinez, 58, was convicted of masterminding a scheme that inflated sales by over $20 million from 1996 through 1998. Centennial's stock price rose an astonishing 450 percent in 1998.

OPTIONAL INSTRUCTIONS FOR STUDENTS

Your risk-analysis report should not be more than five double-spaced pages (bullet-point listings in the report can be single-spaced and the five-page limit does not include appendices and exhibits).

Instructors can also determine if they would like to ask the students to specifically assess the risk of fraud.

USE OF CASE

We have used this case toward the end of the semester as an integrative group exercise. It could also be used after the client acceptance, audit risk or analytical procedures modules. We recommend the case be assigned to small groups of students (3 to 6 students) for a the following reasons: (1) in our experience students benefit greatly by discussing the various aspects of this company, risks posed and implications for the audit, (2) students will be expected to function in small groups after they graduate, (3) the case is long and relatively complex, and (4) group solutions reduce the grading burden for the instructor. We also recommend that you give the students at least one week to complete the assignment.

PROFESSIONAL STANDARDS

Relevant professional standards for this assignment include AU Section 230, "Due Professional Care in Performance of Work," AU Section 316, "Consideration of Fraud in a Financial Statement Audit," AU 319, "Consideration of Internal Control in a Financial Statement Audit," and AU 560, "Subsequent Events."

SUGGESTED SOLUTION

Regarding the risk analysis, obviously student solutions will differ. However, student groups should identify many of the risks noted below. We typically debrief the case in class on the day it is due. We spend 20 to 30 minutes discussing the issues. We usually do indicate when we begin the debriefing that the case is based on an actual company, ***but we do not*** indicate there was accounting fraud until later. When we do begin discussing the actual fraud we always have concerned students ask if their group was expected to have detected the fraud. We reassure the students that we do not expect them to have detected the fraud, but that there were risky areas they should have identified as potential red flags. We further explain that they can see how their group did at identifying risky areas that did, in fact, contain fraud. In our experience we find that most groups do identify, as risky, many of the accounts that had been intentionally manipulated in the fraud. We discuss the background of the case as well as suggested solutions. The debriefing is not intended to cover a complete solution and students are encouraged to discuss their solutions. We typically ask the students to discuss potential audit implications of identified risks.

Notes to instructors. Many of the facts of the actual Centennial case described in the following pages were obtained from articles in the popular press. For example:
"How Centennial Technologies, a Hot Stock, Cooled", *The Wall Street Journal*, Jon G. Auerbach, April 11, 1999, A1, and "Multimillion-dollar illusion: Centennial Technologies' Rise and Fall is a Tale of Fakery and Overreaching," *The Boston Globe*, Joann Muller, June 13, 1999, A1.

RISK ANALYSIS

General Areas of Risk. The following listing specifies general risks facing by Flash (Centennial) Technology:

- Public high tech company—extensive reliance on audited financial statements, rapidly changing technology
- Industry Risks: rapid technological change, evolving industry standards, rapid product obsolescence, intense competition
- Korean Venture and other acquisitions (DCI)—does the current management team posses the necessary global management skills, DCI history of losing money, many uncertainties
- PC Cards represent 98% of sales—extreme reliance on one product, what happens if better technology is developed by a competitor
- Supplier relations—financial statements indicate this is a critical issue as the company has only one supplier for some critical components, no long-term contracts exist, and materials shortages occur often
- Two major customers represent 25% of sales
- Extreme growth—operating and financial management expertise
- Short sales of stock increasing
- Flash 2005 sales to one company and that company is or will be a related party
- Patent litigation
- SEC Investigation
- Allegations that Manny is a "pathological liar" and has a history of wrong doing

As we cover specific risks we ask students to discuss audit implications (i.e., nature, timing and extent of testing). In the actual case the foreign venture was in Thailand and "Flash 2005" was Flash 1998.

Financial Statement Risks. The following listing includes some of the high-risk areas associated with Flash's financial statements:

- Accounts receivable is up significantly and the allowance does not appear to be keeping pace
- What is the increase in other current assets due to?

- Inventory up significantly, turnover ratio is only 1.8 suggesting potential problems with obsolescence or existence
- Rapid increase in sales, is this reasonable, does it raise revenue recognition issues?
- It would seem that research and development expense would be greater given the growth
- Large negative cash outflow from operations—the company is funding operations via financing activities, is there a going concern issue?

One issue that needs to be pointed out is that in instances of extreme growth, as with Flash Technologies, simple comparison-type analytical procedures may not be too informative. Again, as we cover specific risks we ask students to discuss potential audit implications (i.e., nature, timing and extent of testing).

Flash and the Industry. Comparisons of Flash to the industry point out areas of concern:

- Flash's inventory turnover ratio is 1.8 while the industry average is 8.1. This raises concerns with respect to existence and obsolescence (valuation)
- Flash's operating profit has been outpacing the industry. In 2005 Flash is reporting over a 20% operating profit while the industry is about 14%
- Flash is a small player in the industry, competitors (e.g., Intel, Mitsubishi, Epson) are well established and have greater access to investment capital
- The industry Flash competes in is rapidly changing and extremely competitive

CLIENT ISSUES

It is important to inform students that client issues with respect to financial statement disclosure and technical standards interpretation are very common. Inform students that client issues with respect to disclosures and standard interpretations are very common.

Issue #1--Subsequent Event. Yes disclosure is required. The subsequent event is a type 2 event (AU section 560). The actual footnote from the Centennial annual report was:

> *On July 10, 1998, the Company acquired Design Circuits, Inc. ("DCI"), a provider of customized, integrated manufacturing services to original equipment manufacturers in the electronic industry. The Company acquired a majority equity position in DCI for approximately $3.2 million of cash, 125,000 shares of the Company's Common Stock and the assumption of certain liabilities. The purchase price will be allocated to tangible assets based on their fair market values of approximately $6.7 million and goodwill of approximately $9.4 million. In addition, the Company will record approximately $2.5 million as a minority interest for the proportionate share of equity held by the minority shareholders of DCI.*

Issue #2—Contingencies. A contingency is defined in *FASB Statement #5* "as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur." When a loss contingency exits, the likelihood that the future event will confirm the incidence of a liability can range from *probable* to *reasonably possible* to *remote*. Items that are probable and that can be reasonably estimated must be reported in financial statements. Items that are reasonably possible are disclosed in the footnotes. In the Flash case it is not clear any disclosure would be required for the potential patent infringement lawsuit. That said, most SEC clients probably will have a general "catch-all" legal liability footnote saying something like: "The company is engaged in a number of law-suits in varying degrees of completion. The company believes it will be successful in defending against these actions and has insurance that is expected to cover any unforeseen losses. The impact on the financial statements is not expected to be material."

Issue #3—Foreign Currency Futures Contract. The CFO is half right and half wrong. There will be a foreign exchange gain associated with the decrease in the payable due to the supplier. However, as Gary Ryan pointed out, there will be an equal and offsetting loss associated the derivative contract.

November 1, 2005: The entry Flash makes to record the payable would be as follows:

Materials	4,000,000	
Accounts Payable (fc)		4,000,000
(800,000,000 ÷ 200, fc indicates this payable is denominated in a foreign currency)		

December 31, 2005: The entry proposed by the CFO to record a foreign exchange gain would be as follows:

Accounts Payable	249,941	
Foreign Exchange Gain		249,941
(4,000,000 – [800,000,000 ÷ 213.33])		

December 31, 2005: Flash now also needs to report a corresponding loss on the futures contract as follows:

Loss on Futures Contract	249,941	
Futures Contract Payable		249,941

It should be noted that the futures contract Flash entered into does not qualify for hedge accounting under Statement No. 133. The FASB explicitly excluded foreign currency–denominated assets and liabilities from the set of items that can be considered as items underlying a hedge (No. 133, par. 21c). Thus, derivatives that serve as economic hedges of foreign currency assets and liabilities are accounted for as speculations, with all gains and losses recognized as part of income immediately. However, because the accounting standards (in Statement No. 52) already require that foreign currency assets and liabilities be revalued at current exchange rates at the end of each period, with the resulting exchange gains and losses recognized in income, the net effect is the same as if the foreign currency derivatives were accounted for as fair value hedges after all. (This example makes the simplifying assumption that spot rates and forward rates are equal to one another. When this is not true, the foreign currency and derivative gains and losses will not exactly offset because foreign currency assets and liabilities are valued using the spot rate and derivative instruments are valued using the forward rate.)

POSITIVE ASPECTS OF FLASH

There are certainly risks associated with Flash. But every client will have risks; particularly public high-tech clients in the growth stage. There is also good news with respect to Flash. Ask the students to identify the positive aspects associated with Flash. Some of these include:

- Strong cash position
- PC Card market is a leading edge industry with great potential
- Flash has entered into several strategic alliances with reputable firms

- Flash has reported strong growth—NIBT has doubled as a % of sales
- Excellent market performance
- Flash is ISO 9001 certified
- Flash represents many audit/assurance/consulting opportunities for the professional services firm

THE TRUTH BREAKS

The Flash Technology case is based on the real company Centennial Technologies. Emanuel "Manny" Schimez is really Emanuel "Manny" Pinez. Centennial engaged in a massive accounting fraud. The financial statements included in the case contain nearly $23 million in fictitious revenue. The fraud was carried out over several years. Allegedly only a few people were involved in the fraud. The story broke in the popular press. Three of the articles reporting on Centennial were:

- April 11, 1999 "How Centennial Technologies, a Hot Stock, Cooled," WSJ
- June 13, 1999, "Multimillion-Dollar Illusion: Centennial Technologies' Rise and Fall is a Tale of Fakery and Overreaching," The Boston Globe
- June 13, 1999, "Centennial Details Extent of Fake Profits" The New York Times

Not only were the auditors fooled by the Centennial fraud, but so were other sophisticated investors, creditors, brokerage houses, business partners, underwriters, and members of the Board of Directors.

EMANUEL PINEZ

With the benefit of hindsight, management integrity was an obvious issue at Centennial. Manny was a well-know con artist (unfortunately, this fact was not discovered by the auditors until it was too late). Important aspects of Manny's background are provided in the following listing:

- Manny claimed on his resume that he received a degree from Hebrew University, but admitted that he never actually earned a degree. Manny explained that, "It looks much better if you say you graduated." Likewise, after studying computers in London for six months, he claimed to have received a master's degree from the London School of Economics. He concedes this claim is also false.
- Manny was fired from a Swiss computer services company in 1971 because phony invoices were found in his office drawer. The invoices had never been sent out, but corresponding amounts of sales had been booked.
- In early 1980's Manny headed ABL Technologies, a company involved in many lawsuits regarding infringing on other manufacturers' patents.
- Arial Cohen, the vice mayor of Jerusalem said, "I was absolutely surprised that nobody checked about his past because he is a man known in Israel for his propensity to tell whoppers." In 1958, he conned an Israeli magazine into sending him to France for a swimming race across the English Channel. He cabled the magazine from Paris saying he had won and set a new world record crossing in 10 hours, 21 minutes. The magazine published the remarkable story and Manny was hailed as a national hero. Several weeks later, after suspicions were raised by the French press, no evidence could be found that the race ever took place. Manny admitted it was a lie causing enormous embarrassment to the magazine.

- Friends say Pinez often boasted he was a paratrooper in the Israeli army during the Six-Day War, but he admits it is a lie.
- Rachel Pinez, wife of 36 years, says her husband is a pathological liar.
- Manny was very flamboyant, he was a lover of fast cars, fine wine and food.
- In 1998 Manny began telling institutional investors about a $300 million sale to AT&T for a system to track truck fleets by satellite. No evidence was ever produced to substantiate the claims and AT&T denied the report.
- While Manny claimed to not have profited from the fraud because he did not sell his shares, he did use 3.5 million of his 4.2 million Centennial shares as collateral to borrow a total of $18.5 million from Lehman Brothers Inc. and PaineWebber Inc.

DETAILS OF THE FRAUD

Flash 98 Scam. An audit memo in the student case refers to "Flash 2005," a new product. In reality the product was called Flash 98. In the student's case the cost was claimed to be less than $20 while the sales price exceeded $300. In actuality, Centennial (Pinez) claimed the cost of the new product was 10 cents with a sales price of a whopping $500. It turns out there was no such product. As noted in the case, all sales were to one company. The actual company was BBC Computers, and BBC purchased $2.1 million of Flash 98. Robert Lockwood, who ran BBC was a close personal friend of Pinez. Lockwood would later be indicted on 13 counts of tax evasion related to his companies. To fool the auditors into thinking an actual sale took place, Pinez wired $1 million of his own personal funds to a third company, St. Jude Management Corp., which then paid Centennial on behalf of BBC for its Flash 98 purchases. The explanation provided for this rather unconventional form of payment was a "financial agreement" between St. Jude and BBC. Even though the check was from St. Jude Management, the $1 million payment was considered reasonable evidence supporting the sale. After the fraud was uncovered the auditors, Coopers & Lybrand, claimed that the Flash 98 scam was a "unique" fraud because it appeared product was going out and cash was coming in.

While students would not be expected to identify the scam, they should identify the increased risk associated with Flash 2005 because of the secrecy and related party transaction.

PC Card Scam. Some investors started to crave a first-hand look at Centennial's operations. One investor sent an analyst to meet with Pinez and tour the headquarters in Billerica, MA. Although the analyst noticed some computer equipment he noticed there was none in Manny's office. During a tour of Centennial's manufacturing facilities, he saw "a room full of people banging on cards with rubber mallets. I had a bad feeling." He returned to his firm and they "dumped the Centennial shares immediately."

In truth, Pinez had enlisted a handful of employees in the company's Billerica manufacturing plant to assemble fake memory cards by simply welding the casings together and leaving out a critical silicon computer chip. These fake cards made their way into inventory and sales. Most of the sales of these cards are alleged to have gone to other companies controlled by Pinez. While students would not be expected to have identified this scam, they will remember an audit memo referring to "empty cards."

The Fruit Basket Scheme. As noted in the student case Manny had decided to send holiday fruit baskets to some of his most valued customers and other associates. By weighing the fruit baskets before they were shipped, Pinez created paperwork showing a package of a specific weight being sent to one of the company's customers. The papers were later falsified to make it appear as if Centennial had shipped memory cards, instead of bananas, nuts and grapefruit. Because memory cards are small and light, even a 10-pound shipment would amount to hundreds of cards, which sold for $100 to $500 each. The fruit shipments were booked as sales by Centennial.

Financial Statements Restated

In addition to the specific fraud tactics discussed above, post-fraud examinations also revealed that Centennial had recorded as revenue "bill and hold" transactions which did not ultimately meet revenue recognition criteria. Centennial had also overvalued investments and advances to related companies. Necessary restatements to Centennial's (Flash's 2005) financial statements to remove the fraud included:

- Sales were reduced from $37.8 to $33.4 million
- COGS was increased from $23.6 to $29.7 million
- Net income went from a profit of $5 million to loss $4.2 million
- Inventory was reduced from $18 to $8 million
- PPE was reduced from $4.6 to $2 million
- Stockholder Equity was reduced from $45 to $32 million

Cumulative adjustments to the previously reported financial statements included reductions to sales of $21.2 million, increase to COGS of $8.8 million, write-offs of investments in, and advances to, several companies of $15.8 million and other miscellaneous adjustments to expenses of $2.4 million. On the bright side, after the restatement, Centennial was eligible for an $8.1 federal tax refund!

HOW THE FRAUD WAS DETECTED

Coopers & Lybrand rightly considered Centennial a high-risk client. In fact in mid 1996 Coopers changed Centennial's status to that of "high-level risk alert." In the last part of 1996 and early 1997 short sellers began driving the stock price down. These sellers did not believe the company had actually obtained the $300 million AT&T contract and an article in Financial World claimed there was no evidence Pinez was awarded degrees by either the London School of Economics or Hebrew University.

January 1997 the auditors notice "fishy" bill and hold transactions. The auditors warned the company to not release earnings until the concern is resolved; however, the company released earnings anyway. Coopers went to the Board of Directors (BOD) with their concerns and a full financial review was ordered by the board. In a subsequent BOD meeting lasting many hours, one of the fraudsters, Murphy, fingered Pinez as the mastermind of a multimillion dollar accounting fraud. While Coopers was instrumental in uncovering the fraud, unfortunately they had issued unqualified audit opinions on previous year's financial statements that also included fraud.

Manny Pinez was arrested and imprisoned the Plymouth County Correctional Facility in 1997. Manny was described as "charming," "confident he will prevail," and "thoroughly compromising with the truth." From his prison cell he denied any wrongdoing and indicated that his defense would be that his actions were undertaken to benefit the company. Manny attributed his problems to the scrutiny that inevitably comes with success, "You get lightening when you're very high." Despite his initial confidence, in 2000 he pleaded guilty to conspiring to commit securities fraud and was sentenced to 5 years in prison and ordered to pay restitution of $150 million for doctoring the company's financial results from 1994 to 1997 and inflating the stock price. In 2000 Pinez also agreed to pay $5.3 million to settle a civil complaint of illegal stock trading filed by the SEC. The deal will leave Pinez nearly penniless when he gets out of jail and is deported to Israel, his lawyer said.

Centennial's former chief financial officer, James M. Murphy, was sentenced to 15 months in a halfway house and ordered to make the same amount of restitution as Pinez. He had also pleaded guilty. Centennial's former chief operating officer, Bond Fletcher, was sentenced to eight months in a halfway house and ordered to pay $7 million in restitution. The SEC has filed complaints against Murphy and Gilboa Peretz in connection with the fruit basket scam. Murphy sent the baskets and created fake sales documents. Peretz, a firm business partner, is accused of taking a fruit basket while saying he had bought a Centennial product.

ADDITIONAL FACTS—AFTERMATH

- In 1996 Centennials' surging stock graduated to the New York Stock Exchange just two years after going public. It finished 1996 as the best-performing stock on the Big Board, up a stunning 451%. Just before the fraud was uncovered analysts still had "strong buy" recommendations outstanding. After the accounting irregularities were discovered the stock was delisted from the NYSE. As of the end of 1998 it was not listed on any organized exchange. Based on information reported on internet-based bulletin boards, Centennial shares were priced at $1-3 ¾ per share in 1998 down from a peak of $58.25 in late 1996.
- As noted earlier Manny used his stock as collateral for an $18.5 million loan and he gave away as gifts shares that were worth $21 million at the time but would have climbed to several times that value. Four days before he was fired Manny placed an order for 5,400 option contracts betting the stock would fall; the proceeds ($4 million) were frozen by the court.
- Approximately 35 class action lawsuits were filed in US District court against the Company, its directors, certain officers, its independent accountants, C&L, and others, asserting claims under Section 10(b) of the SEC Act of 1934 and Rule 10b-5 promulgated thereunder, and related state law claims of fraud, deceit and negligent misrepresentation. In addition several shareholder lawsuits were filed seeking recovery for alleged breach of fiduciary duties, gross negligence, breach of contract and insider trading. In April of 1998 the US District Court granted final approval of the Company's proposed settlement of the class action and derivative claims described above. The settlement consisted of payment of over $1.5 million in cash and stock valued at $18.5 million (37% of the estimated market capitalization of the company) as well as agreements to adopt certain corporate governance policies and procedures. The settlement did not release Pinez or Coopers & Lybrand.
- Shortly after the fraud was discovered the United States Department of Justice (DOJ) subpoenaed the company to produce documents in connection with a grand jury investigation regarding various irregularities in the Company's previous press releases and financial statements. The DOJ also requested information regarding former officers, stock transactions by Pinez, and correspondence with Coopers and Lybrand. At the same time the SEC launched an investigation. In a statement from the SEC they indicated that its inquiry should not be construed as an indication by the SEC or its staff that any violations had occurred, or as a reflection upon the merits of the securities involved or upon any person who effected transactions in such securities.
- Centennial Technologies survived the fraud and returned to profitability. The company's computer cards are inserted in laptops, defibrillators and wireless telephones to increase memory and communications capacity. In 1999 Intel Inc. took a 16 percent share in Centennial and in 2001 Giant Solectron Corp. purchased the Company for almost $22 per share in Solectron stock.

Flash Technologies Group Case Evaluation **Group________ Score_____/50**

- **Identified and discussed the following major/other issues: ________/10 pts**

______ PC Card industry competitive and subject to rapid change in technology inventory obsolescence (valuation) is an issue
______ Two customers represents 25% of company sales and two other major customers are in bankruptcy
______ Valuation of accounts receivable
______ Public company/debt covenants
______ Related party transactions
______ Supplier concerns, no alternatives, no long-term agreements, raw material constraints
______ Going concern, liquidity, negative cash from operations
______ 98% of sales now in PC card market
______ Flash 2005 sales all to one person
______ Management group qualified to handle growth, management reputation, background checks
______ Questions of Emanuel Schwimez's integrity
______ DCI experiences losses
______ Dominant players with more capital (Intel, AMD) have 80% share
______ Flash technology has not lived up to original expectations
______ Korean Venture, exchange rates, etc.
______ Patent litigation
______ Short sales of company stock increasing
______ Fruit baskets, empty flash cards
______ Most manufacturing in one facility, proper insurance

- **Identified and discussed the following trends/relationships in the financial statements: ______/12 pts**

______ Rapid increase in sales, NI
______ A/R is up substantially, allowance not keeping pace
______ Inventory increased substantially, inventory turnover significantly less than the industry average
______ Growth and profits outpacing industry
______ Other

- **Appropriately Addressed Client Concerns**

1. Subsequent event disclosure of DCI and footnote draft **______/2 pts**
2. Pending Litigation **______/2 pts**
3. Foreign Currency Futures Contract **_____/2 pts**

- **Demonstrated the relationship of the literature/course material (e.g., audit implications) to the case:**

Poor_____ Fair_____ Good_____ Very Good_____ Excellent_____ **________/8 pts**

- **Provided sound rationale for conclusions:**

Poor_____ Fair_____ Good_____ Very Good_____ Excellent_____ **_______/7 pts**

- **Quality of writing, presentation, and expression of thought:**

Poor_____ Fair_____ Good_____ Very Good_____ Excellent_____ **_______/7 pts**