Teaching Students Financial Statements’ Assertions: Crisp-Drinks Case

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Introduction

The case study is based on a hypothetical company, Crisp-Drinks Corporation, (Crisp-Drinks or the company, henceforth).¹ The case presents several misstatements (i.e., violations of financial statement assertions). The case is useful as a teaching tool to facilitate students’ understanding, learning, and applying of the assertions (i.e., why performing a particular procedure is relevant to detect a specific type of misstatement). Students speak highly of the case in enhancing their understanding of the audit procedures once they learn the assertions’ meanings. The study questions require students to learn differences between auditor’s responsibilities and management’s responsibilities. The facts provide a rich setting to discuss managerial intentions when entering into business transactions.

The Case

Crisp-Drinks is a California corporation headquartered in San Diego, California, United States. Crisp-Drinks’ common stock is registered with the Securities and Exchange Commission. Crisp-Drinks is engaged in the marketing, manufacturing, and distributing Crisp-Drinks beverages nationally. Historically, Crisp-Drinks has had three drinks representing the largest source of operating revenue. These are: YumCoffee, AlcalWater, and FuzJuice. Crisp-Drinks has consistently met or exceeded earnings expectations while achieving annual earnings per share growth rate of more than twice the average growth rate of the S&P 500. Crisp-Drinks’ superior earnings performance has resulted in its common stock trading at a price to earnings multiple twice that of the S&P 500’s.

In recent years, Crisp-Drinks has begun experiencing increased competition and a more difficult economic environment. Nevertheless, Crisp-Drinks continuously has issued press releases that its expected earnings per share will continue to grow between ten percent and twelve percent annually.

For the purpose of generating additional revenues to meet both annual business plan and earnings targets, close to the fiscal year-end, Crisp-Drinks asked its bottlers to make additional purchases of YumCoffee and FuzJuice. Even though the bottlers knew that these additional purchases exceeded the forecasted demands for these drinks, the bottlers continued to purchase these drinks to preserve their relationship with Crisp-Drinks. This practice authorized and implemented by the company’s management, effectively allowed Crisp-Drinks to meet Wall Street’s expectations. Furthermore, to entice bottlers to purchase more of the high margin drinks, Crisp-Drinks extended more favorable credit terms than usual, typically increasing payment terms from just ten days to thirty days. Additionally, the bottlers were not allowed rights to return any drink. Crisp-Drinks did not necessarily collect all receivables due from its bottlers nor did it record appropriate allowances for doubtful accounts, especially given these generous credit terms.

The effect of selling to the bottlers without right of returns moved revenues from future periods to the current period. As a result, Crisp-Drinks has had a sales deficit at the beginning of each fiscal year simply because bottlers had more than they can sell already, so their inventory of unsold drinks was carried forward. To further maintain and achieve earnings targets, and to maintain an illusion of strong demand on these drinks, especially in years of increased competition, Crisp-Drinks overstated its inventories of YumCoffee and FuzJuice.

¹ The case is loosely based on fraudulent financial reporting of Coca Cola Corporation as reported in the Securities and Exchange Commission’s Accounting and Auditing Enforcement Action Release no. 51565.

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Over time, employees communicated that maintaining sales was not sustainable and sales had to decrease or cease entirely. As a result, Crisp-Drinks entered into round-trip transactions with Drinks America Corp. (DAC). DAC is wholly-owned by VP of operations of Crisp-Drinks. These transactions were approved by the CEO of Crisp-Drinks and its VP of operations (i.e., the VP of operations was entering into these transactions as the owner and CEO of DAC). Over a period of a few years, DAC appeared to become the largest direct customer of Crisp-Drinks. The transactions between the company and DAC entailed the following: Crisp-Drinks promised to ship YumCoffee, AlcalWater, and FuzJuice to DAC at a future date. DAC agreed to transfer cash to Crisp-Drinks for the future purchases. Crisp-Drinks then recorded the cash as loan payable for sales to take place in future periods. Subsequently, Crisp-Drinks issued credit memos for sales returns that were recorded as purchases of inventory of raw material such as sugar, coloring agents, and flavors from DAC. As of the last few fiscal year-ends, no drink was actually shipped out to DAC.

To reduce its manufacturing costs, and due to potential increased government regulations that encourage and subsidize clean energy manufacturing practices, the company considered upgrading its manufacturing equipment. Crisp-Drinks entered into an agreement with a solar-power energy-efficient equipment manufacturer. Under the two-year agreement, the company would use the manufacturing equipment in its facilities for an annual fee. Crisp-Drinks reported this equipment on its balance sheet and described clearly the use of the equipment in its footnotes to property, plant, and equipment.

Moreover, to improve its cash flows from investing activities, Crisp-Drinks entered into a memorandum of understanding (MOU) to trade real estate with an Irish company. The Irish company would acquire and trade the real estate properties for sale in Europe for the benefit of Crisp-Drinks. Under the MOU, Crisp-Drinks did not acquire the real estate. In its most recent year financial statements, Crisp-Drinks listed investment in real estate in Europe.

Examining the company’s financial statements, Crisp-Drinks did not disclose any information from which investors could determine the impact of the agreements with bottlers on current earnings, or the likely impact on future earnings. Additionally, Crisp-Drinks’ notes to the financial statements were vague at best or silent at worst about the transactions between the company and DAC and the Irish company.

**Case Requirements**

1. Explain management and the auditor’s responsibilities regarding the financial statements and internal controls over financial reporting.
2. What is the purpose of management or financial statement’s assertions?
3. You are a forensic accountant assisting auditors to identify inappropriate schemes that took place at Crisp-Drinks. Please identify the scheme and the financial statement assertions that were violated as a result.
4. Using your audit and forensic accounting knowledge and for each scheme (or assertion that was violated), identify one or two audit procedure(s) that would have effectively uncovered the scheme or caught the resulting misstatement.

**Case Learning Objectives and Implementation Guide**

**Overview of the Case and Learning Objectives**

The accounting profession has increasingly sought students with some level of professional judgment, analytical and critical thinking, and communication skills. Case discussion and analysis provide a tool to develop these needed skills. Learning management and financial statement assertions is the foundation for conducting quality audits, forensic investigations, and fraud examination, and for passing the Certified Public Accountant examination.

The case is designed to expose students to real life misstatements in order to understand and apply auditor’s responsibilities on providing reasonable assurance that financial statements are free of material misstatements due to errors or fraud. The case also exposes forensic accounting and fraud examination students to understand and identify the inappropriate accounting, and identify procedures to uncover the scheme and to detect the resulting misstatements. Therefore, the case discussion may include how different is the role of auditors in comparison to the roles of forensic accountants and fraud examiners. While audits provide reasonable assurance that financial statements are free of material misstatements due to errors or fraud. An audit does not uncover all fraud or errors. Auditors plan and assess risk of material misstatement and conduct their audit using persuasive evidence to support the amounts and disclosures on the financial statements. Thus, it is possible for a company to have fraud that is not uncovered by the audit. Auditors are also constrained by materiality. Forensic and fraud examiners are not. In a forensic examination, the forensic accountant goal is to provide expert legal
advice and support uncovering fraud or suspected fraud and assessing loss or damages frequently in a court of law. On the other hand, fraud investigations are initiated from tips, complaints, and from accounting irregularities. Fraud examinations include designing and implementing fraud prevention and deterrence mechanisms through examining financial data and records, interviewing witnesses, and reporting (Kranacher et al., 2010). Forensic accounting and fraud examinations share accounting and financial knowledge, but the former requires knowledge and skills in other disciplines including litigation, valuation analysis, corruption, cybercrime, and internet and computer forensics, besides skills in collecting and assessing documentary evidence, witnesses interviewing, and reporting (Crumbley et al., 2005). Thus, to uncover misstatements, auditing, forensic accounting, and fraud examination may use the usual procedures (e.g., documentary evidence, inquiries, physical examinations, and financial and non-financial information analysis) and common knowledge of accounting and investigative skills; the respective objectives and the requisite knowledge and skill sets are not the same.

The case is very useful in highlighting channel stuffing, round tripping, and related party transactions. Specific objectives of the case are the following:

1. Understand auditor’s and management’s responsibilities about the financial statements and internal controls.
2. Understand and identify the inappropriate practices that took place and link them to the management/financial statements assertions.
3. Understand the PCAOB assertions versus AICPA/IAASB assertions, yet also understand the comprehensiveness and inclusiveness of the three sets of assertions and their importance in auditing and forensic accounting.
4. Use auditing, forensic accounting, and fraud examination knowledge to identify procedures to uncover the schemes and detect misstatements resulting from violation of these assertions.
5. Develop students’ soft skills (i.e., critical thinking, effective communication, working in a team, and time management).

The case is short enough to allow for a stimulating class discussion without taking considerable class time. Individual students or a small team of students can analyze this case. Students could analyze this case in a class meeting or as an out-of-class assignment. Students may be required to complete answering the questions in a memo style to address different issues critically and write using professional Standard English language. In a graduate course, teams of students may be required to present the case, their analyses, and their answers to the case questions. The case has also been used in a case-based essay examination.

The instructor may initiate discussion about the names and meanings of the different assertions before applying them to the case information. The instructor may use an auditing textbook such as the Arens et al. (2017) covering the AICPA, IAASB, and PCAOB assertions. Appendix 1 provides a summary of the assertions. In addition, the instructor may encourage students to refer to the professional standards covering management and auditor’s responsibilities about the financial statements, assertions, and audit evidence available to use. Relevant laws and professional standards are as follows:

1. PCAOB AS 1001 Responsibilities and Functions of the Independent Auditors
2. PCAOB AS 1105 Audit Evidence
3. AICPA Clarified Standard AU-C 500 Audit Evidence
4. IAASB International Standard on Auditing 315
5. Sarbanes Oxley Act of 2002

**Intended Courses**

The case can be used in a graduate or undergraduate auditing, fraud or forensic accounting, internal auditing or in fraud examination courses. The case can also be used in a financial accounting course to discuss fraudulent schemes in revenue recognition, related party transactions, and investments.

**Summary of Instructor’s Teaching Notes**

The instructor’s teaching notes for the case can be obtained from the author. The instructor’s teaching notes include the following:

1. The recommended responses to the case questions. It should be noted that students’ answers may vary, and students indeed will come up with creative answers and relate this case information to their real-world work experiences.
2. Appendix 1 and a YouTube video on financial statements’ assertions can be used to initiate learning the assertions.
3. The instructor may require students to organize their responses in a memo style. A sample of blank business memo format is provided for reference in Appendix 2. Other business memo formats are also acceptable.

4. Suggestions for discussion of related topics using the case information such as fraud “red flags” or “fraud triangle factors”, effect of misstatements on accounts (i.e., overstatements versus understatements), or identifying internal controls that would have prevented or detected misstatements.

**Students’ Learning Experience**

Students from a state university were asked to complete the assignment and discuss it in class. The case was discussed in an undergraduate auditing course in spring 2017. The students were required to present their analyses of the case in class. The case was assigned after completing a chapter on management’s and auditor’s responsibilities and auditor’s objectives on attesting to management assertions for the financial statements audit. Completing the questionnaire was not required to earn credit for the assignment. A total of thirty students were enrolled. Of which, eighteen students gave back their questionnaire (i.e., a response rate of sixty percent).

Students find financial statement assertions challenging both when studying in an auditing class and for the CPA exam. The table below shows the effectiveness of using the case to learn the meaning of each assertion, apply it, and then identify audit procedures to effectively detect resulting misstatements. The questionnaire indicates that students were able to better understand, apply, and critically come up with audit procedures once they learned the assertions and what misstatements resulted. All respondents indicated that the case helped them understand the meanings of management assertions/financial statements assertions, and 88.89% indicated that they are able to apply the assertions to the case facts. In addition, seventy-two percent of the respondents indicated that they are able to come up with audit procedures to test each assertion that was violated. The case covered the discussion of auditor’s responsibilities about the financial statements as an attest to management assertions (88.89%) and management’s responsibilities (88.89%). Sixteen of eighteen students found the case to be an effective learning assignment and that the case should be used in future auditing classes.

With regard to working in teams, students generally found improvement in learning case concepts (77.78%), improve presentation skills (77.78%), and improve writing skills (88.89%). Students, however, find that working in teams is not necessarily efficient in terms of time management (eleven respondents favored working in teams, six respondents neither agreed nor disagreed, and one respondent disagreed or strongly disagreed).

Three students reported comments on the case. One students mentioned “a clear case with examples that were easy to understand”, “I like how the case was broken down into sections”, and “I really enjoyed this assignment”. Overall, students appreciate the short case and it is not overwhelming to learn the meaning of the assertions and apply procedures to uncover and detect the resulting misstatements.

Other worthy discussion topics: students raised questions about settings where manufacturers ship goods to dealers without the right of return. This resulted in a discussion about consignment inventory and how it is different from channel stuffing. Discussions also led to talking about rights to assets, as in who owns the assets under channel stuffing given that there is no right to return. Students indicated that including shipping terms and returns terms might change how the fraud would have been committed. Even though, this setting in the case may sound legal; it is not legal, and it is not ethical either to hide the true performance of a company. Additionally, students had interesting thoughts on the roundtrip transaction fraud about the legality versus the ethicality of these transactions.
Appendix 1: Management/Financial Statements Assertions under the PCAOB, IAASB, and the AICPA Standards

<table>
<thead>
<tr>
<th>PCAOB ASSERTIONS</th>
<th>AICPA AND IAASB ASSERTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Transactions</td>
</tr>
<tr>
<td>Occurrence/Existence</td>
<td>Occurrence</td>
</tr>
<tr>
<td>Completeness</td>
<td>Completeness</td>
</tr>
<tr>
<td>Valuation or Allocation</td>
<td>Accuracy</td>
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<td></td>
<td></td>
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<tr>
<td>Cut Off</td>
<td></td>
</tr>
<tr>
<td>Rights and Obligations</td>
<td>Rights and Obligations</td>
</tr>
<tr>
<td>Presentation and Disclosure</td>
<td></td>
</tr>
</tbody>
</table>

Appendix 2: Sample Blank Memorandum

TO:

From:

Subject:

Date:

Dear (memo can be addressed to audit manager or partner)
References


Other Useful References


Table 1: Response to Questionnaire about the Effectiveness of Case Achieving Objectives

<table>
<thead>
<tr>
<th>Question</th>
<th>Strongly Agree/Agree</th>
<th>Neither Agree/Disagree</th>
<th>Disagree/Strongly Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Freq.</td>
<td>Percentage</td>
<td>Freq.</td>
</tr>
<tr>
<td>1. This case has helped me understand the management assertions/financial statement assertions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Especially by critically understanding the meanings of management assertions and financial statement assertions</td>
<td>18</td>
<td>100.00%</td>
<td>0</td>
</tr>
<tr>
<td>b. Critically applying and analyzing the assertions to the facts of the case</td>
<td>16</td>
<td>88.89%</td>
<td>2</td>
</tr>
<tr>
<td>c. As a result of my understanding of the assertions, I am now able to come up with audit procedures</td>
<td>13</td>
<td>72.22%</td>
<td>5</td>
</tr>
<tr>
<td>2. My understanding of the auditor’s responsibilities about the financial statements is better as a result of completing this case.</td>
<td>16</td>
<td>88.89%</td>
<td>1</td>
</tr>
<tr>
<td>3. My understanding of the management’s responsibilities about the financial statements is better as a result of completing this case.</td>
<td>16</td>
<td>88.89%</td>
<td>2</td>
</tr>
<tr>
<td>4. This case was an effective learning assignment.</td>
<td>16</td>
<td>88.89%</td>
<td>1</td>
</tr>
<tr>
<td>5. This case should be used in future auditing classes.</td>
<td>16</td>
<td>88.89%</td>
<td>2</td>
</tr>
<tr>
<td>6. I find that presenting cases, findings and working in groups help me:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Grasp case concepts better than working alone.</td>
<td>14</td>
<td>77.78%</td>
<td>4</td>
</tr>
<tr>
<td>b. Better manage my time</td>
<td>11</td>
<td>61.11%</td>
<td>6</td>
</tr>
<tr>
<td>c. Practice my presentation skills</td>
<td>14</td>
<td>77.78%</td>
<td>3</td>
</tr>
<tr>
<td>d. Practice my writing communication skills</td>
<td>15</td>
<td>83.33%</td>
<td>2</td>
</tr>
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</table>