Teaching Case: An Inventory Valuation Dilemma for Financial Statement Reporting

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Using Accounting Standards Update (ASU) 2015-11: Inventory (Topic 330), Simplifying the Measurement of Inventory from the Financial Accounting Standards Board (FASB), and Auditing Standards (AS) 2801: Subsequent Events from the Public Company Accounting Oversight Board (PCAOB), this case study creates critical thinking and ethical decision-making. The assignment requires students to consider inventory valuation given a hypothetical scenario under a triggering event. The case integrates fictitious actors and other components that can be tailored for teaching adaptation. It requires students to assume the role of the participants, while considering how management and auditors could arrive at different standard interpretation.

Keywords: financial reporting, auditing, inventory valuations, business ethics

INTRODUCTION

This teaching case is designed for classroom use and does not involve human participants. The authors present fundamental principles and guidelines of the accounting profession in the United States (US), focusing on US Generally Accepted Accounting Principles (US GAAP) and US Generally Accepted Auditing Standards (US GAAS). Management and auditors can interpret these standards differently, influenced by factors such as market conditions, account valuations, and others. The central dilemma of this case is the financial statement reporting of inventory amid significant price increases resulting from a triggering event. Students are primarily tasked with pondering the proper inventory valuation for year-end reporting considering US GAAP and US GAAS. The First-in, First-out (FIFO) accounting method is used for inventory measurement highlighting the interpretation challenges of these standards. International Financial Reporting Standards (IFRS) are out of scope; however, inventory-valuation restatement under IFRS is mentioned to indicate contrast with US GAAP and for recommendation for future teaching cases.

BACKGROUND

Louis Jackson, Robert J. Green, and Tina D. Lee met at college during their junior year and formed a study group shortly thereafter. The friends met on the weekends throughout the school year focusing on their accounting courses. Over their college years, the friends were oblivious that their study relationship, friendship, and progression in their accounting careers would be destined to converge into the formation of Green, Jackson, and Lee LLC (GJL or the firm). GJL is a small local CPA practice that offers assurance, taxation, and advisory services to several exclusive clients, with audits accounting for a significant portion of their revenue. Since its inception, the firm business has been favorable with steady revenue increases year after year; however, due to unforeseen circumstances the firm is facing financial uncertainties that could have a negative impact on GJL's profitability. For example, CareSource Co. and Health Healers Inc., two of their major clients, were recently acquired by Global Health Network (GHN). In a letter dated December 15, 2019, shortly after the acquisitions, GHN informed GJL of its upcoming plan for audit services that raised questions about the continuity of audit services to these clients by GJL.

In addition, during a contentious meeting with Andreas Berger, CFO of Venti Manufacturing Corporation (Venti), the firm's largest client, Berger proposed the reversal of a $2.3 million write-down of its year-end inventory account for their anticipated annual report as of January 31, 2020. Venti is the USA arm of Venti Care Company, a global entity that specializes in acute care supporting hospitals around the world in treating critically ill patients with medical technology. One of the top products manufactured by Venti is the Oxi-Resp ICU ventilator, which is used predominantly in emergency rooms for patients who risk survival without such a ventilator or similar medical device. As a result of the Coronavirus disease (COVID-19) spreading in Europe and subsequently throughout the world, the need for medical ventilators in most countries grew exponentially, including in the United States. The proposed inventory write-down reversal by Berger is causing increased internal pressure among the partners. As per GJL, the write-down was necessary due to the net realizable value of the inventory as of January 31, 2020, which was 18 percent less than the cost recorded on Venti's books. Berger argued that historically the inventory valuation for ventilators was volatile and that write-down reversals were allowed by the previous auditors when inventory write-downs became questionable. The unusual demand for ventilators in Europe, due to COVID 19 during the end of 2019 and early 2020 in particular, claims Berger, is the reason why no write-down entry should be made for the annual financial statements. In essence, Berger was asserting anticipated market conditions in the United States before the completion and reporting of audited financial statements. Worth noting, is that the first cases of COVID-19 were reported in the United States in January 2020 (Bergquist, Otten, & Sarich, 2020). The year-end valuation of Venti's Oxi-Resp ICU ventilators is at the center of the write-down reversal request. The write-down, if recorded, will reduce Venti's profitability causing Venti to report a net loss.

ACCOUNTING DILEMMA

The current assurance fee from Venti is approximately $2.5 million (or 15%) of GJL's audit revenue. In addition, if expected engagements from CareSource and Health Healers are lost, projected new revenue from other sources would not be sufficient to offset the expected revenue decrease. Jackson, who seems sympathetic to Berger's request is facing significant pressure from Green and Lee, who stand firm on the need for a year-end inventory write-down entry. Jackson's rationale to the other partners to accommodate for management refers to previous inventory valuation practices by their predecessors caused by changing market conditions. In addition, Jackson, who has had increased contact with Berger in recent months, emphasized to the other partners the anticipation of increased revenue for projected non-assurance accounting services with Venti for the upcoming years. The counterargument by Green and Lee is that their predecessors are an international firm with most clients located in Europe, where IFRS allows for inventory valuation restatements that could have made them more agreeable to such inventory valuation practice or some form of smoothing effect. The two partners argued that not recording the inventory write-down entry would be against US GAAP, not to mention what could amount to an unethical violation of professional conduct by siding with management in this inventory valuation.

ACCOUNTING STANDARDS

ASU 2015-11 - Inventory (Topic 330) - Simplifying the Measurement of Inventory

The Financial Accounting Standard Board (FASB), established in 1973, is recognized by the Securities and Exchange Commission (SEC) and other organizations as the accounting standard setter for public and private companies and not-for-profit organizations that follow Generally Accepted Accounting Principles (GAAP) in the United States. In July 2015, the FASB issued Accounting Standard Update (ASU) 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory (FASB, 2024). This ASU arises from the Simplification Initiative that the FASB launched in 2014, aimed to simplify and improve accounting standards. The FASB's objective was to increase efficiency in financial reporting while preserving or enhancing the quality of information reported. One of the main objectives of ASU 2015-11 is to simplify the complex practice of determining subsequent inventory values. Historically, accounting standards have required for inventory to be measured at lower of cost or market (LCM). However, the word *market* in the LCM concept has multiple interpretations - e.g., replacement cost, net realizable value (NRV), or NRV less a normal profit margin (FASB, 2024). The various interpretations resulted in different measurements of similar inventory valuations. Efforts to simplify the measurement of inventory lead to the new concept of lower of cost and NRV. NRV is defined by the FASB as the estimated selling price expected in a normal business setting minus costs of completion, disposal, and transportation. It is important to know that the scope of this ASU does not change the use of LCM application to Last-in, First-out (LIFO) or the retail inventory method; this is due to the doubtful benefit over cost expected from the complexity inherent in these methods. For LIFO or the retail inventory method, LCM is the applicable inventory measurement method. In other words, the scope of this ASU for the use of lower of cost or NRV applies to inventory measures using any method other than LIFO or the retail inventory method. With reference to inventories, the term *market* should thus be limited in accounting reporting when inventory valuation occurs under LIFO or the retail method (Levy, 2018).

In this case study, the authors use First-in, First-out (FIFO) to measure inventory; hence, lower of cost and NRV is the measurement that applies. Specifically, paragraph 330-10-35-1B of the new standard articulates that inventory that is measured using FIFO or average cost should be measured at the lower of cost and NRV, with the difference of book value (BV) in excess over NRV recognized as a loss in earnings in the period in which it occurs. Examples that can cause NRV to be lower than BV include, but are not limited to, damage, physical deterioration, obsolescence, and changes in price levels (FASB, 2024). This change in measurement to lower of cost or NRV under US GAAP makes inventory measurement better aligned with inventory measurements under International Financial Reporting Standards (IFRS), standard IAS 2 - Inventories.

AS 2801: Subsequent Events

The Public Company Accounting Oversight Board (PCAOB), created by the Sarbanes-Oxley Act of 2002 (SOX), oversees the audits of public companies and brokers and dealers registered with the Securities and Exchange Commission (SEC). According to AS 2801 (PCAOB, 2024), two types of subsequent events exist. The first type consists of events that raise evidence of existing conditions as of the balance sheet date. An adjustment to the financial statements of a significant event under this scenario requires judgment and knowledge of facts and circumstances, among other things. The second type consists of evidence of conditions that did not exist as of the balance sheet date but became known subsequently to that date. A subsequent event of this type may require a note to the financial statements. Subject to materiality, an auditor may include an emphasis paragraph in the audit report directing readers to a footnote in the financial statements. In both cases, subsequent events are raised after the balance sheet date and before the financial statements for the reporting period have been issued. In accordance with AS 2801: "*Subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated* *liabilities ordinarily will require adjustment of the financial statements, because such events typically represent the culmination of conditions that existed over a relatively long period of time*."

Consider the following as you explore the discussion questions.

1. What if subsequent events raise doubts about inventory impairment as of the balance sheet date?
2. What if increases in inventory valuations were the culmination of conditions existing as of the balance sheet date?
3. Under the assumption that an event represents a material adjustment to inventory, should management adjust the financial statements, or should management add a note to the financial statements instead?

DISCUSSION QUESTIONS

1. Using the income statement from the Appendix, explain the type of effect (if any) that the write-down reversal would have on Venti's income statement. Also, explain the hypothetical impact (if any) on the balance sheet and the statement of cash flows (not provided).
2. How would GJL ensures that independence will not be impaired by the acceptance of the expected non-assurance accounting services from Venti?
3. What are the restrictions for non-audit services imposed by the Sarbanes-Oxley Act?
4. Based on US GAAP and US GAAS, how should GJL proceed with the inventory valuation for January 31, 2020? Should the write-down entry be made, yes/no, why? Explain using US GAAP and US GAAS.
5. In your opinion, is there potential for AICPA code of conduct violation in this case. Explain.
6. Place yourself as a senior auditor for GJL during the subsequent period. What would your strongest argument be for or against the write-down adjustment?

REFERENCES

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APPENDIX

Venti Manufacturing Corporation
Income Statement
For Year Ended January 31, 2020

	31-Jan-2020	**31-Jan-2019**
Net sales	$132,421,346	$130,609,514
Cost of goods sold	75,255,051	74,791,820
Gross profit	**57,166,295**	**55,817,694**
Selling, general, and administrative expenses	54,425,173	53,249,548
Impairment loss	590,040	661,636
Other general expenses	42,608	82,663
Non-operating income	(102,554)	(194,117)
Operating expenses	**54,955,267**	**53,799,730**
Realized foreign exchange loss	83,505	30,247
Loss on Sale of Investments	193,450	30,685
Non-operating loss	**276,955**	**60,932**
Earnings before income taxes	1,934,073	1,957,032
Income taxes	707,097	739,133
Net income	**$1,226,976**	**$1,217,899**

Note:
Proposed year-end entry by GJL, not included yet in the Income Statement

Cost of goods sold	$2,255,342	
Inventory		$2,255,342
To write down inventory as of January 31, 2020		