

JONES COMPANY: A CASE ON CORPORATE GOVERNANCE, SOX AND AUDIT COMMITTEE PROTOCOL

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ABSTRACT

This case provides senior-level accounting majors and graduate students a perspective and an appreciation of topics in areas of corporate governance, The Sarbanes Oxley Act (SOX) and board of directors/audit committee protocol. Utilizing role playing, this case has a heavy emphasis on the business communication process, written and verbal, necessary to effectively and efficiently describe business issues relating to corporate governance and recommend appropriate actions. The key accounting issue discussed in the case is revenue recognition. This is an area of constant concern to audit committees, management and auditors, especially for public companies.

This case meets the increased need to provide instruction in this new and critical area of corporate governance. The teaching notes provide a roadmap (suggestions on exercises, role playing and communication processes) for instructors who are interested in teaching corporate governance at the undergraduate or graduate level.

Key Words: Corporate Governance, SOX, Sarbanes Oxley Act, Audit Committee, Board of Directors, Revenue Recognition, Software Development

BACKGROUND - FEBRUARY 15, 2008

Jones Company is a public company in the financial software development business located in Minneapolis. Market capitalization has fluctuated between \$350 million and \$375 million over the last twelve months. There are 15,000,000 shares outstanding as of December 31, 2007. Sales have grown from approximately \$100 million in the year ending December 31, 2004 to the current forecast sales of \$150 million for the year ending December 31, 2008. The primary product is a software suite that includes the components of General Ledger (GL), Accounts Payable (AP), Financial Reporting (FP) and Work Management (WM). The company rarely sells the components individually, but they would work quite easily within other systems such as Oracle, SAP or JD Edwards. The company has a reputation of delivering a quality product on time that works. In fact, that has become the company's byline in various types of advertising. Net income for the last four years and forecast for 2008 is as follows:

<u>Fiscal Year Ending December 31</u>	<u>Net Income</u>
2004	\$10,000,000
2005	\$11,200,000
2006	\$13,000,000
2007	\$15,500,000
Forecast 2008	\$18,000,000

The company has the typical type of corporate organization with the exception that the chairman of the board is independent and not a company employee. The corporate governance process and overall Sarbanes-Oxley (SOX) review have gone well for 2004-2007 with management asserting that proper internal controls are in place and the auditors attesting to management's assertion. The relationship with the audit team has gone well, with the same audit team in place from 1999 when the company went public, to 2006. The company board consists of four independent directors with diverse backgrounds including financial systems, accounting and sales. All of the directors are senior officers from Twin Cities companies. The audit committee financial expert is a CFO from one of the local companies and a CPA.

Jones management is very pleased with the software sales for the current fiscal year, ending December 31, 2007 and forecast sales for 2008. The company, due to its strong growth, has needed additional financing from its banks and plans on an additional stock issuance within the next six months. The loans, taken out at the beginning of 2006, must be renewed at the end of each year and have covenants that require a 15 % growth in net income from fiscal year to fiscal year as long as the debt is in place. Management was concerned about meeting these requirements, but with strong sales and new orders in hand, the company is confident that loan covenants will be met easily. In addition, management has had several meetings with underwriters to plan a stock offering and plans are going forward on that financial front. However, as a precaution, the underwriters have reminded the company, that as a relatively small company in a highly competitive industry, a solid strategy and strong revenue and earnings growth are a must to sell equity in this market and that there can be no problems with financial reporting for the current year. The CEO and CFO have been on the road with the underwriters and have created high expectations for company growth.

Jones management is confident in its sales and revenue forecasts and feels the company has made all the right moves in positioning itself in the marketplace. This includes spending

considerable time on SOX, realizing good audit results, and having a strong board and audit committee.

The management, particularly the sales team, is especially proud of the three new customers (shown below). Everyone at Jones could not be happier with results for fiscal 2007; these new system and maintenance sales added in excess of \$4 million to net income for the fiscal year. The remaining sales for fiscal 2007 were systems completed mid-year 2007 and have been fully tested and are operating well at customer locations.

DETAILS ON NEW SALES

Alpha Company

A complete suite of products was sold to Alpha Company. The development went very well and the system is in and operating. There have been minor problems, but were easily resolved by Jones Company's engineers. The product went live on December 31, 2007, and Alpha has had two monthly closes with no problems. Jones did sign a one year service agreement with Alpha that includes fixing software-related problems and installation of any updates developed by Jones. Jones has not experienced any problems with this software in the past and because of this did not book any warranty liability. When pressed by the controller, the software engineers estimated that at worst, there might be a cost of 5% - 10% of expected net income from the project for small fixes in the first several months of operation. But, beyond 2-4 months, if no problems, the system should be fine. The revenue on this system was \$6 million with income of \$2 million.

Beta Company

This sale of the financial suite of components, signed in April, 2007, was somewhat unique in that Beta was short on cash and wanted to sign four separate contracts as a way of slowly integrating the new technology and managing their cash flow. A summary contract was signed obligating Beta to purchase the whole suite, but a separate contract was also negotiated for each of the four components within the suite of products to allow Beta some flexibility on timing of purchase.

At the time of the sale, Jones was fine with this as Beta is a growing company, and Jones expected to do more business with them in the future. They also were confident they would be paid for the software. On their end, Jones managed and accounted for the project as if Beta purchased the full suite as a single project because Beta indicated they would, at some point, purchase the final component, the work management module. It made no sense to the controller to do all that extra accounting by treating each of the components as a separate accounting event.

The first three components were installed at Beta in September, 2007 and have been operating with no problems. Beta liked the software, paid for the first three components, and ordered the last component in December, 2007. Work has been progressing on this and is expected to be completed and tested by February 29, 2008.

The full software suite will generate \$6 million in revenue for Jones with income of \$2 million. Analysis shows that each of the four components yields approximately 25% of the revenue and earnings. As noted, the company booked the full amount of the project revenue and earnings in 2007, stating that the last component was ordered in 2007. There is a minimal amount of work left on the final component, and the company will know the results of the install before the 10K is filed. Therefore, the project should be treated as a single contract with no reason to expect that Beta will not pay their bill.

Coda Company

Jones made a decision in 2007 to enter the business of providing software maintenance services to companies that use all types of financial software. The company expected this to provide continuity of employment for their employees during slow software sales periods. A contract with revenue of \$200,000 was negotiated with Coda Company in June, 2007 and Jones has billed \$50,000 contract-to-date. Jones Company's controller booked the entire \$200,000 as revenue in December stating that as a revenue amount it was immaterial to the financial statements because the company expected to earn little or no income (as this was a start-up business) and, in his opinion, this business was going nowhere, anyway. So, why set up a special accounting process?

EXTERNAL AUDIT TEAM

The current team is rotating off the assignment due to Public Company Accounting Oversight Board rules, and a new manager and partner have been assigned to the Jones Company audit for the 2007 fiscal year. The new audit partner, John Hill, from Minneapolis, has not worked in the software industry before, but his perspective is that, with adequate preparation, you can audit any company. The New York office partner, Bill Smith, was somewhat hesitant in putting John on this assignment. But, with a shortage of experienced partners and the new rotation rules, he had no choice. The new manager, Sally Johnson, a relatively new manager, is "a little" familiar with the industry having worked for SAP for a couple of years. Overall, Jones's auditors, like all CPA firms have struggled to maintain adequate staff due to SOX requirements and a large number of new companies going public.

Hill and his staff have started the 2007 audit. They are interviewing the controller and staff and reviewing accounting records, previous audit reports and other documents necessary to form an audit opinion. John Hill considers himself to be an expert on revenue recognition and is personally reviewing the new customers Jones acquired during the year. As he looks at the contracts and the accounting, he becomes concerned that Jones may have incorrectly booked the revenue and resulting net income for the Alpha, Beta and Coda contracts. His personal opinion is that none of it should be booked for fiscal 2007. First, Alpha may still need warranty work; second, Beta, especially the way it was accounted for, is not complete; and three, there's plenty of uncertainty with Beta's ability to pay their bills. Finally, Coda should be handled as unearned revenue, not booked currently.

John Hill schedules a meeting with the CFO and controller and covers his concerns regarding revenue recognition for the three projects. The CFO and controller are adamant that company accounting is accurate and refuse to consider a change. John states that he will call his New York office and explain his concerns and recommend that the firm issue a qualified opinion for Jones if the company insists on this method of accounting. Sally fully agrees with John on this issue and states that SAP would never engage in this type of accounting.

A board/audit committee meeting has been scheduled to discuss this disagreement. The CFO and staff and the local external audit staff will present their positions and get the board/audit committee's input as to what the next steps should be in this disagreement. Management has discussed the issue with the CFO and controller and supports the current accounting. The New York partner is flying into Minneapolis and is committed to fully understanding the situation before he gives his opinion. However, he is concerned about not supporting his local partner.

RECOMMENDATIONS FOR CASE RESEARCH

Revenue recognition, especially in the software development industry, has long been of concern to management, boards of directors/audit committees and the SEC. The fundamental questions regarding whether the service or product has been delivered and has payment been received or assured continue to be the key questions that must be answered. At the same time, accountants must not be too quick to decide, without carefully evaluating all aspects of a particular transaction and in some respect put themselves in the company's shoes to fully understand the company's accounting.

After you have reviewed the case, professional literature that may help identify the issues and provide guidance are:

- **Statement of Financial Accounting Concepts No. 5**, *Recognition and Measurement in Financial Statements of Business Enterprises*,
- **EITF 00-21**, *Revenue Arrangements with Multiple Deliveries*,
- **AICPA SOP 97-2**, *Software Revenue Recognition* and
- **SEC Staff Accounting Bulletin (SAB) 101**, *Revenue Recognition in Financial Statements*.

There are also numerous articles on the web regarding this topic. These articles should be used as part of your analysis, providing references as necessary.

QUESTIONS AND POINTS TO CONSIDER

Below are items that should be part of your review; however, this should not be the sum total of your analysis. These are to help you get started.

- What should be recognized as revenue for fiscal 2007?
- Of the three contracts in question, what are the relevant issues and what makes each one a different revenue recognition question?
- What roles should the CFO and controller play in this situation? How do they get support for their decisions? What was the appropriate time to consult with other management or the audit committee on the accounting?
- Does the company have other options relative to the accounting?
- Are the auditors too conservative?
- Does the new audit partner have a hidden agenda?
- What role should the New York partner play?
- What should be the expectations of the board and audit committee?
- Are there subject matter experts that can be employed?
- What role does Sarbanes Oxley play?
- Are there any legal precedents, as to accounting, for the contracts?
- Is it realistic to be concerned about legal action against the company?

TEACHING NOTES

Teaching notes and course survey are available from the editor. Send a request from the "For Contributors" page of the journal website, <http://gpae.bryant.edu>.