A Course Format for Problem-Based Learning in Accounting

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Drawing on the objectives recommended in accounting literature, we suggest a course format that requires students to be independent problem solvers and promotes life-long learning. The classroom experience uses Problem-Based Learning techniques and the FASB Codification as the primary research database in the course. For each of the five weeks, students worked with partners from public accounting firms to research and present conclusions to real problems provided by the partners. Using creative design and delivery, accounting programs can adapt to the rapidly changing standards of the profession. Merging accounting practice into the classroom is one way to do that.

INTRODUCTION

Format for the Course

Over the past decade, the accounting profession has increased the emphasis on research, problem solving, critical thinking, and communication skills for entry level staff and candidates for the CPA Exam. As early as 1986, the Bedford report (AAA) advised "educational experiences for students that require them to be active, independent learners and problem solvers rather than passive recipients of information." The Accounting Education Change Commission (1990) continued this advice, "Courses should focus on both basic concepts and the application of the concepts in real-world environments…students…should identify and solve unstructured problems." Problem-Based Learning (PBL) is one approach to providing this type of educational experience. It is a tried and true method of instruction that has been used with great success in the study of medicine. The first step in PBL is to introduce complicated, relevant real-world problems that are neither structured nor easily solved. The student then examines the problem, which may not contain all the necessary information. Through questioning and research, the student finally identifies appropriate discipline relevant theories in order to suggest solutions.

Hansen (2006) recommends PBL be used in Accounting Education. He echoes Duch (2001) insisting that good PBL uses higher cognitive skills than the typical textbook accounting problems. Hanson contends, "PBL can foster students to think critically and solve complex problems, find and use learning resources, work in teams, use effective communication skills, and become continual learners." The NASBA curriculum plan, recent revisions to the requirements to sit for the Exam enacted by the Texas State Board of Public Accountancy, and the format and content of the computer based CPA Exam bear evidence of this. This paper describes a relevant and rigorous design for a graduate accounting course that encompasses these objectives and uses Problem-Based Learning.

Implementation Guidelines

Initially, the course was designed for a five week plus one day summer session. Classes met on a Thursday and then Monday through Thursday for the remaining weeks. Even though the class was officially scheduled to meet from 8:30 am – 11:00 pm for three hours of course credit, upon enrolling in the class, students committed to meet each day from 8:30 am – 2:00 pm. In exchange, the instructor did not assign any out of class assignments, and there were no exams. On the first day of class, the instructor explained the course format, objectives, expectations, and how to meet those expectations. Then, the instructor helped students gain access and navigate the FASB Codification – the primary research database used in the course. For each of the five weeks thereafter, students worked with partners from different public accounting firms to research and present conclusions to problems presented by the partners that they had dealt with in their practice.

Five partners agreed to help with the course, and each partner covered one week. The partners committed to be available for a brief conference call on Monday morning, to be on campus at New Mexico State University for the student presentations on Thursday, and to electronically submit review notes of the student's work each night during the week. The partners from BDO (San Diego, CA), Ernst & Young (Austin, TX), Grant Thornton (Albuquerque, NM), Meyners + Company (Albuquerque, NM), and Moss Adams (Albuquerque, NM) travelled between 250 and 700 miles to be on campus.

Each week of the course followed the same format. Between 7:30 am and 8:00 am on Monday morning, the instructor posted the weekly case problem that had been provided by the partner to the course web site. At 8:30 am, the students met in class for a 15 – 20 minute conference call with the partner. During the conference call, the partner would give an overview of the problem, give some hints or suggestions, and answer any questions that the students had at that point. Generally, the students were too overwhelmed during the conference call to have questions. In most, but not all, cases, the partners offered to be available during the day via email if the students thought of any immediate questions that they wanted answered. After the conference call, students moved to the adjacent computer lab where they worked in their pre-assigned groups of four to begin their research and prepare the first draft of their research memorandum. By 2:00 pm, student had to post the first draft of their memo to the course web site. The students found this to be a very challenging deadline, but the deadline was absolute with no exceptions. Sometime between 2:00 pm on Monday and 8:00 am on Tuesday, the partner would log onto the course web site, read the memos, and post review notes. On Tuesday at 8:30, students met in class for thirty minutes to one hour to review the Monday memos and notes. Next, they again moved to the computer lab to continue their research, prepare the second draft of their memo, and provide documentation of how they cleared the Monday review notes. The revised memo and the document clearing the review notes had to be posted to the course web site by 2:00 pm. On Tuesday night, the partner provided a second set of review notes. On Wednesday morning, the students met in class again to review the Tuesday memo and review notes then moved to the computer lab to complete their research, prepare the final draft of their memo, prepare a document clearing the Tuesday review notes, and prepare a PowerPoint presentation of their analysis and conclusions. The final memo, the document clearing the review notes, and the PowerPoint slides all had to be posted to the course web site by 2:00 pm. On Thursday at 10:00 am, the students met in class, where each group presented their research and conclusions to the instructor and partner. The instructor and partner each challenged their analysis and debriefed the problem. After the presentations, the partner treated the students to lunch. On Monday through Wednesday, the accounting department provided lunch for the students so that they would not lose valuable time that they needed for their research.

The five case problems for the course are presented in Appendix A. By coincidence, all of the case problems are related in some way. The first, from BDO, dealt with a relatively straightforward business combination and the more complex deferred tax issues that arise as a result of the combination. Most of the students had not had a course on mergers and acquisitions, so they learned business combinations from reading the FASB pronouncements. The students had to use their judgment to decide whether the acquiring company should recognize a deferred tax asset from the acquired net operating loss carryforward and whether a valuation allowance should be recorded. The second case, from Meyners + Company, presented a more complex business combination problem. The combination involved five general transactions. The students had to identify that one was not qualified as a business combination and should therefore be treated as an asset acquisition. Two of the remaining four were straight forward business combinations that would be accounting for using the acquisition method. One transaction was clearly under common control, so pooling-type accounting should be used. This transaction posed some challenge for the students because the issue of common control is not clearly defined in the standards. The most significant transaction of the five required the students to use a significant amount of judgment in their conclusion. Under a strict application of the standards, the transaction qualified for the acquisition method of accounting, but, in principle, the transaction seemed to be under common control so a pooling-type method should be used. Note that the fact pattern of this case stated that some of the entities involved in the business combination had previously been consolidated under FIN 46(R). The third case, from Grant Thornton, addressed the issue of whether an entity should be consolidated under FIN 46(R) and, if so, by whom. Aside from the inherent complexities of dealing with FIN 46(R), students had to be able to identify the primary beneficiary. In the problem, the primary beneficiary changed based on whether or not the entity remained solvent. To identify the primary beneficiary, the students had to read and understand a waterfall analysis. The fourth case, from Ernst & Young, again dealt with a business combination. The business combination in this case included a continuing ownership interest. The business combination was financed by the issuance of convertible, redeemable preferred stock. Students had to determine how to account for the continuing ownership interest and the preferred stock, which was not mandatorily redeemable. Students also had to be aware of and comment on the magnitude of goodwill in this case. The fifth case, from Moss Adams, addressed a health care company that had been rapidly expanding by building new hospitals. To finance the expansion and operations, the company had arranged several forms of financing. This financing included the issuance of subordinated notes payable that included warrants with attached put options and the issuance of convertible, mandatorily redeemable preferred stock. The students had to determine how to account for the warrants and put options, identify that the preferred stock was mandatorily redeemable and specify the appropriate accounting treatment, identify what interest should be capitalized, and determine the capitalization rate which would include the dividend/interest rate on the mandatorily redeemable preferred stock, since it would be treated as a debt instrument. In addition, the partner asked the students to identify any audit issues that should be of concern for the company. The students had to recognize the possibility that the company could be in danger of violating debt covenants. In short, each of the cases pushed the students to not only read and understand the original pronouncements but to also critically interpret and apply the standards and to present their analysis in a clear and meaningful way.

Classroom Experience

The course created a unique and challenging experience for the students, and their response was generally positive. The complexity of the case problems, the reality of presenting their analysis to partners from firms that actively recruit on campus and the daily 2:00 pm deadline resulted in a significant and noticeable amount of pressure and stress for the students. One student commented that he could not believe that a six hour class could fly by so fast. Free riding was not a problem in the groups, but each of the groups had to deal with some group related issues at some point during the class. All of the students were capable and motivated and used to being the leaders of their groups. Ultimately, opinions and personalities clashed. There was simply too much to do not to cooperate, so the students had to learn how to work together more so than in any other group setting that they had experienced before. The students also had to learn how to adapt to the styles of the different partners. Some partners gave extensive review notes with quite a bit of guidance. Others gave review notes that were short, to the point, and answered the questions asked by the students but were oftentimes not very helpful. As the course progressed, the students got better at identifying the relevant authoritative literature, thinking about the guidance provided, and asking relevant questions regarding the application of the standards to the fact of the cases. All of the comments as well as the numerical data from the course evaluations are included in Appendix B. Students seemed to genuinely appreciate the learning opportunity and challenge they received from the course.

The partners were even more enthusiastic about the class than the students. They were generally, and sometimes significantly, impressed with the quality of work, professionalism, and enthusiasm that they saw from the students. One partner commented that seeing what the students could do had caused him to raise his level of expectations for his staff. The partners also commented that they received some personal benefit by being invigorated by working with the students and sensing their energy. Without being asked, all of the partners readily volunteered to participate in the course again. Two of the partners presented new cases to reflect more recent problems they had dealt with in their practices and to challenge the students at an even higher level. See Appendix C for the new cases.

Although the class was an overall great experience for the instructor, it was surprisingly time consuming. Planning began in early spring for the class that was scheduled for the first summer session. The planning involved scheduling the partners and working with them to develop and edit the case problems. The partners provided review notes and other feedback, but the instructor retained sole responsibility for assigning grades. The instructor provided feedback, mostly of an editorial nature, on the daily memos. Students' grades were based on the final drafts of the memos, the PowerPoint slides, the presentation, and the discussion. Individual grades were function of the group grades and weekly peer evaluations. The instructor remained available to the students between 8:30 am and 2:00 pm during the day for consulting purposes. Also, the instructor took care of all of the arrangements for lunches. It was never the intent, but having the partners "teach" the class certainly did not create free time for the instructor. Simply coordinating and managing a course of this nature is requires a nontrivial amount of effort. The effort is well worth it when you see the students move to a new level.

Limitations and Conclusion

This course design has some apparent limitations. First, it was designed for a summer school format with classes meeting over consecutive days. Also, the students self-select and are prescreened to ensure that they can and will commit to the time block necessary. Finally, the course was designed around financial accounting research content. The research database, the FASB Codification, is readily available at a minimal cost. It remains to be seen if the course design is adaptable when any of all of those design characteristics change. The general format is currently being used in a graduate auditing class, and plans are in place to apply the format on a limited basis in an upper division tax class.

Adding courses or otherwise restructuring curriculum is, by design, a slow and bureaucratic process at most universities. By being flexible and creative in the design and delivery of the content of existing courses, accounting programs can more readily adapt to the rapidly changing standards of the profession. As shown by this course format, merging accounting practice into the accounting classroom is one way to do that. The goals of PBL are to help students "(a) think critically, analyze, and solve complex real-world problems; (b) find, evaluate, and use learning resources; (c) work cooperatively in teams; (d) demonstrate effective communication skills; and (e) use content knowledge and intellectual skills to become continual learners" (Hansen, 2006). Students involved in this course accomplished these goals.

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APPENDIX A - ORIGINAL CASE PROBLEMS

CASE 1
BUSINESS COMBINATIONS/ACCOUNTING FOR INCOME TAXES
Guest Instructor – Shelly McGuire, BDO LLP

Facts

Bread Corporation ("Bread") is a manufacturer engaged in the production of bread, crackers and other grain products. On May 30, 2007, Bread acquired the stock of Candy Corporation ("Candy"), a manufacturer of confection goods, for $10 million cash. *(Hint – Neither Bread nor Candy elected under IRC Sec. 338 to treat the transaction as an acquisition of assets constituting a trade or business.)*

Historical Bread

Bread was formed in 2004 as the result of a reverse merger and is a privately-held entity. Bread sustained a small operating and tax loss in 2004, but has since been profitable. Bread's trailing three-year Income Statements have reported the following:

TABLE 1

	December 31			May 30
	(thousands)			
	2004	2005	2006	2007
Sales	$2,000	$7,000	$7,500	$4,000
COGS	1,780	5,000	5,250	2,000
Gross Profit	220	2,000	2,250	2,000
SG&A	1,000	1,100	1,300	800
Net Income <Loss>	<780>	900	950	1,200

Bread's Balance Sheet as of May 30, 2007 follows:

(thousands)

Cash	$ 25	Accounts Payable	$ 100
Accounts Receivable	150	Deferred Tax Liability	200
Allowance for Bad Debts	<20>	Line of Credit	50
Inventory	1,257	Common Stock	50
PP&E	2,500	Retained Earnings	2,270
Accumulated Depreciation	<1,250>		
Deferred Tax Asset	8		
Assets	$2,670	Liabilities & Equity	$2,670

Historical Candy

Candy was formed in 2006 by one shareholder, Mr. Smith. Mr. Smith developed a unique, sugar-free frosting, and contributed the recipe and patent to Candy. Mr. Smith graduated at the top of his culinary class, however he did not have any education or experience in business, and did not hire outside financial advisors. As a result, Candy found itself in financial trouble.

Candy's 2006 and year-to-date 2007 Income Statements reported the following:

TABLE 2

	December 31, 2006	May 30, 2007
	(thousands)	
Sales	$ 500	$ 300
COGS	1,580	900
Gross Profit	<1,080>	<600>
SG&A	1,500	700
Net Income <Loss>	<2,580>	<1,300>

Candy's Balance Sheet as of May 30, 2007 reported the following. *(Note – Candy's accountants did not adopt FAS109 and did not account for income taxes.)*

(thousands)

Cash	$ 1	Accounts Payable	$ 500
Accounts Receivable	100	Note Payable	5,016
Allowance for Bad Debts	<40>	Common Stock	100
Inventory	1,100	Retained Earnings	<3,880>
PP&E	800		
Accumulated Depreciation	<225>		
Intangible Assets	100		
Accumulated Amortization	<100>		
Assets	$1,736	Liabilities & Equity	$1,736

As of May 30, 2007, Candy has a tax loss carryover of $4,000,000 and has taken $160,000 more of tax depreciation than book depreciation on its property, plant & equipment. Candy has not deducted the bad debt reserve for tax purposes. All other assets and liabilities have the same basis for tax as they do for GAAP.

The Transaction

Bread has been Candy's primary customer since Candy's formation. Candy's unique sugar-free frosting has been used in many of Bread's products to create a one-of-a-kind packaged dessert that has been very successful and produces high margins. When they learned of Candy's financial troubles, Bread's shareholders made a generous cash offer to Candy's shareholder for his stock.

The new consolidated enterprise obtained a valuation report from a third-party specialist immediately after the transaction closed to determine how to allocate the purchase price. The report indicated that that 10% should be allocated to property, plant & equipment; 15% should be allocated to inventory; and 20% should be allocated to recipe and trademarks. Cash and accounts receivable should receive an allocation equal to their book value, and the remainder should be allocated to goodwill.

The new consolidated enterprise expects its future effective tax rate will be 40%, consisting of a 35% federal rate and a 5% state rate.

Questions

1. What effect does purchase accounting have on Candy's Balance Sheet (including its tax accounts)?
2. Should Candy recognize its deferred tax asset? What analysis should management undertake to decide?

CASE 2
BUSINESS COMBINATIONS
Guest Instructor – Brandon Haines, Meyners + Company

Facts

- ABCE is owned by three individuals ("A" with 70% interest, "B" with 26% interest and "C" with 4% interest).
- The stockholders of ABCE are proposing the creation of a new limited liability company, ABC Holdings LLC (Holdings).
- ABCE will contribute its 100% wholly owned subsidiaries - ABC Services, LLC (ABCS), ABC Leasing, LLC (ABCL) and XX Daisy Logistics, LLC (XX Daisy) to Holdings.
- Two of the stockholders ("A" & "B") intend to contribute their interest in ABC Moving LP (ABC LP) and ABC Moving Management LLC (ABC Mgmt) to Holdings. ABC LP owns the property that ABCL, ABCS and XX Daisy lease for their facilities. In 2005 and 2006 this entity was consolidated with ABCE under FIN46(R) *Consolidation of Variable Interest Entities.*
- One stockholder ("A") intends to contribute his 100% interest in a newly formed LLC which will own real estate (HHH Property) and associated debt. It is the intention of ABCE to eventually build a facility to be used in its operations on this property.
- "A" intends to contribute his 100% interest in ZZ Leasing LLC (ZZ Leasing) and ZZ Leasing Management LLC (ZZ Mgmt) to Holdings. ZZ Leasing operates the EZ Lease franchise for ZIP (another entity owned by some of the stockholders).
- Also, "A" intends to contribute his receivable from ABCS and his personal debt associated with this receivable.
- ABCE will receive an LLC membership interest in Holdings (approximately 79%) for the contribution of ABCS, MLTL and XX Daisy. B will receive an LLC membership interest in Holdings (approximately 8%) for his contribution of his interest in ABC LP and ABC Mgmt. "A" will receive an LLC membership interest in Holdings (approximately 13%) for his contribution of his interest in ABC LP, ABC Mgmt, ZZ Leasing and ZZ Mgmt, the new HHH property LLC and the receivable from ABCS with the associated debt.
- Anticipated ownership of ABCE after the restructure will remain the same with "A" with 70%, "B" with 26% and "C" with 4%.
- See the following table for voting stock percentages.

TABLE 1

	ABCS, ABCL & XX Daisy	ABC LP & ABC Mgmt	ZZ Leasing & ZZ Mgmt	HHH property (new LLC)	"A" receivable and debt
Control structure before restructure (voting stock ownership)	"A" (5.67%) "B" (5.67%) "C" (0.24%)	Combined: "A" - 50% "B" - 50%	"A" – 100%	"A" – 100%	"A" – 100%
Control structure after restructure (voting stock ownership)	"A" (5.67%) "B" (5.67%) "C" (0.24%)	"A" (5.67%) "B" (5.67%) "C" (0.24%)	"A" (5.67%) "B" (5.67%) "C" (0.24%)	"A" (5.67%) "B" (5.67%) "C" (0.24%)	Holdings 100%

Questions
How should these various contributions be recorded?
Are these transactions between entities under common control?
If under common control, is there a change in control?

CASE 3
INVESTMENTS IN OTHER ENTITITES
Guest Instructor – Lisa Todd, Grant Thornton LLP

Development, LLC

The following problem is derived from actual issues encountered on a Grant Thornton client.

Company Information

You are completing the 2008 audit of Development, LLC. Development, LLC began operations on October 1, 2005 for the purpose of acquiring and developing real estate for commercial and residential use throughout the United States. Through September 30, 2008, the Company had accumulated net losses of $100 Million.

Development, LLC has a portfolio consisting of consolidated variable interest entities, investments and direct ownership investments. The Company takes active management roles with these majority-owned direct investments.

During January 2008, the Company invested in the equity of Spear, LLC for cash consideration of approximately $21.1 million, which included approximately $73,000 of acquisition expenditures and contributed capital of $21.0 million.

Spear, LLC was organized to develop a 42-story condominium tower in downtown Los Angeles, California. Spear is capitalized by $34.4 million of members' contributed capital (which includes the $21.0 million was invested in January 2008 by Development, LLC). The project is financed by a senior lender for $118.0 million, a mezzanine lender for $11 million and an $8 million unsecured loan from another third party.

The Company possesses a 50.5% ownership interest in Spear, LLC. The other interest in Spear is held by Noodles Partnership. Noodles interest is a carried interest, meaning they have not may any cash contributions to the Spear, LLC. The Noodles Partnership does not have any equity at risk for their 20% interest, but in the event of a total failure of the Spear, Noodles partnership has provided additional subordinated financial support, in the form of this guarantee to the senior lender in the amount of $118 million.

The project operation is managed daily by Randy Noodles, Noodles Partnership. The enterprise has appointed two designees with powers to direct business on behalf of the partners: Randy Noodles appointed by the non-Development partners and Chris Cookie by Development, LLC. Construction of the condo tower is scheduled for completion December 2009 and projected to be substantially completed on time and within the project budget.

The enterprise risk resides primarily in the ability to perform construction as originally scheduled and sell the units as projected for revenue proceeds. The financing to complete the project is in place through April 2010. Spear is projected to provide investors a Proforma net profit before distribution of $45 million. Noodles partnership is granted a 20% profit participation for its operational management of the project. Cash distribution from Spear is controlled by Development, LLC, per the operating agreement.

The Spear LLC project provides a positive undiscounted operating cash flow per the most recent Proforma. Additionally, the rentals ($2.20 SgFt) of units Proforma support a positive cash scenario. The cost of construction build out materials is 98% locked in fixed price contracts. The market sales price for these units start in the mid $200's (over 59% with pricing under $400k with a total average sales price of $424k, which is in the average sales price range for the Los Angeles MSA). Condo unit sales are projected to commence January 2009. Controls exist for approval of the project sales and cost change orders per the operating agreement and the senior loan agreement. The agreement also requires Spear to pre-sales 25% of the units prior to closing the first condo unit. Preliminary condo sale interest lists for this uniquely located project in downtown Los Angles provides an indicator that the project should be able to exceed the presale requirement.

Development LLC has prepared a waterfall analysis with regards to the performance of Spears, LLC (see attachment).

Something to Consider (As You Might Have Noted on Your Other Case Studies)

Last year, students had little problem in identifying the issue, but generally did not address the proper accounting in sufficient detail or fully think through all the implications, which occurs frequently in actual practice. Issues that seem straightforward can often cause restatements due to differing circumstances and interpretations from one client to the next. Please take all facts of the case into consideration when addressing this issue.

Questions:

1. Should Spear, LLC be consolidated by Development, LLC? I am looking for a well-defined, step by step conclusion regarding interim considerations under VIEs.

The partner included an internally generated waterfall analysis, which is available from the authors on request.

CASE 4
BUSINESS COMBINATIONS
Guest Instructor – Darin McNelis, Ernst & Young

General Background

Las Cruces, Inc. (the "Company") is a leading online marketplace for college-related paraphernalia, and connects consumers with multiple retailers. The Company's website, www.lascruces.com, enables consumers to search for, compare and apply for a variety of college-related memorabilia. The Company provides consumers with research, news articles, expert advice and online tools to help them select purchases and gifts based on their individual needs. Its online marketplace matches consumers actively seeking college-related materials with retailers, and allows retailers to solicit and approve purchases in a manner that is more cost effective than traditional offline channels.

We have been engaged to audit the consolidated balance sheet of Las Cruces,, Inc. (the "Company") as of December 31, 2007 and the consolidated balance sheet of Las Cruces, L.P. (the "Predecessor") as of December 31, 2006, and the related consolidated statements of operations, stockholders equity and partners' capital, and cash flows for the period from October 31, 2007 (inception) to December 31, 2007 (representing the Company); and the period from January 1, 2007 through October 30, 2007, the year ended December 31, 2006, and the period from March 25, 2005 to December 31, 2005 for Las Cruces, L.P. (representing the Predecessor); and the period from January 1, 2005 through March 24, 2005 for NMSU, L.P. (representing the Predecessor's Predecessor).

To recap, During the three years ended December 31, 2007, there have been three separate entities operating as the Company, as follows:

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NMSU, LP+++++++++LasCruces, LP+++++++++++++++++  Las Cruces, Inc.
|----------------|--------------|--------------------------|----------|-------------------|
1/1/05           3/24/05     12/31/05                 12/31/06    10/30/07       12/31/07
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NMSU, LP (Original Company) held the assets of the business for the period from January 1 to March 23, 2005. At that time, the assets of the business were contributed to a new previously non-existent entity, Las Cruces, LP (Predecessor) which was the business from March 24, 2005 through October 30, 2007. At that time, the assets of the business were sold to a newly created entity, Lac Cruces, Inc. (Successor), the Company that is the business today, which is wholly owned by Calk Holdings, Inc.

Acquisition of Predecessor Entity

In September 2007, a syndicate of investors led by Calk Ventures created a holding company called Calk Holdings, Inc. to purchase all assets of Las Cruces, LP (the Predecessor), an operating company. Las Cruces, LP (the Predecessor) had net tangible assets of $10 million.

On October 30, 2006, the Company issued approximately 9.9 million shares of Series A redeemable preferred stock (Series A) and 1 million shares of common stock to the investors and raised approximately $63.8 million. $63,799,000 was allocated to the preferred shares as the shares were ultimately redeemable for the initial issuance price plus any future accrued dividends. The common stock was given a value of $1,000, based on its par of $0.001. Simultaneous with the preferred stock issuance, the Company obtained approximately $75 million in bank debt to help fund the acquisition.

The Company then acquired the Predecessor by paying approximately $133.5 million cash to the Predecessor, and issuing approximately 2.2 million shares of Series A Preferred Stock valued at $16,504,747 and 1,000,000 shares of common stock. The former owner was paid in cash and also retained approximately a 20% ownership in the new company.

Preferred Stock Features

As mentioned above, the Company issued Series A Convertible Redeemable Preferred Stock. The conversion characteristics for the Series A Stock are as follows: each outstanding share of preferred stock will be converted into i) the number of fully paid and non-assessable shares of common stock which results from dividing the conversion price per share in effect for the preferred stock at the time of conversion into the conversion value of the preferred stock and ii) one fully paid and non-assessable share of Series B redeemable preferred stock per share of preferred stock (i.e. 1 share of Series A converted into 1 share of Series B + 1 share of common stock). The business purpose behind these preferred stock arrangements is to allow the holders of the Series A instruments to convert into the combination of both Series B preferred stock and common stock. In addition, this allows the holders to redeem the Series B shares while maintaining their ownership percentage in the Company (i.e., have no dilution).

Questions:

1. What is the proper accounting treatment for the purchase of the assets of Las Cruces, LP (Predecessor)?
2. What affect does the former owner's continuing ownership have on the accounting treatment?
3. How should Las Cruces, Inc. (the Company) account for the preferred stock?
    a. Where on the balance sheet should these financial instruments be classified?
    b. How should these financial instruments be measured each year?
    c. Does EITF 00-27 Application of Issue No. 98-5 to Certain Convertible instruments apply to these financial instruments?

CASE 5
PREFERRED STOCK/DEBT FINANCING
Guest Instructor – Brandon Fryar, Moss Adams

MA Healthcare, Inc.

The following problem is derived from actual issues encountered on a Moss Adams healthcare client. Certain facts have been changed to protect the innocent.

Company Information

You are completing the 2006 and 2007 audits of MA Healthcare, Inc. MA Healthcare, Inc. was formed in 2004 for the purpose of establishing free-standing long-term acute care hospitals across the Rocky Mountain region. The Company builds hospitals from the ground up, and all are very similar in design and construction, which results in cost savings and shorter turnaround time through the construction cycle. Through December 31, 2007, the Company had accumulated net losses of $100 Million.

At December 31, 2007, the Company had 12 hospitals that were in operation, including 4 hospitals that received their certificate of occupancies in the months of May, June, October and November of 2007. The remaining 8 hospitals were completed and placed in service in 2006. At December 31, 2007, the Company also had an additional 2 hospitals under construction, which are expected to be completed during the first quarter of 2008. The cost of a hospital, comprised of land and building, ranges from $11M to $14M depending on the hospital's location and local building codes. FF&E for each hospital is an additional $3M.

To fund the Company's development and start-up activities, the Company entered into the following financing agreements in 2006 and 2007:

- Individual hospital construction loans, secured by individual hospitals, with local banks, at rates of LIBOR plus 3%. Construction loans are interest only loans for the first year and convert to 10 year amortization thereafter.
- Individual hospital equipment loans, secured by individual hospital equipment, with local banks, at rates of LIBOR plus 3.75%. Equipment loans are amortized over 10 years.
- Individual hospital working capital loans, secured by A/R of individual hospitals, with local banks, at rates of LIBOR plus 2.75%. Working capital loans are amortized over 10 years.
- A corporate working capital revolver, limited to $25 Million, of which $15M was outstanding at December 31, 2007, at LIBOR plus 3.75%. Principal and interest due 2017.
- Issued Subordinated Note Payable of $10 Million at 3% (Interest payable monthly, Principal due 2016), with attached warrants for 150,000 shares of common stock. The warrants have an attached put option whereby the holder can put the shares back to the Company for the then appraised value of the common stock.
- Issued preferred stock of 7 million shares for a total of $70 Million. The preferred stock is subject to the following dividend rights and redemption provisions:

Section 6.2, Dividend Rights

> (a) Holders of the Preferred Shares, in preference to the holders of any other stock of the Corporation including the Common Shares, shall be entitled to receive, but only out of funds that are legally available therefore, cumulative cash dividends at the rate of ten percent (10%) of the Original Issue Price (as defined below) per annum compounded annually on each outstanding share of Preferred Shares. The "Original Issue Price" of the Preferred Shares shall be $10.00 per share. Such dividends shall accrue in arrears on each share of Preferred Shares from the date of original issuance of each such share, whether or not earned or declared, and shall be payable (i) when, as and if declared by the Board of Directors; (ii) upon the liquidation, dissolution or winding up of the Corporation; or (iii) upon any redemption of Preferred Shares pursuant to Section 6.5 below.

Section 6.5, Redemption

> (a) The Corporation shall, to the extent it may lawfully do so, redeem the Preferred Shares in their entirety upon the earlier of (i) any liquidation, distribution, or winding up of the Corporation; (ii) the closing of the Corporation's first public offering of its Common Shares; or (iii) December 22, 2009, each of which shall be deemed a "Redemption Date."

Some Basic Terminology / Guidance to Help You Get Started

In finance, a warrant is a security that entitles the holder to buy stock of the company that issued it at a specified price, which is usually higher than the stock price at time of issue. Warrants are frequently attached to bonds or preferred stock as a sweetener, allowing the issuer to pay lower interest rates or dividends. They can be used to enhance the yield of the bond, and make them more attractive to potential buyers. Warrants can also be used in private equity deals. Frequently, these warrants are detachable, and can be sold independently of the bond or stock. *Generally, you can substitute the word options for warrants as they essentially have the same meaning.*

A put option (sometimes simply called a "put") is a financial contract between two parties, the seller (writer) and the buyer of the option. The buyer acquires a short position offering the right, but not obligation, to sell the underlying instrument at an agreed-upon price (the strike price). If the buyer exercises the right granted by the option, the seller has the obligation to purchase the underlying at the strike price. In exchange for having this option, the buyer pays the writer a fee (the option premium). An American put option allows exercise at any time before expiration. *In this example, the put option allows the warrant holder to sell the shares back to the Company.*

Please don't spend time trying to measure the put option or warrant's value. You are welcome to include the proper methodology for valuation in general terms in your memo, but for purposes of this case, I am looking more to get you to reach a conclusion on the proper accounting for the transactions and the rationale for that accounting. To the extent it helps you in your write-up, you can assume a value of $2,500,000 for the warrants with the attached put option.

Also, the third item in the bullet below: Last year the students had little problem in identifying the issue, but generally did not address the proper accounting in sufficient detail or fully think through all the implications, which occurs frequently in actual practice. Issues that on their surface seem straightforward, can often cause restatements due to differing circumstances and interpretations from one client to the next. Please take all facts of the case into consideration when addressing this issue.

Issues

- Based on these facts, the engagement team identified 3 technical accounting issues, 1 audit reporting issue, and 1 audit presentation issue. The accounting issues pertain to: 1) preferred stock, 2) the subordinated notes and related warrants, and 3) one matter indirectly relating to accounting for interest and/or dividends. The audit presentation issue relates to proper presentation of these items in the financial statements.

- For the issues you identify, either individually or collectively, please prepare a memo to present the issue and your conclusions. Please reference the title of the authoritative literature and provide *key excerpts* of the authoritative literature in your memo(s). Please ensure memo(s) clearly make the connection between the authoritative literature and the facts as presented.
- Are there any other issues that you uncovered?

APPENDIX B – UNEDITED COMMENTS FROM COURSE EVALUATIONS

Course Evaluations ACCT 564 – Applied Accounting Concepts Summer Session I 2009					
	a	b	c	d	e
The instructor showed a thorough knowledge of the course material.				3	5
The instructor communicated information effectively.				2	6
The instructor showed a good rapport and attitude towards students.			1	1	6
The course was well organized.				1	7
The instructor was fair in grading.			3	3	2
The instructor had high achievement standards in this class.					8
As a result of this class, I developed specific skills, competencies, and points of view needed by professionals in the field most closely related to this course.					8
Students enrolled = 12; Responses = 8 a = strongly disagree b = disagree c = neutral d = agree e = strongly agree					

Comments:

(The instructor) is doing a great job of keeping the teams on the right track. He provides helpful insight when the students have questions and he makes himself available to hear students concerns or issues.

Continuous feedback and help. This class was one of the most difficult and stressful classes I have ever taken. Dealing with group synergy issues, time constraints, and wrapping our heads around some pretty difficult case studies proved to be very exhausting mentally.

Lunch conversations are interesting and helpful. This is by far the best class I have ever taken. The class engages around a large case that takes days to work through with a team that really digs into GAAP and has us apply it to the case. I feel I have worked harder and learned more these past few weeks than in any class before.

I really liked this class. Even though it was hard, I feel it has improved my research skills and made me more comfortable at presenting. I like that we got lunch every day and that the class started at 8:30 and ended at 2:00 so the entire day was not used up.

(The instructor) engages with the students and makes them think through the issues. He cares but is unwilling to give answers for nothing. His method of making the students apply themselves is fantastic.

I believe that having the class from 8:30 – 2:00 was a good time slot. I also preferred weeks 4 and 5 when groups were met with individually for critiquing. It enabled other groups to keep working while one group was being critiqued. I also preferred the week when the partner and (the instructor) chose which team would present first. The presentations almost seemed to build on one another.

(The instructor) has strong expectations and does not waiver from student pressure. He forces the students to think and take it to the next level. You do not see this in a lot of professors.

I really enjoy the criticism. I feel that he does a very good job in telling you what you need to fix so that you can improve yourself. I enjoy how he stays hands off while still being very involved with comments and suggestions. I really like the aspect of the class of working together in groups. I also think that it is good that the groups are random; it brings a new aspect which we will face in the real world. Sometimes you might not always get along, but you must work through your differences.

APPENDIX C – SUMMER 2010 CASE CHANGES

CASE 6
JAKE'S CONSTRUCTION, INC. - ACCOUNTING FOR VARIABLE INTEREST ENTITIES
Guest Instructor – Brandon Fryar, Moss Adams

Background

Moss Adams will be auditing Jake's Construction, Inc. (Company) for the year ended September 30, 2009. Previously, the Company was audited by other auditors, who expressed an unqualified opinion on the financial statements. The Company is a general contractor engaged in construction of industrial and commercial buildings throughout New Mexico.

The Company leases their Albuquerque home office building under a long-term agreement from BBB, LLC (BBB) in which certain of the Company's shareholders have ownership interest. The lease was entered into on May 1, 2006 and expires on April 30, 2011.

BBB is owned by shareholders of the Company as follows:

TABLE 1

	BBB Ownership	Company Ownership
Britanie	33.33%	40%
Bradie	33.33%	15%
Brody	33.33%	12%
	99.99%	67.00%

Profit and loss of BBB are distributed based on member ownership interest based on the Operating Agreement. Each member of BBB personally guaranteed the BBB's notes payable of $1.05 million, based on their ownership interest or $350,000 each.

Aside from the lease agreement, there are no other transactions between the Company and the LLC. BBB was formed on April 12, 2006, and there have been no changes in BBB ownership since that time. Further, the lease agreement with the Company remains the only lease agreement of BBB.

Britanie is the CEO and founder of the Company, Bradie is the COO, and Brody was the CFO through June 2009, at which time his employment with the Company was terminated. During 2009, Brody filed suit against Britanie and Bradie seeking to dissolve BBB such that the assets can be liquidated and distributed to the partners.

At formation of BBB on April 12, 2006, each member contributed $60,000 as an initial capital contribution. In April 2006, BBB obtained a loan from a local financial institution for $1.05 million. To secure the financing, the bank required personal guarantees of each of the members for $350,000 per member. In April 2006, BBB subsequently purchased a land and building, completed necessary improvements for a total cost of $1,210,000.

Moss Adams was able to obtain the most recent financial statement of BBB as of and for the year ended December 31, 2008, which was unaudited, but compiled by a CPA. See Attachment A for a copy. Moss Adams confirmed the outstanding balance of the note payable on the books of BBB without exception as of December 31, 2008.

Moss Adams has obtained a copy of the lease agreement between the Company and BBB. See Attachment B. Moss Adams has also obtained a copy of a lease agreement for a similar property in the area from a local real estate broker. See Attachment C.

Issue

Moss Adams has reviewed the prior auditor's workpaper files. Of specific interest was their conclusion on FIN 46R with respect to BBB, as per review of the prior year financial statements and discussions with management, "the Company determined it was not the primary beneficiary of BBB". Moss Adams was not provided any documentation to support this conclusion. Moss Adams asked the CFO, who is new to the entity, and she has searched and cannot find any documentation at the Company and believes the auditor handled it. Per subsequent conversation with the Controller, Moss Adams is told that she recalls being asked a few questions by the prior auditor, but they were "basic questions". She knows that the prior auditor was provided the lease agreement, as that was required for the lease commitment disclosure in the financial statements, but no other information was provided.

Moss Adams needs to conclude on the applicability of FIN 46R to BBB and if applicable, determine if Moss Adams can support the prior conclusion that the Company is not the primary beneficiary of BBB.

Moss Adams wants this issues addressed prior to our fieldwork on the current year audit. Please prepare a memorandum for the audit file, and be prepared to explain to management your conclusions and the basis for your conclusions.

To assist you in the organization of the memo, Moss Adam's FIN 46R checklist has the following steps that you may consider:

1. If the initial determinations of whether Entity B (BBB) is a variable interest entity and whether the Entity A (Company) is the primary beneficiary have previously been made, determine if there have been any reconsideration events under FIN 46R. If so, proceed to next step, and if no reconsideration events, you may stop here.
2. Determine if the Entity B is scoped out under FIN 46R.
3. Identify the variable interests in Entity B – Please list all known implicit and explicit variable interests held by Entity A and its related party group in Entity B.
4. Determine whether as a group, the holder of the equity investment in Entity B have insufficient equity at risk or lack the characteristics of a controlling financial interest. If they do, continue to the next step, and if not, you may stop here.
5. Determine whether as a group, Entity A and its related parties are the primary beneficiary of Entity B. If yes, then continue to next step, in not, you may stop here.
6. Consider whether Entity A is the most closely related of all the related parties to entity B.

CASE 7
ACCOUNTING FOR UNCERTAIN TAX POSITIONS
Guest Instructor – Shelly McGuire, BDO Seidman LLP

Note, pre-codification references are used herein.

Kratos Defense Security and Solutions, Inc. ("Kratos" or the "Company") is preparing to adopt FIN 48. The Company's management has been reviewing the Company's various tax positions to determine if the ‘more likely than not’ (“MLTN”) standard is met. While they believe the MLTN standard has been met for virtually all of their tax positions, they are unsure about the following positions:

- The Company has generated approximately $250 million of net operating loss carryovers (“NOL”). The Company has been carefully monitoring the change in ownership that has occurred amongst its five-percent shareholders to determine if IRC Sec. 382 may limit the NOL carryovers. As of December 31, 2008, the Company had a cumulative 48.5% change. When reviewing the Form 13G (copy attached) filed by T. Rowe Price, the Company identified a new fund, the T. Rowe Price Small Cap Value Fund, was reported for the first time. The Company is unsure whether this fund should be treated as a five-percent shareholder or if it is an investment advisor and thus not a five-percent shareholder. If it is a five-percent shareholder, it will cause the Company to experience a greater than 50% change of ownership amongst its five-percent shareholders and IRC Sec. 382 will apply.
- In tax year 2008, the Company disallowed 45% of its meals and entertainment expenses as a nondeductible item.
- The Company disallowed the cost of its luxury suite at Petco Park for tax years 2007, 2008 and 2009.

The Company does not have any statute extensions with the IRS or any other state taxing authorities.

The Company does not have a valuation allowance on any of its deferred tax assets.

The Company has asked us to prepare the FIN 48 implementation memorandum, and to evaluate the tax positions of which they are unsure to determine if a FIN 48 reserve is necessary.

The partner included additional documentation, including Form SC 13G/A filed by T Rowe Price.