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Amazing Deals Auto Mart: Financial Reporting and Analysis of Receivables and Securitization

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ABSTRACT: Amazing Deals Auto Mart (ADAM) is a nationwide retailer of late model pre-owned premium cars. Due to the changes in the industry and economy, its senior management is concerned with a slowdown in collections and loan defaults, and is worried whether or not ADAM will meet the 2005 consensus earnings estimate of analysts. You are required to analyze the accounts receivable and allowance for doubtful accounts data to assess a possibility of earnings management. You are also required to perform financial analyses of the two financing alternatives (securitization and secured borrowing) that ADAM is considering for cash generation from receivables and to determine their effects on financial statements and ratios.

CASE

Amazing Deals Auto Mart (ADAM or the Company) is a nationwide retailer of pre-owned cars selling high quality late model vehicles, such as Audi, BMW, Lexus, and Mercedes. The company was founded ten years ago by Greg Raines, CEO, and went public five years ago. Operating 31 used car superstores in 20 states, with projected sales exceeding $2 billion in 2005, ADAM is perceived as a growth company and a leader in the automotive industry. Since the time of ADAM's IPO in 2001, its revenues and earnings have almost doubled.

Automotive retailing is the largest retail trade sector in the U.S.[1] With annual sales in excess of $1 trillion, it comprises roughly 10 percent of GDP. Within the automotive sector, car retailers with a focused strategy of selling late model used automobiles of premium brands have done well. Not only is the market for used cars twice that of new cars, it is also less volatile during the periods of economic swings. The gross margins are also higher on used vehicle sales (11 percent–13 percent) in comparison with the new vehicle sales (7 percent–8 percent). As the economy improves, buyers who move from used cars to new cars are replaced by the buyers who can now afford a later model used car. Correspondingly, as the economy deteriorates, the number of new-car buyers that move to late model used cars more than offsets the number of used car buyers that can no longer afford them.

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[1] This section is based on Kellogg's case, "U.S. Automotive Retailing in the mid-1990's (A)." Available at: http://www.kellogg.northwestern.edu/faculty/alnajjar/htm/Cases/Autoretailing%20(A).pdf.

ADAM prides itself in running high quality professionally managed used car superstores. The company makes an automobile purchase a one-stop customer-friendly experience. All vehicles are very competitively priced and sold on a fixed-price basis. The company's inventory can be searched over the ADAM website or searched via computer at each superstore. Prices are clearly marked on all vehicles and are nonnegotiable. Competitive fixed-priced extended warranty plans are also available for purchase. Sales consultants are available to assist customers and are paid a fixed dollar commission per vehicle sold regardless of the selling price or profit margin on a vehicle. The extensive inventory selection at each location is based on consumer preferences and demographics of the area. All vehicles undergo an extensive 100-point inspection program prior to sale. ADAM offers a seven-day or 350 mile, no questions asked, money-back guarantee and a 30-day limited warranty for the vehicles sold.

ADAM has a wholly owned finance subsidiary, Amazing Deals Acceptance Corporation (ADAC), that provides competitive financing for customers and additional earnings and cash flow for the company. ADAM's sales consultants collect customers' credit information and submit it electronically to ADAC. Customers are then rated by ADAC from 1 (highest quality credit/least risk) to 5 (lowest quality credit/most risk). Through 2003, ADAC only offered credit to customers rated 1 or 2 and arranged credit for customers rated 3 to 5 with third-party lenders. Beginning in 2004, however, the company started offering financing to a broader spectrum of customers. Thus, ADAC now offers credit to all customers rated 1 to 3, although terms and rates will differ for different categories.

The senior management team of the Company is proud of its accomplishments and has been rewarded handsomely by the board of directors of the Company. In 2001, when ADAM went public, the Compensation Committee of the Board instituted a compensation plan linking performance (defined as growth in earnings per share, EPS) to share awards. For the team to be entitled to the share awards in a given year, the growth in EPS had to exceed pre-specified targets (15 percent each for 2001 and 2002, 18 percent each for 2003 and 2004, and 21 percent each for 2005 and 2006).

Changes in economic conditions and the competitive landscape have challenged the automotive industry in 2005. Rising interest rates, rapidly increasing gas prices, and new entrants in the used-car superstore market have put pressure on the existing players. The "big three" automakers have started offering employee discount pricing on a number of new vehicles, and have included extended warranty contracts in the price of their vehicles. Greg Raines, ADAM's CEO, fears that this could shift buyers from used vehicles to new vehicles. Furthermore, he anticipates increased competition in the auto-financing segment of the business, since many auto manufacturers find auto financing operations to be more profitable than auto sales. Raines is worried about current-year consensus analysts' EPS estimates and ADAM's ability to maintain sales and earnings growth.

Executive Management Meeting

At the October 3, 2005, executive management meeting attended by Greg Raines (CEO), Paul Whitley (newly hired CFO), Linda Kellerman (Controller), Sidney Mueller (Vice President, Investor Relations), and Herb Pattchi (President of ADAC), a discussion ensued concerning several operating and financial issues. An edited transcript of the meeting follows:

Raines (CEO): Welcome, Paul, to our management team. Thanks, everyone, for making ADAM a successful and vibrant company. We have come a long way since our

IPO in 2001, but as you all know, the changes in the industry and economy have cast a cloud on our ability to maintain a rapid growth in sales and profits.

Pattchi (President, ADAC): Yes, especially in the current environment of increasing interest rates, I'm concerned about a slowdown in collections as well as loan defaults. And who knows whether the Fed is done raising the rates.

Raines (CEO): It appears unlikely that ADAM will make its numbers for 2005 and I fear an adverse market reaction. Linda, do you have the preliminary numbers for 2005? How do they look?

Kellerman (Controller): I sure do. Here is a comparative summary of selected financial data for the past five years (Exhibit 1). Please note that the 2005 numbers represent a combination of actual results for the first nine months, and estimates for the last three months of the year. We have historically performed better than our competitors, and 2005 results will be an improvement over 2004. But you are right, Greg. We are unlikely to meet the consensus analysts' EPS estimate for 2005.

Raines (CEO): Do you see any other problems, Paul?

Whitley (CFO): Being new, I don't have a good grasp on the situation yet, but the receivables data do not appear very comforting to me. I also noticed that we are perilously close to violating our debt covenants with some lenders. A breach of these covenants could possibly cause an acceleration of loan repayment, or an increase in the interest rate. Linda, what is the status of this?

EXHIBIT 1
Selected Financial Data
(numbers in thousands, except for the EPS data)

	2005*	2004	2003	2002	2001
Net sales	2,150,600	1,765,206	1,478,443	1,260,657	1,095,133
Auto loans generated	801,734	588,430	449,962	395,864	350,953
Bad debt expense	11,071	9,087	4,805	4,097	3,559
Net income	63,443	53,133	44,353	37,694	32,635
Number of shares	50,000	50,000	50,000	50,000	50,000
Earnings per share (EPS)	1.27	1.06	0.89	0.75	0.65
EPS (analysts' consensus estimate)	1.30	1.04	0.86	0.71	0.61
Auto loans receivable (gross)**	1,097,143	805,523	509,997	440,180	388,504
Allowance for uncollectible accounts	3,536	3,620	3,655	3,729	3,776
Auto loans receivable (net)	1,093,607	801,903	506,343	436,451	384,728
Inventories	236,610	185,325	153,712	132,405	114,428
Current assets	1,369,241	1,279,172	987,948	852,287	742,148
Current liabilities	711,098	596,285	450,065	395,100	329,112
Total liabilities	1,089,342	951,216	724,495	630,279	534,807
Total assets	1,512,974	1,419,725	1,097,720	940,714	822,781
Current ratio	1.93	2.15	2.20	2.16	2.26
Total liabilities/Total assets	0.72	0.67	0.66	0.67	0.65
Return on average assets	4.33%	4.22%	4.35%	4.27%	4.15%

* 2005 numbers represent a combination of actual results for the first nine months, and estimates for the last three months. Effective tax rate is 30 percent.

** Auto loans receivable are reported by ADAM as a current asset. Current assets consist of cash, auto loans receivable, and inventories.

Kellerman (Controller): Our major lender requires us to maintain a 2:1 current ratio and a minimum working capital of $660 million. Unless we do something, we could violate one or both of these covenants. Also, our long-term debt is inching up and currently stands at 25 percent of total assets.

Raines (CEO): Do you or Paul have any suggestions to improve our financials?

Whitley (CFO): Yes, I have one. At my previous company, we extensively used a securitization program. I know several firms in the automotive industry that use securitization as an effective financing tool. They don't have to wait until the due date of receivables to get the cash. Instead, the firms receive cash right away by assigning a portfolio of receivables to a special purpose entity (SPE). The SPE, in turn, categorizes the receivables into different buckets (called tranches) based on their riskiness and sells them as debt securities (bonds, for example) to individual and institutional investors.

Raines (CEO): Paul, what's involved in setting up a special purpose entity (SPE)?

Whitley (CFO): Linda and I can consult with our legal department, and report in the next week's executive management meeting.

Mueller (VP, Investor Relations): This is too complex for me to understand. Can you explain more simply how the cash flows move between the firm, the SPEs, and the investors?

Whitley (CFO): Yes. I have prepared a diagram that depicts the process of securitization and parties involved (Exhibit 2) and a write-up on the key elements of a securitization program (Exhibit 3). Deloitte, our auditing firm, has told me that they have an informative article on securitization available on worldwide web at: http://atc.bentley.edu/media/gujarathi/Securitization101.pdf.

Mueller (VP, Investor Relations): Why securitization? Why don't we just pay down our current debt to shore up our current ratio?

Whitley (CFO): I'm not sure that's the right approach. Cash is an issue. Moreover, it doesn't help our EPS number or working capital covenant.

Mueller (VP, Investor Relations): If cash generation is a consideration, maybe we should borrow against receivables. Would securitizing, instead of borrowing against the receivables, improve our financial statements?

Whitley (CFO): I discussed this with Herb last week, and he has prepared an illustration of securitizing a portion of our loan receivables. (See Exhibit 4).

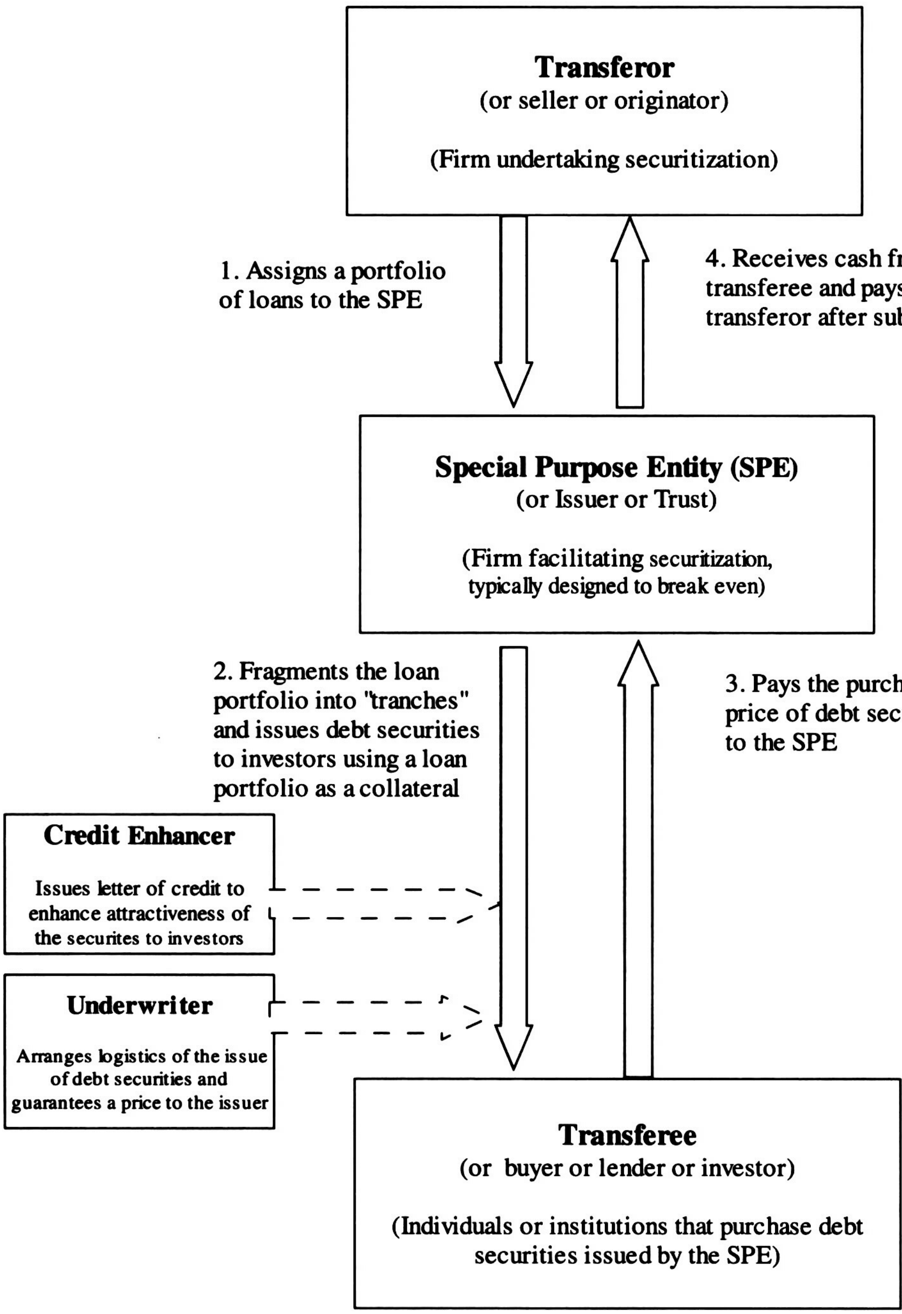
Pattchi (President, ADAC): Folks, please note that we plan to securitize only 20 percent of our portfolio of estimated auto loans receivable of $1,093,607,000 at the end of 2005. Also, we will continue to service the receivables securitized to make logistics easier for our customers. In other words, we will collect cash from the customers (including late fees and finance charges) and remit the proceeds to the SPE. The fair value of these servicing rights is estimated to be about $1.6 million, as shown in Exhibit 4.

Mueller (VP, Investor Relations): And what about the retained interests? What do they represent?

Pattchi (President, ADAC): The retained interests represent our right to receive collections on the transferred receivables in excess of amounts required by the SPE to pay interest and principal to investors, servicing fees, and other required payments. The fair value of the retained interests is estimated to be $8.5 million, as shown in Exhibit 4.

Mueller (VP, Investor Relations): My eyes are starting to glaze over with all this technical accounting talk. Is the stock market's reaction going to be different depending

EXHIBIT 2
Parties and Processes in a Securitization Transaction*



* Typically, the transferor firm services the receivables. It collects the cash from the loans receivable and remits to SPE. The SPE, in turn, uses that cash for the payment of interest and principal to the investors.

EXHIBIT 3
A Primer on Securitization

Importance

Since its inception about two decades ago, financial asset securitization has grown dramatically as financial institutions and businesses have started using it as a means to immediately realize the value of their cash-producing assets. The total outstanding issuance of asset-back securities has reached a staggering level of approximately seven trillion dollars (Deloitte 2004).

Definition

Securitization is a method of funding receivables through creating freely tradable securities backed by those receivables. It involves a process by which existing or future cash flows against third parties (for instance, customer receivables) of an entity are identified, consolidated, separated from the original entity, and then fragmented into collateralized "securities" to be offered to investors. Securitized mortgages are known as mortgage-backed securities (MBS), whereas securities collateralized with assets such as automobile or credit card or student loans are known as asset-backed securities (ABS). Securitization allows repackaging of cash flows into different categories of loans (also called tranches) based on their riskiness and other characteristics such as seniority and timing of repayment.

Process

The parties involved in securitization are the originator, a special purpose entity (SPE), investors, underwriters, and credit enhancers. The firm doing the securitization (originator) forms a special purpose entity (or SPE). The SPE is typically a trust or a corporation that is legally separate from the originator firm and is created solely for the purpose of securitization transactions. Unlike most businesses, because an SPE's activities are strictly limited, the role of equity investors is fairly minor. Indeed, they serve as a technical requirement to allow the SPE to function as a legal entity.

The primary reason for the creation of the SPE is to protect the interests of investors by keeping the receivables beyond the reach of the transferor and its creditors. In other words, even if the originator firm were to go bankrupt, the collateral underlying the securitized notes is safe. Control of an SPE oftentimes does not rest with its equity holders. Instead, it is exercised through contractual arrangements with the sponsoring firm. The fact that the originator may own little, if any, of the voting shares in SPE is unimportant because such shares do not effectively allow the equity holders to exercise control.

The originator firm then sells the receivables to the SPE. The SPE, in turn, creates and issues securities (such as commercial paper, or notes) with the receivables as collateral to outside investors (also known as transferee, buyer, or lender). The underwriter arranges the logistics of the securities issuance and guarantees a price to the issuer. The credit enhancer issues a letter of credit to enhance attractiveness of the securities to investors. The cash received from the investors is remitted to the firm, after subtracting a transaction fee. In most cases, the firm doing the securitization continues to service the asset (i.e., continues to handle cash collection and record-keeping duties). The value of these servicing rights is typically recorded as an asset in the balance sheet of the originator.

The cash flows from the collection of receivables are remitted by the originator firm to the SPE and are used to make the periodic interest and principal repayments to the investors who bought the securities. Oftentimes, the originator has a right to receive collections on the transferred receivables in excess of amounts required by the SPE to pay interest and principal to investors, servicing fees, and other required payments. Such rights are recorded in the balance sheet of the originator as "retained interests."

Advantages of Securitization

To the originator firm, securitization offers a means of instant cash as it does not need to wait for the scheduled dates of receipts from the receivables.[2] Second, the credit rating of securities issued by the SPE is little affected by the credit rating of the originator firm because the SPE is a separate legal entity. This yields the originator firm the advantage of lower cost financing. Third,

(*continued on next page*)

EXHIBIT 3 (continued)

securitization can be used to create securities with unique characteristics (coupon, maturity, and seniority) that appeal to different classes of investors. Finally, most securitizations qualify as sales per SFAS No. 140 and thus allow the originator firm to enjoy the advantages of a stronger balance sheet and desirable income effects. It is important to note that a qualifying SPE is not consolidated in the financial statements of the originator firm.

Securitization is attractive to investors because they can obtain liquid financial instruments of different characteristics that suit their risk-return profile. In contrast to other debt securities (bonds, for instance), securitization gives investors a claim on receivables from the third parties (i.e., consumers). As a result, the credit quality of the issuer *per se* does not matter as long as the receivables are of acceptable quality, and the debt is duly secured. An investor's risk in securitization is limited because of the segregation of collateralized securitized assets from other assets of the originator.

Risks in Securitization

The main risks associated with securitization transactions are credit risk, interest (or market) rate risk, and prepayment risk. These risks are borne by different parties to securitization depending on the structure of the transaction.

If the loans (or receivables) are not collected as expected, the SPE might have insufficient funds to pay to investors. The originator firm typically addresses this risk by using different "credit enhancement" mechanisms. These can include over-collateralizing the receivables, providing a limited recourse from the SPE to the originator, or providing a cash collateral account or credit lines that the SPE can use in the event of cash gaps between receivables collection and payments to the investors. The SPE can address the credit risk by subordinating one or more tranche, or portion, of the securities issued. Thus, any defaults affecting the securities are absorbed by the subordinate tranche before the senior tranche is affected. Alternatively, it might seek from the originator an external credit enhancement such as a surety bond or a letter of credit.

The interest rate or market risk is present for any loan asset with a fixed interest rate. When the market interest rates rise, the value of these loans is reduced, and vice versa. This risk is typically borne by the SPE except for the part of the residual interest owned by the originator firm. It is common for the firms to manage the interest rate risk through the use of interest rate swaps. The prepayment risk relates to the borrowers (or customers) repaying the loans early.

As stated in the "process" section above, the originator firm retains various interests in the loans that it securitizes. The fair value of the retained interests may fluctuate depending on the performance of the securitized receivables. To that extent, it impacts earnings and financial position of the originator firm.

Transfer of Receivables in Securitization (SFAS No. 140)

The transfers of receivables are accounted for in accordance with Statement of Financial Accounting Standards (SFAS) No. 140. The pivotal issue is whether asset securitization represents sales of assets or secured borrowing. A transfer of financial assets in which the transferor surrenders control is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange.

[2] Factoring is an alternative way of converting receivables into cash. In contrast to securitization, factoring usually involves sale to only one company, the fees are high, and the seller afterward does not service the receivables.

on whether we securitize our receivables or borrow against them? How do the analysts typically look at the two financing methods?

Raines (CEO): That's a good question. I wonder what adjustments analysts make for securitization versus secured borrowing. Regardless of the financing method, we should expect a decisively negative reaction if we don't make our numbers, or disrupt the positive growth trend in earnings. Any other issues we need to address?

EXHIBIT 4
Securitization Details

Tranche (Category)	Net Carrying Amount	Interest Rate	Price	Fair Value
A-1	131,233,000	5.50%	100%	131,233,000
A-2	87,489,000	6.00%	95%	83,114,550
Gross proceeds from securitization				214,347,550
Retained interests				8,480,638
Estimated upfront transaction costs				2,190,000
Servicing rights				1,642,500

Pattchi (President, ADAC): I am not sure about this, but separate and apart from the securitization issue, I have heard about cash flow reporting issues for loan portfolios. Paul, do you know what I am referring to?

Whitley (CFO): Yes, my previous firm reported changes in the loan portfolio as investing cash flows, but there was some question if they should be treated as operating cash flows. I've requested a clarification from our auditors.

Raines (CEO): Before we make a final decision on the financing vehicle at our next meeting, I want Paul and Linda to present a report on what the impact of the proposed securitization would be on our 2005 financial statements. I know that FASB Statement No. 140 on securitization is very complex.

Whitley (CFO): But all the FASB statements lately are getting complex. Luckily, Deloitte, our auditors, have shared with me their publication on securitization, and I would encourage you to refer to it to get a better idea of what securitization would entail for us. I have some paper copies in my office, but you can also access the publication at: http://atc.bentley.edu/media/gujarathi/SecuritizationAccounting.pdf.

Requirements

1. Present a detailed analysis of the auto loans receivable and allowance for uncollectible accounts presented in Exhibit 1. Are the changes in these accounts consistent with the changes in the economy, automobile industry, and ADAM's business strategy? Is there evidence of earnings management? Explain your reasoning and present supporting calculations. (Hint: It would be helpful for you to evaluate the trends in auto loans receivable as a percentage of sales, year-to-year growth in sales and receivables, loans receivable turnover, days credit sales outstanding, bad debt expenses recorded as compared with receivables written off, and allowance for uncollectible accounts as a percentage of auto loans receivable.)
2. Present the journal entries to (1) record the proposed securitization transaction, and (2) mark the residual interest to market, as required by SFAS No. 140.
3. Securitization has been suggested in the case as a way to improve ADAM's financials. Will securitization help ADAM to (1) meet analysts' estimate of earnings and (2) comply with the current ratio and working capital covenants? Support your response with computations.
4. Sydney Mueller (Vice President, Investor Relations) has suggested a possibility of paying down the debt to shore up ADAM's current ratio. Assuming that the Company uses

the entire available cash at the year-end to repay the debt, would ADAM be able to meet the current ratio covenant of 2:1? Support your answer with computations.

5. Sydney Mueller (Vice President, Investor Relations) has also suggested borrowing against receivables instead of securitization for improving ADAM's financials. Assume that it will be a short-term (nine months) loan of $210,000,000 that will be consummated on December 31, 2005, at an annual interest rate of 6 percent. Compute (1) Earnings per share (EPS) for 2005, (2) Current ratio on 12/31/05, (3) Total Liabilities/ Total Assets on 12/31/05, and (4) Return on average assets (ROA) for 2005, under the following two independent assumptions:
   (a) ADAM securitizes its receivables as proposed.
   (b) ADAM obtains secured borrowing, using receivables as collateral.
6. From the perspective of ADAM's management, present arguments in favor of securitization as a financing vehicle in comparison to secured borrowing.
7. Discuss whether ADAM should report the changes in its auto loans portfolio in the statement of cash flows as operating or investing activities in order to comply with generally accepted accounting principles (GAAP). Cite the appropriate reference. Ignore the proposed securitization transaction for answering this requirement.

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CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

Learning Objectives

Amazing Deals Auto Mart (ADAM) is a multifaceted hypothetical case addressing the issues of analysis and interpretation of accounts receivable, financial analyses of securitization as a financing vehicle, and financial reporting of securitization transactions.

The case has five learning objectives. First, it provides a forum for students to determine whether the financial statement numbers reflect the economic environment of the firm. This is helpful for them to decipher whether or not the company is managing earnings. Specifically, students are required to analyze the multiyear accounts receivable and bad debt allowance of an automobile retailer to determine if the data are consistent with changes in the company's strategy and in the industry and economy.

Second, the case requires students to perform financial analysis of securitization and secured borrowing. To become successful professionals, accounting students need proficiency in financial analysis and not just financial reporting. Understanding the rationale and implications of a critical business decision (such as securitization versus secured borrowing) is a good preparation for students aspiring for higher-level management positions. Accountants are increasingly being called upon to be partners in major business decisions by companies rather than passive providers of data to operating managers.

Third, the case requires students to examine the effects of business transactions on financial statements and ratios. As noted by Cornell and Bushong (2005), "for making optimal business decisions, it is necessary to understand the impact of transactions on financial statements." Financial reporting texts oftentimes present the journal entries for individual topics without a clear demonstration of how they affect financial statements.

Fourth, the case presents a context in which students are required to understand the essentials of securitization and the terms used in the context of securitization. With the proliferation of complex financial instruments and transactions, it is necessary for students to become conversant with the terminology used and to understand the business purpose and economic rationale for such instruments and transactions. Oftentimes, students' difficulty in understanding accounting relates to their lack of familiarity with the economics of the underlying financial instruments (bonds or derivatives, for example) and transactions (troubled debt restructuring, for example).

Finally, the case presents a context for students to determine the relevant provisions and illustrations of a complex and technical accounting standard. In their roles as accounting and auditing professionals, students need to understand technical pronouncements to determine which of the provisions apply to the circumstances of their company or client. In contrast to many published cases that require students to identify the applicable accounting pronouncement(s), the ADAM case specifies the applicable accounting standard (Statement of Financial Accounting Standards [SFAS] No. 140). SFAS No. 140 is a long and complex accounting standard. In response to many questions raised by preparers and auditors, the FASB issued an implementation guide for SFAS No. 140 in February 2001. However, students experience that while the pronouncement can be long, technical, and complex, it is not as necessary to understand each of its intricate provisions as it is to identify the applicable provisions of the pronouncement to a given context. In the ADAM case, the student needs to grasp the essence of SFAS No.140 to realize the need to focus on paragraph 65 of the Standard, which provides an illustration with the case facts very similar to ADAM's. Students realize also the usefulness of alternative literature sources—many available on the worldwide web—to obtain guidance on financial reporting issues.

Oftentimes, they provide a bridge to understand and apply a complex accounting pronouncement. In the ADAM case, students recognize the usefulness of the two publications by Deloitte and Touche referred to in the case in understanding securitization transactions and their accounting.

Case Setting

Given the numerous instances of aggressive accounting practices, a critical examination of the relationship between different items in the financial statements is important for a financial analyst. There are several instances of U.S. companies creating "cookie jar reserves." For instance, in a report to the United States Congress, the Securities and Exchange Commission (SEC) noted that of the 101 enforcement matters involving improper expense recognition over five years, 17 involved improper use of reserves (SEC 2003). A recent (November 22, 2005) *Wall Street Journal* article raises a suspicion whether General Motors Acceptance Corporation (GMAC) and Ford Motor Credit Corporation (FMCC) are relying on lower loan-loss reserves for bolstering profits.[3] The article also raises the issue of whether GMAC and FMCC need to increase loan-loss provisions as higher interest rates and fuel costs impair borrowers' ability to cover car payments. *Business Week* (2005) refers to the banks using loan-loss reserves to manage their income, and the resulting distortion in the true quality of their earnings. Lately, the issue of lower loan-loss reserves has surfaced significantly in the context of sub-prime lending companies.

The possibility of earnings management through the allowance for doubtful accounts provides a backdrop for the case requirement to critically examine the financial statement data as to whether ADAM's management might be managing earnings.[4] Developing this "business" sense is important for performing tasks such as analytical review or due diligence. In their procedures for auditing the allowance for doubtful accounts, accounting firms typically ask associates to evaluate data such as historical trends in days' sales outstanding, bad debt expenses, and percentage of allowance to gross accounts receivable. An inadequate balance in the allowance for doubtful accounts is one of the indicators of financial fraud that many textbooks mention (Albrecht et al. 2006; Hopwood et al. 2008; Wells 2005).

The context of securitization is chosen because of its increasing use by businesses. Asset securitization has become a big industry for raising finances from home equity, car, or credit card loans. In the United States, out of $6.92 trillion in debt issuance for 2003, $3.8 trillion represented mortgage- or asset-backed securitized bonds (Bond Market Association 2004). Securitization is assuming importance in the international arena as well. The annual issuance of asset-backed bonds in Europe is expected to double in less than three years from $243 billion in 2004 to an estimated $531 billion in 2007 (*Financial Times* 2007). In early 2004, the first asset backed securitization by a Chinese commercial bank was carried out in China (*SinoCast* 2004).

Not only do more firms use securitizations, they use securitizations to manage earnings. Demonstrating this aspect of securitization makes learning deep and meaningful for students. Dechow et al. (2007) find that 76 percent of firms report gains, 14 percent report no gain or loss, and 10 percent report losses from securitizations. Dechow and Shakespeare (2006) conclude that the reporting of gains or losses from securitizations appears to be

[3] For instance, Ford Credit's loan-loss provision has fallen steadily from $3.2 billion in 2001, to $2.75 billion in 2002, to just $87 million at the end of the third quarter of 2005.

[4] Instructors can also use this context to highlight that the use of reserves and provisions, although common (and criticized) in the international arena, is possible even in the U.S., where reserves are explicitly prohibited.

influenced by financial reporting incentives (e.g., to exceed the previous year's income or analyst forecasts). Further, they note that firms arrange securitizations just before a financial reporting date to increase efficiency ratios, decrease leverage ratios, and increase reported operating cash flows.

Despite the dramatic growth in securitization transactions, some accounting textbooks do not cover the topic at all, and others accord only a cursory treatment that does not give students a feel for the business reasons behind securitization. Surprisingly, almost every intermediate accounting text elaborately describes and illustrates factoring of receivables when many more companies engage in securitization rather than factoring. The American Institute of Certified Public Accountants (AICPA) (2006) notes that of the 134 survey companies that disclosed either a sale of receivables or pledging of receivables as collateral, only eight disclosed a factoring arrangement but 69 disclosed that the receivables were transferred to a special-purpose entity (i.e., securitization).

The case helps instructors achieve many of the competencies identified by the AICPA (1999). In addition to the personal competencies (such as problem solving, interaction, and communication) and functional competencies (such as understanding and applying relevant information), the case helps to develop broad business competencies among students (such as critical thinking and legal/regulatory perspective).

Implementation Guidance

The case serves as a bridge between introductory accounting courses (which at many institutions have changed in focus from the preparer to the user perspective) and the intermediate accounting courses that aim to continue with that focus but also develop student proficiency in technical accounting literature and in applying accounting pronouncements to a given context. The analyses of accounts receivable and allowance for doubtful accounts data puts students in the position of a financial statement user to decipher the evidence of earnings management. The other part of the case requires students to perform financial analysis of the securitization and secured borrowing alternatives and apply an accounting standard to a given situation.

The case can be used in a variety of financial reporting, accounting theory, or capstone courses at the graduate or undergraduate level. It is best used as a collaborative project in which groups of two or three students submit written analyses of the case. Subsequently, the case should be discussed in class to highlight the salient points, and to indicate additional avenues for analysis. A lead-time of at least three weeks is suggested before the case analyses are required, and a minimum of 60 minutes should be allowed for class discussion. It is immensely useful if the topic of earnings management is addressed in the course before the case is handed out. It would be very helpful if the instructor covers the basics of securitization and communicates its increasing importance as a financing mechanism. Exhibit 3 of the case, which provides a good summary of the parties and processes involved in securitization, can be used for this purpose.

It is not necessary for students to posses the skill of researching accounting literature as much as it is necessary for them to read, understand, and apply a complex accounting pronouncement. Development of this skill is one of the intended outcomes of the ADAM case assignment. Depending on the intended learning objectives, instructors can assign a subset of the requirements. For instance, instructors not wanting to address the issues of interpretation of financial statements and earnings management can skip requirement 1, and instructors wanting to de-emphasize the cash flow reporting issues relating to loan portfolios can skip requirement 7. Similarly, instructors intending to add challenge to the assignment involving analysis of accounts receivable (requirement 1) can delete the hint before distributing the case assignment to students.

The case is a challenging exercise for students, especially at the undergraduate level, and requires significant out-of-class preparation. Given their unfamiliarity with the context (securitization), lack of textbook coverage of the topic and complexity of the accounting pronouncement (SFAS No. 140), students find the case a bit overwhelming at the outset. Many look for a template for analysis, which is neither available nor should be made available to protect the integrity of their learning experience. When they read the case a couple of times, and start to make connections with SFAS No. 140 and the two Deloitte publications, issues become clearer to students. Working through the issues is itself a valuable learning experience. Moreover, most students find the context of the case—pre-owned premium automobiles—very interesting. Our reason for developing the case was that such experiences help accounting educators to prepare students for the challenges of addressing real-life business transactions, which are becoming increasingly more complex.

Analysis of Faculty and Student Feedback

The case was used at an AACSB-accredited institution in five sections of Intermediate II (in a two-course sequence) course by three instructors (including one of the authors) with a total of 119 students, primarily majoring in accounting or finance. It was subsequently used by two instructors (at two different institutions) in the graduate Intermediate I (in a two-course sequence) course with a total of 48 students.[5]

Each instructor expressed great satisfaction with the case, the issues raised, and skills that the case can potentially develop in students. However, each reported that significant preparation was needed for the students and instructors both. On average, students spent 7.4 hours to complete the case requirements.

A summary of student feedback is presented in Table 1. Students found the case useful, and they overwhelmingly agreed that the case assignment required critical thinking and problem-solving skills. Not surprising, compared to the undergraduate students, the feedback is more positive from the graduate students. They generally are more goal-oriented, and a more mature group with work experience. They are willing to embrace real-life assignments more positively despite the difficulty level of such assignments. An additional reason for the difference could be the course in which the case was used. In the graduate course, the case was used in the Intermediate I course which included the topics of accounts receivable, doubtful accounts, and generating cash from receivables. We thought that the issues in the case are applicable to all financial reporting students given the focus of the case on earnings management. However, the undergraduate students perhaps did not see a fit between the case and the topics covered in the Intermediate II course.

As another way of assessing whether students improved their understanding of certain concepts, instructors administered a questionnaire before the case assignment was handed out, and again after collecting assignments. Students were asked to indicate on a scale of 1 (not proficient at all) to 5 (quite proficient) how they felt in different skills and concepts. Results are presented in Table 2. The change cannot be attributed solely to the experience of case analysis; however, it is encouraging to see that there were significant improvements in the perceived proficiency of each skill/concept by both undergraduate and graduate

[5] One of these instructors put a copy of SFAS 140 and the two Deloitte publications on the website. Therefore, the questions on the use of computerized databases (such as FARS) were not included in the student feedback forms.

TABLE 1
Summary of Student Feedback[a]

Course	Intermediate Accounting II (Undergraduate)	Intermediate Accounting I (Graduate)
Number of sections	5	2
Number of instructors	3	2
Number of students	119	48
Overall usefulness of the case.	3.28	3.89
The case context was realistic.	3.97	4.08
The case context was interesting.	3.32	3.94
The case enabled me to understand that business environment of an entity and accounting estimates it uses are intertwined.	3.61	3.94
This case helped me understand how companies can use allowance for doubtful accounts to manage their earnings.	3.36	3.83
The case assignment improved my ability to use a computerized database such as FARS.	3.26	Not Asked
I feel more comfortable in applying an accounting pronouncement (such as SFAS No. 140) to a real-life situation (such as Amazing Deals Auto Mart).	3.32	3.85
My understanding of securitization improved as a result of analyzing the ADAM case.	3.66	4.29
The ADAM case improved my understanding of different variables that companies consider in their decision to raise finances from securitization or secured borrowing.	3.84	4.09
The case assignment required critical thinking and problem-solving skills.	4.42	4.19
I would recommend that this case be used as a part of this course in the future.	2.85	3.87

[a] Scale: For usefulness question, 1 (highly useless) to 5 (very useful). For other questions, 1 (strongly disagree) to 5 (strongly agree).

students. For both groups, the improvement was statistically significant for each skill/concept at the 1 percent level.

TEACHING NOTES

Teaching Notes are available only to full-member subscribers to *Issues in Accounting Education* through the American Accounting Association's electronic publications system at http://aaapubs.aip.org/tnae/. Full-member subscribers should use their usernames and passwords for entry into the system where the Teaching Notes can be reviewed and printed.

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TABLE 2
Student Perception of Skills Proficiency Before and After the Case[a]

Skill/Concept	Intermediate II (Undergraduate) (n = 96) Before	Intermediate II (Undergraduate) (n = 96) After	Intermediate I (Graduate) (n = 56) Before	Intermediate I (Graduate) (n = 56) After
Understanding subtleties of earnings management	2.42	2.92	2.46	3.16
Financial analysis of accounts receivable and allowance for doubtful accounts in the context of an entity's business environment	2.85	3.18	2.71	3.39
Understanding a technical accounting pronouncement, and applying it to a real-world business situation	2.51	2.95	2.43	3.06
Understanding the reasons for and process of receivables securitization	2.27	3.23	2.38	3.45
Understanding financial statement effects of securitization versus secured borrowing	2.05	3.15	2.21	3.29

[a] Scale: 1 (not proficient at all) to 5 (quite proficient).

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