

Teaching Note

An Inventory Letter from Carter's to Kohl's – What Could Go Wrong?

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Critical Incident Overview

This critical incident presents a situation that an executive vice president, who oversees the children's division of the third largest department store in the world, faces concerning whether or not he should sign a letter from a reputable and well-known supplier. The letter understates the amount of discounts or accommodations that his firm actually received in a given time period. His incentive for signing this letter is to protect a mutually profitable business relationship with a supplier that has been generous to his company. Signing this letter did not impact his company's financial information. In fact, his company probably had no knowledge of the letter. Although the case describes an actual situation, a decision is required on whether the executive should sign the letter and the possible consequences of this decision. Therefore, this critical incident is a decision-based case.

This case is most appropriate for use in a financial accounting class (e.g., Intermediate I, Intermediate II, Advanced Accounting, and perhaps Principles of Accounting). The case may also be used in an auditing class. However, neither individual mentioned in the critical incident was an accountant. Mr. Johnson was the executive in charge of the children's division of Kohl's, and Mr. Elles was marketing director for Carter's. Therefore, this case may also be suitable for other business classes, such as a management, marketing, or an MBA class, as it points out how signing a seemingly innocent, but false, document may have significant potential ramifications.

Research Methods

This critical incident was developed from secondary sources – primarily releases of the Securities and Exchange Commission and magazine and newspaper articles. The names of the individuals and companies presented in the critical incident and teaching note are factual. The amounts for the accommodations given below were obtained from an SEC (2012) litigation release. Other amounts were estimated from Carter's financial statements contained in their 10-K reports.

Learning Outcomes

In completing this assignment, students should be able to:

1. Illustrate the accounting for inventories, including accommodations, by a department store and its supplier using a perpetual inventory system
2. Analyze the impact that recording the accommodations in the wrong accounting period has on the financial statements
3. Evaluate the implications of signing a letter that misrepresents financial information of another company even though one's own company is not impacted
4. Appraise the difficulty of detecting a misstatement when collusion exists and the importance of conducting auditing procedures subsequent to the date of the financial statements

Discussion Questions

1. Assume that during the year Carter's credit sales to Kohl's were \$153,200,000. These goods cost Carter's \$92,900,000 to manufacture. In addition, assume that \$12,100,000 of discounts were given to Kohl's, and Kohl's paid \$127,000,000 of the amount due to Carter's. Make the following journal entries for Carter's (assuming a perpetual inventory system). (LO 1)
 - a. The sale of the merchandise to Kohl's.
 - b. The amount of discount that Kohl's was granted.
 - c. The receipt of cash from Kohl's.
2. Prepare journal entries for Kohl's using the information from question #1 (assuming a perpetual inventory system) for: (LO 1)
 - a. The purchase of the merchandise from Carter's.
 - b. The amount of discount that Kohl's was granted. Assume that the accommodation or discount of \$12,100,000 pertains to merchandise that Kohl's had already sold.
 - c. The payment of cash to Carter's.
3. Should discounts be recorded in the period when Kohl's made the purchases or when they made the payment? What principle or principles support your answer? (LO 2)
4. In this case, the discounts were misstated by \$4.4 million. How does this misstatement affect Carter's earnings before taxes? Assuming that Kohl's paid the amount due in the subsequent fiscal year, what accounts on Carter's balance sheet are misstated for the current fiscal year? (LO 2)
5. Assume that Carter's reported net income of \$75,000,000 on sales of \$1,412,000,000. Based on this information, what is Carter's return on sales? If the \$4.4 million discount was recorded in the current accounting period, what is its return on sales? Do you think that the \$4.4 million was significant (material in amount)? (LO 2 and LO 3)
6. Assume that the accounting department for Carter's discovered this error during the current fiscal year. Prepare the correcting journal entry for Carter's to record this \$4.4 million discount. (LO 1)

7. Assume the same situation as in #6 above, but that the error was discovered in the subsequent fiscal year. Prepare the correcting journal entry necessary for Carter's to record this \$4.4 million discount. Ignore the effect of income taxes. (LO 1)
8. Should Johnson sign the letter? Briefly state the advantages and disadvantages of signing the letter and indicate the basis for your conclusion. (LO 3)
9. If Johnson signs the letter, do you think it is likely that he will be presented with a similar letter the following year? Why or why not? (LO 3)
10. Assume Johnson suspected that Carter's executives might be involved with insider trading. Explain how this concern serves to modify or solidify Johnson's decision on whether or not he should sign the letter. (LO 3)
11. Assume that Johnson is convinced that the letter is used solely to verify the amount of accommodations or discounts that Carter's was granting Kohl's. Are there any liability issues that he could possibly face if he signs the letter? [Note: Although not necessary to answer this question, there is helpful information on the laws pertaining to public companies, found at <http://www.law.cornell.edu/cfr/text/17/part-240>.] (LO 3)
12. Should the external auditors have been able to detect the misstatement of \$4.4 million due to underreporting of the discounts? What audit procedures might enable auditors to uncover this misstatement? (LO 4)

Answers to Discussion Questions

1. Assume that during the year Carter's credit sales to Kohl's were \$153,200,000. These goods cost Carter's \$92,900,000 to manufacture. In addition, assume that \$12,100,000 of discounts were given to Kohl's, and Kohl's paid \$127,000,000 of the amount due to Carter's. Make the following journal entries for Carter's (assuming a perpetual inventory system). (LO 1)
 - a. The sale of the merchandise to Kohl's.
 - b. The amount of discount that Kohl's was granted.
 - c. The receipt of cash from Kohl's.

To record the sale, Carter's would increase accounts receivable – Kohl's and sales by \$153,200,000. To record the cost of the inventory sold, Carter's would increase cost of goods sold and decrease inventory by \$92,900,000. When the accounting department received the Internal Authorization Form (IAF), the entry is an increase in a contra-revenue and a decrease in accounts receivable – Kohl's account of \$12,100,000. To record the cash receipt, Carter's would increase cash and decrease accounts receivable – Kohl's for \$127,000,000. Kohl's will pay the balance of the amount owed in the next fiscal year. The journal entries are as follows:

	Debit	Credit
a. Accounts Receivable - Kohl's	153,200,000	
Sales		153,200,000
a. Cost of Goods Sold	92,900,000	
Inventory		92,900,000

b.	Sales Allowances	12,100,000	
	Accounts Receivable - Kohl's		12,100,000
c.	Cash	127,000,000	
	Accounts Receivable - Kohl's		127,000,000

- 2. Prepare journal entries for Kohl's using the information from question #1 (assuming a perpetual inventory system) for: (LO 1)**
- The purchase of the merchandise from Carter's.**
 - The amount of discount that Kohl's was granted. Assume that the accommodation or discount of \$12,100,000 pertains to merchandise that Kohl's had already sold.**
 - The payment of cash to Carter's.**

To record the purchase, Kohl's would increase inventory and accounts payable – Carter's by \$153,200,000. The amount of the discount is usually not known until the end of the fiscal period after the merchandise has been sold by the retailer. Thus, a separate entry is made for the discount. If the discounts had been known at the time of purchase, the net amount (i.e., \$153,200,000 - \$12,100,000 = \$141,100,000) would have been recorded for transaction *a* as shown below. To record the cash payment, Kohl's would decrease accounts payable – Carter's and cash by \$127,000,000. The journal entries are as follows:

		Debit	Credit
a.	Inventory	153,200,000	
	Accounts Payable - Carter's		153,200,000
b.	Accounts Payable - Carter's	12,100,000	
	Cost of Goods Sold		12,100,000
c.	Accounts Payable - Carter's	127,000,000	
	Cash		127,000,000

- 3. Should discounts be recorded in the period when Kohl's made the purchases or when they made the payment? What principle or principles support your answer? (LO 2)**

Based on the matching principle and the accrual concept, Kohl's purchases discount should be recorded in the period in which the purchases were made. The discount or accommodation is equivalent to a cost for Carter's and should be reported in the same period that the related sales were reported. For Kohl's, the accommodation is a reduction of the cost of inventory, and eventually, a reduction in its cost of goods sold.

- 4. In this case, the discounts were misstated by \$4.4 million. How does this misstatement affect Carter's earnings before taxes? Assuming that Kohl's paid the amount due in the subsequent fiscal year, what accounts on Carter's balance sheet are misstated for the current fiscal year? (LO 2)**

The understatement of discounts or accommodations would overstate net sales, gross profit and earnings before taxes by \$4,400,000. Accounts receivable – Kohl's and retained earnings are also overstated by \$4,400,000 on the balance sheet.

- 5. Assume that Carter's reported net income of \$75,000,000 on sales of \$1,412,000,000. Based on this information, what is Carter's return on sales? If the \$4.4 million discount was recorded in the current accounting period, what is its return on sales? Do you think that the \$4.4 million was significant (material in amount)? (LO 2 and LO 3)**

Carter's return on sales is 5.3% ($\$75,000,000 / \$1,412,000,000$). If the discount was recorded in the current period, the return on sales is 5.0% ($(\$75,000,000 - \$4,400,000) / (\$1,412,000,000 - \$4,400,000)$). Yes, the \$4,400,000 is significant. It caused a 5.9% decrease in net income ($\$4,400,000 / \$75,000,000$).

- 6. Assume that the accounting department for Carter's discovered this error during the current fiscal year. Prepare the correcting journal entry for Carter's to record this \$4.4 million discount. (LO 1)**

Carter's will decrease accounts receivable – Kohl's and increase the contra-revenue account for \$4,400,000. The journal entry is:

	Debit	Credit
Sales Allowances	4,400,000	
Accounts Receivable - Kohl's		4,400,000

- 7. Assume the same situation as in #6 above, but that the error was discovered in the subsequent fiscal year. Prepare the correcting journal entry necessary for Carter's to record this \$4.4 million discount. Ignore the effect of income taxes. (LO 1)**

Carter's will decrease accounts receivable – Kohl's and retained earnings for \$4,400,000. The contra-revenue account would have already been closed to retained earnings at the end of the previous fiscal year. Therefore, the journal entry is:

	Debit	Credit
Retained Earnings	4,400,000	
Accounts Receivable - Kohl's		4,400,000

- 8. Should Johnson sign the letter? Briefly state the advantages and disadvantages of signing the letter and indicate the basis for your conclusion. (LO 3)**

Johnson should not sign the letter. Although he obtained extra discounts for his company, he assisted in the material misstated financial statements of another company. Signing this letter is probably an illegal act. The advantage of Johnson signing the letter is that the generous discounts allowed by the supplier may continue. Johnson is head of the Children's Division of Kohl's. Thus, the increased profits may favorably affect his bonuses, salary, and stock options and holdings.

9. If Johnson signs the letter, do you think it is likely that he will be presented with a similar letter the following year? Why or why not? (LO 3)

Yes, by accepting the letter, Johnson is approving the behavior and encouraging it to continue. Since \$4.4 million of the discount was delayed until the following year, the discounts for the next fiscal year will be excessive unless a portion of it is deferred until the following year. As the amount of the purchases made by Kohl's increases, the amount of the discrepancy will continue to increase. [Note: Johnson was indeed presented with a similar letter the following year which had an even larger discrepancy.]

10. Assume Johnson suspected that Carter's executives might be involved with insider trading. Explain how this concern serves to modify or solidify Johnson's decision on whether or not he should sign the letter. (LO 3)

Insider trading is an illegal activity. If Johnson did not intend to sign the letter, this information should solidify his decision. The letter and allegations of insider trading taint the ethical values of the Carter's executives involved in this matter. However, if Johnson was considering signing the letter and it came to his attention that Carter's executives may be involved with insider trading, he should not sign the letter. During their investigation of insider trading, the Securities and Exchange Commission (SEC) may discover the letter, and then Johnson will face SEC penalties. In essence, the signed letter assists Carter's filing of fraudulent financial statements since the accounting department is relying on it to record the amount of discounts. Revenues and net income are overstated as a result of deferring the accommodations to the subsequent accounting period.

11. Assume that Johnson is convinced that the letter is used solely to verify the amount of accommodations or discounts that Carter's was granting Kohl's. Are there any liability issues that he could possibly face if he signs the letter? [Note: Although not necessary to answer this question, there is helpful information on the laws pertaining to public companies, found at <http://www.law.cornell.edu/cfr/text/17/part-240>.] (LO 3)

The consequence of signing a false document may have severe implications. Although Kohl's financials are not affected by the letter, there is a possibility that Carter's financial statements would be affected. Signing this letter is probably an illegal act. Johnson may be in violation of §240.13b2-1 of the Securities and Exchange Act of 1934 which states that "no person shall directly or indirectly, falsify or cause to be falsified, any book, record or account" of a public company (Cornell, 2014). Carter's is a public company which comes under the Securities and

Exchange (SEC) regulations and Sarbanes-Oxley (SOX) Act. Johnson may face civil and criminal liability for violating SEC and SOX laws.

Johnson's lack of knowledge on how the letter might be used does not justify signing the letter. Ignorance is usually not a good defense. "The traditional rule that ignorance of the law is no excuse" appears to be upheld in a 1998 Supreme Court ruling (Bryan, 1998). In this case, the petitioner claimed that he had no knowledge of federal licensing requirements, and therefore should not be found guilty of "willfully" violating the law. Although this case dealt with the trafficking of firearms, this Supreme Court decision has been referenced in other cases where the ignorance defense was used.

Carter's financial statements were misstated. In recording the amount of accommodations given to Kohl's, Carter's accounting department relied on the letter signed by Johnson. The SEC claimed that Johnson knew or should have known that the letter may be used to misstate the financial statements.

12. Should the external auditors have been able to detect the misstatement of \$4.4 million due to underreporting of the discounts? What audit procedures might enable auditors to uncover this misstatement? (LO 4)

Accommodations or discounts are more difficult to verify than sales or purchases because there are no shipping confirmations or purchase orders to examine. Accommodations are negotiated amounts that take place near or after the end of the fiscal year. The exact amount of the accommodation is generally not known until the product has been sold to the customer (SEC, 2012).

It may have been difficult for the auditors to detect this misstatement. There was collusion at a high level involving executives from both Carter's and Kohl's. Collusion "may cause the auditor to think that the audit evidence is persuasive when it is, in fact, false" (IAASB, 2009, par. 6). Due to the significant nature of the discounts, the auditors should trace the payments to the "Internal Authorization Form (IAF) which sets forth the details of each accommodation" (SEC, 2012). The problem in this case is that the IAF for the Kohl's account is not accurate. Therefore, the misstatement would not have been detected by this audit procedure.

This situation also illustrates the importance of performing audit tests in the subsequent fiscal year. In the subsequent year when Kohl's took the additional \$4.4 million in discounts, the amount taken will exceed the amount shown on the IAF. After Carter's received the payment from Kohl's, the auditor's should trace the discount taken back to the IAF to verify the amount. The discount that Kohl's took is greater than the amount reported on the IAF. Elles, the executive in charge of sales, would probably have given the auditors the same explanation that he provided to his upper level management. This explanation - that Kohl's took discounts in anticipation of future purchases - should be a red flag to the auditors. Elles' statement should have piqued the professional skepticism of the auditors.

A reasonable question may be whether or not the \$4.4 million is material to the financial statements. This amount is approximately 4% of Carter's receivables and 0.3% of its sales. The amount, however, is 6% of net income. Kohl's was Carter's largest customer, accounting for

approximately 10% of its sales. Thus, the auditors should trace subsequent payments made by Kohl's to the IAFs. Regardless of the amount, it appears that Elles was violating company policy in exceeding the budget and the law. [Note: As explained in the Epilogue to this case, the SEC, not the auditors, discovered the misstatement of discounts.]

General Discussion

The focus of the critical incident is on the possible consequences of signing a letter that misstates an amount pertaining to one of its suppliers. If Johnson does not agree to sign the letter, the future profitability of his company and his bonuses would decrease. Though signing this letter does not affect the financial statements of Johnson's company, there may be significant ramifications for the supplier and for Johnson personally.

The responses to the core question in this critical incident related to whether Johnson should sign the letter may appear obvious, particularly to more experienced individuals. As society continues its progression toward moral relativism, the answer to the core question presented in this case may not be so clear. When this case was presented as an in-class exercise to 32 senior-level accounting students, 28% noted that they would sign the letter. Students should be made aware of the possible ramifications of signing a deceptive letter. The most common reasons given by students for signing the letter were: 1) Kohl's financial statements will not be misstated, and 2) Kohl's will continue to benefit by receiving the large discounts. One student, who thought that Johnson should sign the letter, correctly concluded that Kohl's financial statements will actually be understated by delaying the recording of the discounts. Another student in favor of signing the letter wrote, "What harm could come from signing a letter from such a trusted supplier?" If the students took the assignment home, we expect a much lower percentage would recommend signing the letter given that information regarding the situation presented in the CI is available on the Internet. In a senior-level accounting night class, which consisted of employed and mostly older students, only 1 of 13 said that they would sign the letter.

Presented below is a table showing a recommendation of the questions that may be appropriate for various courses. The answers given in the TN are considered "A" answers by auditing and advanced accounting students. Auditing and advanced accounting students should give a more complete answer than Intermediate I or II students. Principles of accounting students will most likely struggle on the answers involving journal entries and the impact on financial statements.

TABLE
SUGGESTED QUESTIONS BY COURSE

Course	Appropriate Questions	Comments
Advanced Accounting	1-11	Students should have the background to give an answer to all of the questions except Q12 which deals with an auditing topic
Auditing	1-12	Q12 will be challenging, but students should be able to provide an answer to all of the questions
Intermediate I	1-6 and 8-11	Assigned after covering the inventory chapters; Q7 deals with a topic that is not normally covered in Intermediate I
Intermediate II	1-11	Q7 pertains to prior period adjustments, which is normally covered in Intermediate II
An MBA Class	3-5 and 8-11	Questions that contain journal entries are not included
Management or Marketing	8-11	Questions that contain journal entries or that ask for the effect on the financial statements are not included
Principles of Accounting	1, 4, 5, 8	These questions emphasize Carter's financial statements, and they will be challenging for principles of accounting students

This case leads nicely into a discussion of several core issues. Specifically, this critical incident illustrates (1) the importance of the matching principle, (2) the significance of the ethical issue of signing a false document, and (3) the impact of collusion on management controls. These core issues can be covered in a class discussion after students had a chance to complete the assignment.

Generally accepted accounting principles (GAAP) require that the matching principle be followed. That is, revenues should be reported as earned and expenses reported as incurred. This critical incident involves the reporting of a contra-revenue rather than an expense in an accounting period other than that in which the related revenue was earned. Recording a contra-revenue, however, has the same impact on net income as recognizing an expense. Kohl's received accommodations based on the amount of its purchases from Carter's. Elles, a Carter's executive, granted discounts to Kohl's greater than the amount that he was authorized to allow. To conceal this fact from Carter's management, he instructed Johnson, the Divisional Merchandise Manager for Kohl's Children's Division, to take some of the accommodation in the subsequent accounting period. As a result, the accommodations were understated for the fiscal year (SEC, 2012), and this understatement overstated Carter's net income.

Deceptive practices are often not isolated incidents. Frequently, they are only the tip of the iceberg. The business world is replete with examples. For instance, among other deceptive practices, ENRON began establishing unconsolidated partnerships, called special purpose

entities (SPEs), to conceal debt and losses on assets, improve its balance sheet by increasing assets and equity, increase its net income, and improve its credit ratings. Eventually more than 3,000 of these SPEs were created before the massive fraud was detected. Tyco's CEO used one million dollars of company funds for his wife's birthday party. In time, both the CEO and CFO were accused of misusing hundreds of millions of dollars for their personal benefit.

WorldCom's controller was instructed to record certain expenses as assets. Before this fraud was discovered, WorldCom improperly capitalized \$11 billion of expenses as assets. When Johnson was asked to sign the letter, he evidently was not aware that certain Carter's executives were involved with insider trading. The Securities and Exchange Commission (SEC) brought action against eight individuals involved in insider trading of Carter's stock. Four of these individuals were Carter's executives, including Elles, a past president, a former head of investor relations, and the ex-chief of operations.

Dishonest practices are often difficult to conceal. The excess accommodations described in this case appeared to be granted for approximately five years (SEC, 2012). As Kohl's purchases from Carter's increased, so did their amount of accommodations. As a result, it was inevitable that Kohl's eventually took a larger accommodation in a given period than Elles was authorized to allow. When this occurred, Carter's management asked Elles for an explanation. He told top management that the "excess" accommodation was given in anticipation of future purchases by Kohl's. Management was satisfied with this explanation, but requested a letter from Kohl's confirming this information. Elles then composed the letter mentioned in the critical incident. Johnson faced the dilemma of whether to sign the letter. If Johnson signed the letter, then he and Elles are acting together to mislead Carter's management. Internal controls are established to prevent individuals from committing fraud and concealing their actions. However, controls may be circumvented when collusion exists.

Epilogue

In 2009, the Securities and Exchange Commission (SEC) accused Elles of insider trading and fraud. As of May 2015, eight individuals have been charged by the SEC for insider trading, including Elles and three other former executives of Carter's. In its investigation of Elles, the SEC uncovered the letter noted in this critical incident, which Johnson was asked to sign. In exchange for complete cooperation on the part of Carter's, the SEC agreed not to prosecute Carter's.

Johnson signed the letter presented to him by Elles. It misstated the amount of accommodations by \$4.4 million. The following year, a similar letter was presented to Johnson by Elles. The misstatement was larger than that in the previous year. It amounted to a \$13 million discrepancy in the accommodations for the year. The letter listed \$20.3 million in accommodations when the actual amount was \$33.3 million. As in the previous year, the difference or understatement of \$13 million was deferred until the following year. The SEC brought civil, but no criminal charges, against Johnson for signing false assertions that helped to conceal materially misstated financial statements issued by Carter's, Inc. The SEC claimed that "Johnson knew or recklessly failed to note that the letters were being requested as a part of Carter's financial reporting process and would be incorporated into Carter's financial books and records" (SEC, 2012, par. 39). The case against Johnson is still pending. Kohl's was not charged with any wrongdoing.

The SEC entered a non-prosecution agreement with Carter's in exchange for Carter's complete cooperation with the SEC's investigation [Gorman, 2014]. A class action suit, however, was filed against Carter's, its principal officers, and its auditor, PricewaterhouseCoopers (PwC) LLP. The lawsuit concerned the misreporting of the accommodations over a five-year period, totaling \$64.5 million. The class action lawsuit was brought by those who purchased Carter's stock during this five-year period. A settlement was reached. It resulted in Carter's, Inc. and its officers paying a total of \$20,000,000, and PwC settling for \$3,300,000. Despite making the payment, PwC denied any allegation of misconduct, liability, or wrongdoing [Carter's, 2013].

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