

Case 09-5 — Part A
Pit Stop Closed

Auto World Inc. (Auto World), a calendar year-end SEC registrant, is a leading automotive retail and service chain. Auto World operates exclusively in the automotive aftermarket industry. Auto World is engaged principally in the retail sale of automotive parts, tires, and accessories, automotive repairs and maintenance, and the installation of parts. Auto World has two primary operating unit formats: (1) Auto Boyz Retail Centers (Auto Boyz Centers) and (2) Pit Stop Service & Tire Centers (Pit Stop Centers). As of April 15, 2007, Auto World operated 120 stores consisting of 90 Auto Boyz Centers and 30 Pit Stop Centers. Auto World operates approximately 1,800,000 gross square feet of retail space. The Auto Boyz Centers average approximately 20,000 square feet per store. The 30 Pit Stop Centers offer service labor, installed merchandise, and tires. Auto World maintains distinct advertising and branding policies for each format. The Auto Boyz Centers are usually placed in high-traffic areas within major metropolitan cities. Auto World invests heavily in marketing and advertising for the Auto Boyz Centers. For example, Auto World purchases commercial airtime on local and national television stations and relies heavily on local newspaper advertising, frequently including discount coupons and promotions in newspaper distributions. Auto World typically places the Pit Stop Centers within 10 miles of the Auto Boyz Centers primarily to facilitate a close supply line of parts, if needed. Auto World also relies on television and newspaper advertising for the Pit Stop Centers.

During the second quarter (on April 15, 2007), Auto World announced a decision to close all 30 freestanding Pit Stop Centers by June 30, 2007, under a new restructuring plan. The following is a copy of the press release issued by Auto World.

FOR IMMEDIATE RELEASE

FROM: Cal Naughton, Jr., Investor Relations

DATE: April 15, 2007

Auto World Inc. announced that it recently completed an exhaustive study of its current operating structure and determined that the most efficient delivery of retail products and automotive services to its customers would be under a “one-stop” shopping approach. As a result, Auto World plans to close its 30 freestanding Pit Stop Service & Tire Centers and begin providing these services out of its existing Auto Boyz Retail Centers. Ricky Bobby, chairman and chief executive officer, said, “Overall, we have made considerable progress in the last three years in strengthening our portfolio of businesses at Auto World. The actions we are announcing today will further enhance our ability to increase market share and improve sales and earnings at our company by providing our customers with ‘one stop’ shopping for our ‘do-it-yourself’ retail customers and our ‘do-it-for-me’ customers.”

The 30 facilities are expected to be closed on or before June 30, 2007. It is also expected that Auto World’s Auto Boyz Retail Centers will be fully prepared to take

over all of the automotive service and tire business currently handled by the Pit Stop Service & Tire Centers by June 30, 2007, and that there will be minimal loss of customers during this transition. These actions are expected to generate significant cash flow in 2007 and to increase free cash flow in 2008 and beyond. In addition, these actions are expected to yield improvements in operating earnings of approximately \$58 million in 2008 and approximately \$67 million annually thereafter.

In conjunction with these actions, Auto World currently estimates it will incur restructuring and other charges totaling \$52 million pre-tax. The majority of these charges are associated with the termination of operating leases. The amount of this charge is preliminary and remains subject to change, pending the outcome of negotiations with landlords and other third parties. The company intends to record the charges in the second quarter of the current fiscal year.

Mr. Bobby continued, “We have worked hard over the past few years to expand our auto parts and service business, and these efforts have been successful. However, our efforts to reverse significant performance declines within the freestanding Pit Stop Service & Tire Centers have not been successful. The accelerating deterioration in the financial performance of these freestanding stores has convinced us that it is in the best interest of our company and of our shareholders to cease operations in these freestanding stores. This will enable us to refocus our efforts to ensure that our most productive divisions and formats are best positioned to deliver the returns that we and our shareholders want.”

“We are keenly aware of the effects of this decision, and we commend all our associates for their efforts and perseverance in recent years. We are working hard to make sure that, where possible, we place these associates in other positions within the company.”

Mr. Bobby also commented, “In this regard, we remain committed to the automotive business and we expect to deliver significant additional profitable growth.”

After the closure of the Pit Stop Centers, Auto World estimates that there will be continuing cash flows from the sale of automotive services and tires by the ongoing Auto Boyz Centers of approximately \$600 million. Auto World estimates that the Pit Stop Centers would have generated approximately \$700 million of sales absent the disposal transaction. Auto World undertook a marketing strategy to notify the existing Pit Stop Center customers via direct mail of the changes and of the location of the nearest Auto Boyz Center. In addition, Auto World offered bounce-back coupon promotions that would allow a customer to get a coupon redeemable at any Auto Boyz Center once the Pit Stop Centers close. Auto World also provided its Internet address to enable customers to schedule automotive service and order tires online at the nearest Auto Boyz Center.

Other Relevant Facts

For financial reporting purposes, Auto World has two operating and reportable segments in accordance with ASC 280, *Segment Reporting*. The segments are Auto Boyz and Pit Stop Service & Tire.

Segment Information (in millions):

	<u>2006</u>	<u>2005</u>
NET SALES		
Auto Boyz	\$1,158	\$902
Pit Stop Service & Tire	<u>701</u>	<u>689</u>
Total net sales	\$1,859	\$1,591
OPERATING EARNINGS		
Auto Boyz	\$279	\$208
Pit Stop Service & Tire	<u>(172)</u>	<u>(88)</u>
Total operating earnings	\$107	\$120

- For Q2 2007, Auto World determined that it meets the criteria in ASC 420-10, *Exit or Disposal Cost Obligations: Overall*, for recognizing an accrual related to this event.
- Auto World determined that the Pit Stop Centers meet the definition of a “component of an entity” as that term is defined in ASC 205-20-20, *Presentation of Financial Statements: Discontinued Operations*, for reporting discontinued operations.

Required:

- Should the Pit Stop Centers store closures be reported as a discontinued operation in Auto World’s second quarter financial statements? (As part of your response, include a calculation of the level of significance of any continuing cash flows after the disposal transaction.)
- Discuss any additional issues you have identified and the professional literature you relied on in developing your recommendations and conclusions for resolving the issues.