Financial Reporting Quality

Learning Problems

Answer Keys

**Types of Accounting Transactions**

1. Error correction that is accounted for retrospectively which means previous financial statements are adjusted to correct the error and make past financial statement more comparable to current statements.
2. Change in accounting estimate that is accounted for prospectively which means it is applied in future periods only.
3. Contingent asset that is noted even though it is probable. It must be virtually certain to be recognized based on the conservatism principle. Recognition will most likely occur when the regulatory commission makes its decision.
4. Change in accounting policy that is accounted for retrospectively. Accounting policy changes should only be made if they improve the quality of the financial information provided to users. A company may switch to FIFO from the average cost method to increase the value of its inventory and net income. An auditor can request that the change not be made.
5. The contingent liability is noted since it is a possible obligation dependent on the outcome of a product liability lawsuit. Also, IFRS gives companies the option to just disclose the contingent liability in general terms with an explanation that saying anything more may prejudice their legal position in the dispute.
6. Related party transaction that is disclosed. Able and Doris are related because they are a parent and subsidiary. The transaction should not be disclosed separately but categorized by the nature of the relationship between the two companies. Doris is Able’s parent, so this transaction should be included in the parent category. Also, IFRS requires that all parent-subsidiary relationships be disclosed even if no transactions between the parties occurred that year.
7. Related party transaction that is disclosed. Jackson and the CEO’s daughter are related as she is a close family member of the CEO who is key management personnel. The transaction should not be disclosed separately but categorized by the nature of the relationship between the two companies. The correct category is other related parties.
8. Event after the reporting period that is accrued since the conditions existed at year-end. Even though the company did not learn of the bankruptcy until January 5, Allison was likely already experiencing financial distress on December 31.
9. The contingent liability is noted since it is a possible obligation dependent on the outcome of a product liability suit. Also, IFRS gives companies the option to just disclose the contingent liability in general terms with an explanation that saying anything more may prejudice their position in the dispute.
10. Related party transaction that is disclosed. Charlotte and Sigma are both subsidiaries of Rasputin. The transaction should not be disclosed separately but categorized by the nature of the relationship between the two companies. The correct category is other related parties.
11. Source of estimation uncertainty that is disclosed. The estimate of the discount rate and the remaining capacity of the mine could change the value of the mining property by a material amount in the coming year once the study is complete. Estimation uncertainty disclosures should only be provided for items that could be affected in the near term as this is of the most concern to users.
12. Event after reporting that is accrued but only noted since the conditions did not exist at year-end since fires are a random event.
13. Change in accounting estimate that is accounted for prospectively. IFRS specifically states that adopting a different depreciation method is a change in estimate since going from the straight-line to the declining balance method is similar to reducing the depreciation period.
14. Event after reporting that is accrued but only noted since the conditions did not exist at year-end as Zippo was not purchased till March 10, 2018. The two companies were likely discussing the purchase at year-end, but the agreement was not final.
15. Related party transaction that is disclosed. The parent company Ryley and its subsidiary are related. The transaction should not be disclosed separately but categorized by the nature of the relationship between the two companies. Ryley is the parent, so this transaction should be included in the subsidiary category. Also, IFRS requires that all parent-subsidiary relationships be disclosed even if no transactions between the parties occurred that year.

This transaction is also a contingent liability that should be noted since it is less than probable, and its amount cannot be reasonably determined. It is not remote, so it should be noted.

**Revenue Recognition and Classification Strategies**

1. This is an acceptable practice for ABC as long as the consignment returns can be estimated accurately. These are regular transactions with a short duration, so the estimates are probably accurate. If not, revenue should not be recognized until the return period expires.
2. Turbo Prop should recognize revenue when it transfers control of the completed airplane and not when the order is booked. At that time, it will have satisfied its performance obligation under the sales contract and the cancellation provision will have expired. The cancellation deposit is recognized as revenue at the same time as the revenue from the plane’s sale. If the order is cancelled, the non-refundable cancellation deposit is recognized as revenue.
3. Initially, Thompson Wineries can recognize revenue equal to the fair market value of the grapes, and the grapes are classified as raw materials inventory. Once bottling begins, the raw materials are transferred to work-in-progress and then finished goods inventory. All inventories are carried at the lower of cost or net realizable value during production. Additional revenue is recognized when the bottled wine is sold.
4. Happy Trails should recognize revenue over the life of the contract likely on a time elapsed basis.
5. Delta Construction can adopt a different method for prorating revenue as long as it accurately reflects the effort that goes into each stage. Using construction costs instead of labour hours results in faster revenue recognition. Purchasing construction materials at the beginning of the project is a passive activity so labour hours is likely a more accurate measure of the work completed. An auditor could insist that labour hours be used, but a desire to keep the client and other valuable consulting work may influence their decision.
6. SuperGrill should recognize revenue when products are sold by retailers or the return privileges expire next fall. This practice is called “channel stuffing” or “trade loading” and is used by companies to reach their annual sales quotas. It is costly because of the generous price discounts, returns privileges, and storage provided.
7. These activities by Pinnacle Ltd. are fraudulent but are used by companies to meet their annual sales quotas.
8. These activities are fraudulent and could result in criminal prosecution.
9. Amber Computing should divide this project into five performance obligations including software sales, installation, modification, training, and technical support. The contract price is allocated among the different obligations. Revenue from software sales is recognized immediately but revenue for installation, modification, training, and technical support is deferred and recognized on a prorated basis such as labour hours. Instead of recognizing all the revenue immediately, Amber may try to deceive analysts by allocating an excessive amount of the contract price to software sales instead of after-sales services as software sales are recognized immediately while after-sales service revenue is deferred.
10. Online Retailer Ltd. is engaging in a practice called “grossing up” which is used by companies to make their revenues appear larger or like they are growing faster. The company does not take legal ownership of the item, so only the commission revenue should be recognized.
11. The flat fee and commission should not be recognized by Casper until the product is sold and the performance obligation is met. If the item is not sold and removed from the site, then the non-refundable flat fee only is recognized as revenue.
12. AccuSoft should delay revenue recognition until the return provisions under the side agreements expire unless the returns can be estimated accurately. Using secret return provisions to increase sales is fraudulent and offering stock options as an incentive to go along with the arrangement is bribery. If there were no return provisions, AccuSoft could recognize the revenue immediately.
13. In a non-cash or barter transaction, Datacom and EDE should recognize revenue equal to the market value of the fiber optic capacity they are receiving from each other. If that cannot be reasonably estimated, they should recognize revenue equal to the cost of the capacity they are giving up. This is a related party transaction because EDE has significant influence over Datacom and the companies have interlocking boards. In this case, Datacom and EDE are engaging in a fraudulent act called “round-tripping” where they are not using the capacity. The sole purpose of this fraudulent transaction is to meet their sales targets, so revenue should not be recognized.
14. Vendor financing is often extended without a thorough credit investigation to increase sales. Quasar Technologies should not recognize revenue until collection is probable. If collection is probable and bad debts can be accurately estimated, then sales can be recognized. Any sales should be recognized at their present value and the discount rates must reflect the riskiness of the receivables, so sales are not overstated.
15. Amber Ltd. should recognize revenue immediately, but the price discounts and extended payment terms are costly ways for the company to meet its sales quota. Unpredictable returns and collections are the only factors that could delay revenue recognition. Sales should be shown net of price discounts. If payment is deferred, the revenue recognized equals the present value of the future payments, and interest revenue is recognized over the life of the agreement.
16. Dexter Ltd. is committing a fraudulent act that the auditors should stop.
17. Explorer Online’s non-cash transactions are legal and should be recorded at the fair value of what was received or, if that is not available, what was given up. This is a related party transaction because the two companies operate a joint venture together. When non-cash transactions make up such a large portion of revenue, auditors and analysts should be cautious. Fraud could be proven if the ad space were not used, technical services were not provided, prices were inflated, or it was discovered that the true purpose of the transaction was to inflate sales.
18. Marvelous Meats should recognize the initial fee over two years as the performance obligation to open the store is completed. The method used to recognize this revenue must reflect the amount of work done to that point. Product sales are recognized when the products are shipped. The advertising charge is recognized as the service is provided. No revenue is recognized by the franchisor relating to the store fixtures or construction costs as the franchisee is only reimbursing the franchisor.
19. This accounting treatment was adopted to inflate the amount and growth rate of sales and increase the company’s gross profit margin ─ the net profit margin is unaffected. The cost of loss leaders and price discounts should be netted against sales instead of classified as marketing expenses.
20. Creative Productions is borrowing money using a repurchase agreement. The transaction provides enhanced collateral to the lenders who now own the property and inflates Creative Productions’ sales. A loan should be recognized, and interest expense incurred over the life of the contract. Revenue is only recognized at the end of two years if the play is not repurchased.
21. Hanson Brothers are trying to meet its annual sales quota by offering rebates, but this will cannibalize future sales and reduce the gross profit margin because of lower prices.
22. Alpha is deferring revenue to improve its future post-merger performance.
23. Rebel is trying to deceive investors into thinking its high growth rate is sustainable when in fact it is just “buying” growth. Research indicates companies overpay for most acquisitions, so this growth strategy is not recommended.
24. Shakey is inflating its operating income by moving non-operating investment income “above the line.” This may help hide poor operating performance.
25. Barber Ltd. correctly classified the proposed product line sale as a discontinued operation. Analysts tend to focus on continuing income as it is more forward-looking, so being able to disclose a poorly performing business unit “below the line” as discontinued operations is beneficial. Companies may attempt to manipulate their earnings by classifying assets sales as discontinued operations when they do not meet the requirements, not following through with proposed sales, or including regular operating expenses in discontinued operations to increase continuing income.

**Cost Recognition and Classification Strategies**

1. These costs should have been expensed in the current period as their future value is questionable. Costs were deferred to lower expenses and increase profits in the current period.
2. Rita is cutting back on discretionary maintenance to increase its profits in the current period. This will affect profits in the future as maintenance costs rise to compensate for a lack of spending in the past and production is interrupted by machine breakdowns.
3. Frequent restructuring charges are used to “smooth” income. Restructuring charges are recorded in high-profit years and are reversed in low-profit years resulting in “smoother” earnings over time.
4. Asset impairments are being timed to lower profits in good years. Impairments could subsequently be reversed to raise profits in bad years.
5. Alexa is increasing its operating profit by putting normal operating expenses into one-time restructuring charges. These one-time charges are “below the line” and are often ignored by analysts.
6. Delta is having a “big bath.” It is writing down subjectively valued assets all at once so future operations appear better due to lower amortization. Analysts tend to ignore these large one-time charges and focus more on the future.
7. Allison is timing the gains on its long-term investments to compensate for the loss of a major customer and “smooth” profits.
8. Tango reduced the pension obligation by raising the discount rate. This will also lower pension expense thus raising profits. The pension obligation is measured as the present value of all future pension benefits earned by employees. Pension expense is measured as the present value of all future benefits employees earned that year.
9. Marble is trying to get analysts to focus on its non-IFRS disclosures instead of its financial statements. These non-audited amounts can be manipulated and used to distract investors from the firm’s poor performance.
10. Hecktor is reducing depreciation expense and asset impairments to increase earnings. This is unjustified due to rising levels of technical obsolescence.
11. Haggart will increase future profits by lowering its bad debts percentage. It is unlikely that improved collection methods will compensate for higher bad debts in a recession.
12. Hi-tech capitalized more R&D expenditures to increase its earnings. Companies are required to be very conservative in capitalizing R&D, so these deferrals are likely unwarranted.
13. Able expensed excessive amounts of insurance this year to “smooth” earnings, but this violates the matching principle.
14. Essence negotiated rebates on its inventory purchases in exchange for higher prices in the future to “smooth” earnings.
15. Suza Ltd. is moving price discounts into operating expenses instead of netting them against sales to make revenue growth and gross margins appear higher, but this does not affect net profits. The company may do this if it feels analysts are more focused on sales and gross profit when making stock recommendations.

**Restructuring Provisions**

1.

|  |  |  |
| --- | --- | --- |
| December 31, 2018 | Restructuring charges | 4,110,000 |
|  |  Restructuring provision | 4,110,000 |

|  |
| --- |
| Permissible Costs |
| Severance pay | 2,580,000 |
| Retraining and relocation costs | 1,530,000 |
| Total | 4,110,000 |

 All other costs should not be included in the provision as they do not directly relate to the restructuring.

|  |  |  |
| --- | --- | --- |
| March 1, 2019 | Restructuring provision | 1,950,000 |
|  |  Cash | 1,950,000 |

|  |  |  |
| --- | --- | --- |
| April 1, 2019 | Restructuring provision | 200,000 |
|  |  Cash | 200,000 |
| September 1, 2019 | Restructuring provision | 1,150,000 |
|  |  Cash | 1,150,000 |
| November 1, 2019 | Restructuring provision1 | 810,000 |
|  |  Reversal of restructuring charge | 810,000 |

1 4,110,000 – 1,950,000 – 200,000 – 1,150,000

Because the restructuring provision was for less than a year, the present value of the obligation was not used, and no attempt was made to adjust the provision to reflect its proper value in light of new information.

2.

* Roanoke attempted to include many costs in the restructuring charge and provision that were not directly related to the restructuring. They relate to the future operation of the business and not the restructuring. The “big bath” would have made 2018’s net income much lower but this would likely have been ignored by analysts given the company’s current financial situation. Costs recognized in future years would have been lower, so net income would have been higher making it appear that the company’s restructuring measures were having a greater positive effect than they were. The CEO certainly would have taken credit for this improved performance.
* Restructuring costs may have been intentionally overestimated so a large restructuring charge reversal could be realized next year. This reversal would help to “smooth” net income if the company had a difficult year financially. The company may also try to delay recognizing the reversal of the restructuring change till 2020 or 2021 to give them more flexibility in “smoothing” income.
* Restructuring costs may have also been intentionally overestimated so other costs in future years could have been charged against the provision. Roanoke may use this to hide embarrassing cost overages in the future that are difficult to explain or to “pull” operating expenses “below the line” to make ongoing operating income appear higher than it is.

**Warranty Provision**

1.

|  |  |  |
| --- | --- | --- |
| January 1, 2018 | Warranty expense1 | 300,000 |
|  |  Warranty provision | 300,000 |

1 15,000,000 x .02

|  |  |  |
| --- | --- | --- |
| December 31, 2018 | Warranty provision1 | 220,000 |
|  |  Parts, wages payable, etc. | 220,000 |

1 440,000 / 2

|  |  |  |
| --- | --- | --- |
| December 31, 2019 | Warranty provision | 220,000 |
|  |  Parts, wages payable, etc. | 220,000 |

|  |  |  |
| --- | --- | --- |
| December 31, 2019 | Warranty expense1 | 140,000 |
|  |  Warranty provision | 140,000 |

1 300,000 – 220,000 – 220,000

2.

Ryan reduced warranty expense in 2018 by lowering the warranty cost estimate from 3.0% to 2.0% of sales. Given actual warranty claims, this reduction was not justified. The additional warranty expenses were recognized in 2019 when the obligation expired, but this is likely being used by Ryan to increase 2018 net income to meet its short-term earnings goals.

**Beneish Model**

1.

|  |  |  |  |
| --- | --- | --- | --- |
|   | **Variables** | **Coefficients** | **Components** |
| Y-intercept |   |   | -4.84 |
| DSR | 1.167 | 0.920 | 1.074 |
| GMI | 0.300 | 0.528 | 0.159 |
| AQI | 0.929 | 0.404 | 0.375 |
| SGI | 1.295 | 0.892 | 1.155 |
| DEPI | 1.283 | 0.115 | 0.147 |
| SGAI | 0.516 | -0.172 | -0.089 |
| ATA | 0.105 | 4.679 | 0.491 |
| LEVI | 0.795 | -0.327 | -0.260 |
|   |   | **M-Score** | -1.788 |

2.

Agassi is likely engaging in earnings management as its M-score is at the limit of -1.78. The DSR and SGI variables indicate the company is using aggressive revenue recognition to support high sales growth. The DEPI and AQI variables show the company is reducing its costs by lowering its depreciation rate and engaging in questionable cost capitalization.

**Cash Flow Quality**

1.

No, the CFO’s claims about Ashby’s cash position are not justified. Although the cash to income ratio is much higher and approximates 1.0, this ratio is not sustainable. To increase cash flows from operations, Ashby stretched its accounts payable well beyond the industry average and maybe in jeopardy of being put on cash and carry by its creditors. It has significantly lowered its discretionary R&D expenses which will affect product innovation and future sales. Rising accounts receivable and inventory turnover in days continue to be a drain on cash as collections take longer and inventories accumulate. The falling fixed asset turnover could indicate that more operating expenses are being capitalized to move them from operations into cash flows from investing. Finally, interest expense is now classified as cash flows from financing instead of operations.

**Balance Sheet Quality**

1. Taka does not control any of its associated companies, so it accounts for them using the equity method instead of consolidation. This increases the company’s operating profit margin and reduces its debt ratio. An analyst should consolidate these associated companies despite the level of ownership to prevent this manipulation.
2. Ella is attempting to increase its current ratio by selling its receivables early and using the proceeds to partially pay down its current liabilities. As long as its current ratio is initially above 1.0, the current ratio will rise. These actions are negated if Ella controls the financing unit and has to consolidate its operations, so the company is intentionally keeping its ownership position below 50% and controlling the unit using other means like guaranteeing its debt. To prevent this abuse, IFRS has expanded the definition of control for these special purpose entities so they are consolidated even when a company owns less than 50%. An analyst may consolidate all financing units, regardless of IFRS’s new definition of control, so its financial statements are comparable to its competitors who do not sell their receivables.
3. FIFO gives a lower cost of sales (i.e. higher gross profit) and a higher inventory valuation compared to the average cost method. This is because older units are expensed first and ending inventory consists of recent inventory purchases. An analyst may convert the financial statements to the average cost method, so some financial ratios are more comparable with its competitors, but the inventory is more accurately valued using FIFO.
4. Gaylord can only recognize goodwill in an acquisition and cannot develop it internally. The value of internally developed intangible assets is often understated or excluded entirely from the balance sheet because the development costs were difficult to trace to the asset, conditions for capitalizing costs were not met when the initial expenditures were made, and revaluation gains cannot be recognized unless there is an active secondary market. An analyst should reassess intangible assets at their fair value regardless of whether there is an active market. Goodwill may also be estimated and recognized on the balance sheet.
5. Simpson’s investments are classified as current or long-term depending on when they mature, or if the company plans to sell them over the next 12 months. These investments may have been reclassified as short-term investments to increase the current ratio to meet a bank loan requirement. An analyst may exclude these assets from the calculation of the current ratio to prevent this manipulation. Financial institutions often have specific rules as to what can be included in the calculation of the current ratio.
6. Wilson claims that it reclassified some of its receivables as long-term because of collection problems, but it may be trying to improve its accounts receivable turnover in days which is calculated using short-term receivables only. An analyst may instead classify these receivables as short-term to prevent this manipulation.
7. Howard’s deferred income tax asset is probably overvalued given the company’s financial prospects. An analyst should record an impairment if the likelihood of the asset being realized is less than probable.
8. Hanson is reducing its annual pension expense and defined pension plan liability by lowering its actuarial estimate for the rate of compensation increase. An analyst may re-calculate these amounts using the average rate of compensation increase for the industry.
9. Columbia may be overvaluing these assets since they are relying solely on management assessments instead of active market data. An analyst should review these valuations and adjust them if necessary.
10. Hanover may be timing property, plant, and equipment impairments and reversals to meet its profit targets or smooth its earnings. An analyst should eliminate these questionable impairments and value the assets at their true value by adopting the revaluation model.
11. Global may be over-allocating the price of the acquisitions to goodwill to reduce amortization costs. It may also have overpaid for past acquisitions but failed to record any goodwill impairments. An analyst should examine goodwill for each cash-generating unit and recognize any needed impairments.
12. Emerson’s fixed turnover is likely higher than the industry average because of its older assets. It may also have removed the idle facilities from its fixed assets when calculating the ratio, which other companies may not have done. Higher fixed asset turnover is a positive sign, but the older assets may require additional maintenance and higher labour costs to operate. An analyst should verify this and also examine whether Emerson can generate sufficient cash to replace these assets soon.
13. Anton is reducing its accrued liabilities by reassessing the probability of several of its liabilities as less than probable. These contingent liabilities still have to be noted, so an analyst can review the assessment and accrue them again if appropriate.
14. May has increased the value of its long-term receivables by using a lower discount rate. An analyst should determine if it is reasonable by comparing the rate used by its competitors.
15. McDougal can account for its leases as operating by keeping the term under one year. By getting the assets and liabilities relating to these leases off their balance sheet, McDougal can raise its asset turnover ratios, lowers its debt ratio, and generated a higher return on assets. To make the financial statements more comparable, even though it is not required by IFRS, an analyst should capitalize these operating leases since the amount is material.