Financial Reporting Quality

Answer Keys

**Revenue Recognition and Classification Strategies**

1. This is an acceptable practice for ABC as long as the 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 the work-in-progress and then the 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 are 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, return 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 fibre 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 was 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. Marvellous 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 being 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 is 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 asset 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 hefty 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 expenses, thus boosting 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 debt 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.

**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 |

DSR = (354.7 / 1,401.8) / (234.7 / 1,082.6)

GMI = ((1,082.6 – 990.7) / 1,082.6) / ((1,401.8 – 1,005.2) / 1,401.8)

AQI = (1 – (289.0+ 789.6) / 1,344.4) / (1 – (242.1+ 686.6) / 1,180.0)

SGI = 1,401.8/ 1,082.6

DEPI = (52.1 / (52.1 + 242.1)) / (46.3 / (46.3 + 289.0))

SGAI = (157.2 / 1,401.8) / (235.4 / 1,082.6)

ATA = (131.3 – (-9.8)) / 1,344.4

LEVI = ((233.5 + 237.7)/ 1,344.4) / (298.8 + 221.2)/ 1,180.0)

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 that the company is using aggressive revenue recognition to support high sales growth. AQI variables show the company is engaging in questionable cost capitalization. The GMI indicates a greater incentive to manipulate earnings due to a declining gross profit margin. The ATA also indicates aggressive revenue recognition.

The DEPI, SGAI and LEVI were ignored as they have low statistical significance, or their coefficient signs are wrong. The probit analysis should be redone with the remaining five variables.

**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 may be 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.