Financial Reporting Quality

Learning Problems

**Revenue Recognition Strategies**

1. ABC Media sells CDs, DVDs, magazines, and books to retailers with the right to return unsold items. Sales minus an allowance for returns are recognized immediately.
2. TurboProp Ltd. recognizes plane sales when the salesperson books the order. The customer specifies the date of delivery, which can be several years into the future. The planes are manufactured on a just-in-time basis, but orders can be cancelled before the beginning of production, subject to the loss of a cancellation deposit. Full payment is made when the plane is completed.
3. Thompson Wineries recognizes revenues on its wines when they are stored in barrels for aging. Several years later, it bottles and ships the product.
4. Happy Trails, a campground operator, records membership fee revenue when a new customer signs and pays for a two-year contract.
5. Delta Construction has switched from labour hours incurred to date as a percent of total labour hours to a method based on construction costs for prorating revenue. Construction costs are incurred disproportionately at the beginning of most projects.
6. SuperGrill Inc., before year-end in December, offered its retail customers the opportunity to buy barbeques at a substantial discount for resale the following summer. It agreed to pay for warehousing and did not require payment until the units were sold. Unsold items could be returned in the fall or resold to customers provided by SuperGrill. Revenue was recognized when the product was sold in December, but SuperGrill was not able to accurately estimate returns.
7. To meet its sales goals, Pinnacle Ltd. regularly pre-dates packing lists, shipping records, and invoices so it appears the goods were sent to customers before quarter-end, and periodically changes quarterly cut-off dates.
8. During bankruptcy proceedings, investigators discovered Global Outreach Ltd. had falsified its revenues to deceive creditors. They booked sales to fake companies for non-existent products, paid holding fees to customers to accept products that were later returned, recorded sales after shipping products to warehouses they had leased, recognized sales before finalizing orders, and did not reverse sales when products were returned.
9. Amber Computing Ltd. recognizes all revenues from the sale of its software products when they are shipped. It also provides extensive installation, modification, training, and technical assistance to its users.
10. Online Retailer Ltd. resells airline flights, hotel rooms, car rentals, and vacations for established travel companies. It recognizes as revenue the cost of the service, plus a 15% commission, even though it does not take legal ownership.
11. Casper Ltd., an online auction service, charges a non-refundable flat fee for placing products on its auction site and then levies a commission equal to 10% of the selling price if it sells. Both amounts are recognized when the items are put up for auction.
12. AccuSoft Ltd. sells accounting software. Revenue is recognized at the time of sale because the company provides no installation or support, and there is no return provision. During the annual audit, it was discovered that the sales manager had entered into several secret verbal side agreements allowing customers to return products for up to six months. Stock options were offered to customers as an incentive to participate.
13. Datacom and EDE Ltd. regularly engaged in back-to-back swaps of unused fibre-optic capacity on the same routes to meet analysts’ sales growth expectations. The CEOs sit on each other’s board of directors, and EDE owns 25% of Datcom.
14. Quazar Technologies Inc. offers vendor financing with extended terms. Most customers have questionable credit ratings, but Quazar books all revenues at the time of sale at their present value. The discount rates are significantly below those used by other firms.
15. At year-end, to meet its annual sales quotas, Amber Ltd. offers significant price discounts and extended payment terms on its new products.
16. Dexter Ltd. regularly holds its sales ledger open after year-end until it meets its sales quota. Last year, employees held a contest on how many days past year-end it would take to meet the target.
17. Explorer Online Ltd. bartered ad space for the technical services of another software company with a market value of CAD 1,350,000. This represents 25% of its yearly sales. The companies have a joint venture, which they plan to take public soon.
18. Marvellous Meats Ltd. is a franchisor of specialty meats and frozen food products. Franchisees pay an initial fee of CAD 100,000 to open a store in a community for 10 years. The company assists with management training, site selection, and construction over two years. Marvellous Meats pays all construction costs and buys all store fixtures, but is later reimbursed by the franchisee. It generates most of its revenue selling inventory to franchisees and charges an annual advertising fee equal to 1% of store sales.
19. Books and Stuff Ltd. is a new online book retailer that uses loss leaders extensively to build sales volume. Sales are recorded at their list price, and any price discounts are included in marketing expense.
20. Creative Productions sold 50% of one of its musical plays to a group of private investors. It agreed to repurchase the property in two years and pay 9.0% interest per year. The sales were recorded as production revenue.
21. Hanson Brothers Inc. provides new customers with price rebates in the final quarter of the year if they buy before year-end.
22. The CEO of Alpha Ltd., realizing that a merger is likely to be finalized in the coming weeks, delays recognizing revenue on several consulting projects even though the conditions for revenue recognition have been met.
23. Earnings at Rebel Ltd. have grown at 20% per year for the last ten years, but further research indicates that growth came mainly from business acquisitions.
24. Shakey Ltd. records interest and dividend income and investment gains and losses as operating income. The company has a sizeable investment portfolio.
25. Barber Ltd. classified the proposed product line sale as a discontinued operation. The unit is operationally and financially distinguishable, and the sale is highly probable.

**REQUIRED:**

1. For each of the above scenarios, describe the appropriateness of revenue recognition.

**Cost Recognition Strategies**

1. Amsterdam Ltd. incurred considerable costs developing channels of distribution for new products. The CFO decided to defer and amortize these charges over five years.
2. At Rita Company, maintenance costs as a percent of total sales fell by 35% over the last two years, and profits increased.
3. Ella Enterprises uses more restructuring provisions than its competitors. A review indicated many of these reserves are later reversed.
4. It is common practice at Wittley Inc. to delay asset impairments so they can be matched against unexpected gains or profits in the future.
5. During a formal SEC investigation at Alexa Company, restructuring provisions were found to contain normal advertising and promotional expenses.
6. As part of a major corporate restructuring, Delta Ltd. wrote off all of its goodwill and several patents it had purchased two years before.
7. Allison Company lost a major customer, but its profits did not fall because of gains on the sale of several long-term investments.
8. Tango Ltd. increased the discount rate used to calculate its defined pension benefit obligation.
9. Marble Inc. issued regular financial statements plus non-IFRS disclosures in its M,D&A.
10. Hecktor Ltd. increased useful life estimates for a number of its asset classes and reduced the number of asset impairments despite rising technical obsolescence.
11. Haggart Corp. decreased its bad debt percentage, claiming its stricter collection policies will compensate despite a recession.
12. Hi-tech Ltd. decided to capitalize more of its R&D costs to measure the future value of these expenditures better.
13. Able Company purchased an insurance policy with a three-year life but expensed it immediately as it was a good year financially.
14. Essence Ltd. receives a 10% discount on its inventory purchases from a major supplier, but has signed a secret agreement to pay higher prices in the future.
15. Suza Inc. uses price discounts to develop new markets. They are classified as distribution costs in the operating expense section of its income statement instead of netting them against sales.

**REQUIRED:**

1. For each of the above scenarios, describe the appropriateness of cost recognition.

**Restructuring Provisions**

Roanoke Industries is experiencing financial difficulties and has decided to eliminate a number of its unprofitable product lines over the next year. A restructuring provision will be recognized at year-end on December 31, 2018, consisting of the following costs (in CAD):

|  |  |
| --- | --- |
| Severance pay | (2,580,000) |
| Retraining and relocation costs |  |
| Terminated employees | (1,530,000) |
| Continuing employees | (525,000) |
| Estimated future product line losses | (5,780,000) |
| Expected gain on sale of production assets | 2,140,000 |
| Marketing | (950,000) |
| Computer systems development | (1,380,000) |
| **Total** | (10,605,000) |

Roanoke’s board approved a formal restructuring plan of directors, and the company has begun interviewing employees to present them with their options. The company has retained a liquidation firm for CAD 150,000 to find buyers for its surplus assets. Marketing costs relate to a new advertising campaign to help increase demand for the company’s remaining products. Computer systems development costs will be incurred to build a product information system that will provide real-time information on sales and profitability. Roanoke’s CEO feels that a lack of product information is a major reason for the company’s current difficulties.

On March 1, 2019, Roanoke paid out CAD 1,950,000 in severance costs.

On April 1, 2019, Roanoke paid out CAD 200,000 in legal costs relating to several lawsuits involving terminated employees. These costs were not included in the original estimate of restructuring costs.

On September 1, 2019, Roanoke paid out CAD 1,150,000 in retraining and relocation costs relating to terminated employees.

The restructuring plan was completed on November 1, 2019.

**REQUIRED:**

1. Make the appropriate journal entries relating to the restructuring provision in 2018 and 2019.
2. Describe the earnings management techniques that Roanoke is likely using.

**Warranty Provision**

On January 1, 2018, Ryan Ltd. sold CAD 15,000,000 in heavy-duty equipment with a two-year warranty. In the past, it used a 3.0% warranty cost estimate, but the company has decided to reduce the estimate to 2.0% beginning this year. Ryan incurred CAD 440,000 in warranty costs uniformly over the two-year warranty.

**REQUIRED:**

1. Make the appropriate journal entries relating to the warranty provision.
2. Describe the earnings management techniques that Ryan may be applying.

**Beneish Model**

Kyle Wellington is a loans officer at the Bank of Montreal who is reviewing a commercial loan application from Agassi Industries. During his analysis, he detected several possible warning signs of earnings management, so he employed the Beneish Model. The following inputs came from the company’s most recent financial statements:

|  |  |  |
| --- | --- | --- |
| (CAD thousands) | **2020** | **2019** |
| Trade accounts receivable, net | 354.7 | 234.7 |
| Current assets | 789.6 | 686.6 |
| Current liabilities | 237.7 | 298.8 |
| Total assets | 1,344.4 | 1,180.0 |
| Property, plant, and equipment, net | 289.0 | 242.1 |
| Long-term debt | 233.5 | 221.2 |
| Net sales | 1,401.8 | 1,082.6 |
| Depreciation expense | 46.3 | 52.1 |
| Cost of sales | 1,005.2 | 990.7 |
| Selling, general, and administrative expenses | 157.2 | 235.4 |
| Cash flow from operations | -9.8 | 15.6 |
| Continuing income | 131.3 | -251.1 |

**REQUIRED:**

1. Calculate Agassi’s Beneish M-score for 2020.
2. Assess the quality of the company’s earnings.

**Cash Flow Quality**

Becky Carruthers is a stock analyst for a large investment banking firm. Ashby Industries has experienced financial difficulties since Carruthers began to follow the company three years ago. During Ashby’s last quarterly earnings announcement, its CFO bragged that the company’s cash flow from operations had greatly improved since he joined the company last year and its cash to income ratio was now above 1.0 Carruthers knew the CFO from his previous position where he forced out after an investigation by the Ontario Securities Commission. She was very suspicious of these claims, so she collected the following information:

|  |  |  |  |
| --- | --- | --- | --- |
|  | **2020** | **2019** | **Industry Average** |
| Cash-to-income ratio | 1.02 | 0.72 | 1.01 |
| Accounts receivable turnover in days | 41 days | 36 days | 30 days |
| Inventory turnover in days | 76 days | 68 days | 60 days |
| Accounts payable turnover in days | 128 days | 89 days | 90 days |
| Fixed asset turnover ratio | 3.01x | 3.32x | 3.23x |
| R&D / Sales | 4.39% | 7.43% | 7.24% |

A review of the notes to the financial statements showed Ashby began to classify interest expense as a financing item on the 2020 cash flow statement.

**REQUIRED:**

1. Are the CFO’s claims about Ashby’s cash position justified? Explain.