Case 03-05

Trademark, Inc.
Part 1—Accounting Issues

This case study is the first of a two-part Earnings Management Case. The purpose of Part 1 is to provide you with background information relating to Trademark, Inc. and raise several accounting and auditing issues affecting Trademark during the current fiscal year. The conclusions reached in this case study will be used in Part 2 — Misstatements & Materiality.

Trademark, Inc., a public company, designs, manufactures, and distributes greeting cards, calendars, stationery, party goods, and specialty gift merchandise. Trademark operates through four divisions: Greeting Cards and Stationery, Calendars, Party Goods, and Specialty Gifts. In 1994, Trademark acquired a 100 percent interest in a Swiss company that manufactures and distributes similar products in Western Europe. Trademark has not integrated its operations on a global basis, and through fiscal year 1999, the Swiss company operated as a separate, wholly-owned subsidiary.

Trademark operates five manufacturing plants in the U.S. Trademark’s primary customer base in both the U.S. and Europe consists of drug store and supermarket chains as well as specialty gift retailers. For its U.S. operations, Trademark maintains its inventory in both company-owned and public warehouses. Typically, Trademark’s shipping terms are FOB shipping point, and orders are shipped, if stock levels permit, to customers within 48 hours or upon completion of production. Trademark’s return policy allows customers to return damaged goods for a refund or credit within 30 days of shipment.

The company began operations in 1981 and, after experiencing significant growth from fiscal years 1989 through 1991, offered its stock to the public in 1992. Trademark’s growth continued through fiscal year 1993. However, revenues were flat from fiscal years 1994 through 1997 (ignoring the acquisition of the Swiss company). In fiscal year 1998, Trademark’s revenues decreased. The schedule included as Exhibit 5-1-1 shows Trademark’s revenues for each of the past five fiscal years ending on June 30, along with other financial data.

Trademark’s CFO, Rob Arnold, attributes the company’s growth rate through 1993 to its successful magazine and in-store marketing campaign led by Maxine Hartman, Vice President of Marketing. Mr. Arnold attributes the flat growth rate, beginning in fiscal year 1994, to increased competition from specialty companies and entertainment companies who began providing similar merchandise. Mr. Arnold cites the popularity of “electronic” greeting cards offered on the Internet for the decrease in revenues in 1998.
Mr. Arnold recently engaged Munney, Groughs, & Treez, an investment banking company, to evaluate Trademark’s financing options. The company and its advisors are currently exploring the possibility of a public debt offering in the near future. Trademark plans to use the funds on new equipment for three of its manufacturing plants and possibly an e-commerce endeavor.

Nancy Drew, a senior auditor with four years of experience, is the in-charge accountant on the Trademark audit for the year ending June 30, 1999. In addition to her supervisory and administrative responsibilities, including the coordination of the audit of the Swiss subsidiary, Nancy is responsible for auditing Trademark’s revenue accounts for its U.S. operations. Based on her work during the first week of final audit fieldwork, Nancy has learned the following:

**Returns of Damaged Goods**

Trademark records a reserve for returns of damaged goods at the time of sale based on an estimated return rate of 0.25 percent. In fiscal year 1999, Trademark accrued $5.025 million for returns based on 0.25 percent of sales. Warehouse management has informed Nancy that actual return rates during the past two years have declined. Trademark switched packaging material vendors in early fiscal year 1998 and has been using more durable packaging materials. The new boxes and packing materials appear to have substantially decreased the damage to Trademark’s products during the shipping process. Warehouse management estimates that in fiscal year 1998, returns averaged 0.23 percent, and in fiscal year 1999, returns averaged 0.22 percent. The return rate in 1999 was lower than 1998 because the company was still in the process of using up its stock of old packaging materials in 1998. Warehouse management believes that damage levels will remain at the 0.22 percent level going forward.

Recognizing that the company may have over-accrued in fiscal year 1999 for future returns of damaged goods, Nancy requested audit evidence to support warehouse management’s claims that return rates had decreased. Based on the evidence examined, Nancy concluded that the 0.22% return rate was accurate for fiscal year 1999 and appeared sustainable. To assess the reasonableness of management’s estimate for the reserve at June 30, 1999, Nancy developed an independent estimate of the reserve, factoring in the impact of the new packaging materials. Nancy developed a range of acceptable estimates and determined that management’s estimate was outside that range. The difference between management’s estimate and the high-end of the range was $923,077. This amount represents the estimated gross sales amount for the related returns. The average gross margin for the year was 65%.

**Other Returns**

In addition to returns of damaged goods, over the years Trademark has periodically permitted certain specific large customers to return slow-moving merchandise for full credit so that Trademark may sell new merchandise in the space previously occupied by the old merchandise. Since customers do not have the legal right to return the merchandise, these returns have been permitted only when negotiated with Trademark.
When previously permitted, Trademark required that the customer purchase a minimum amount of new merchandise concurrently with the return of the old merchandise. In prior years, management recorded a reserve for these returns at the time of the original sale based on their best estimate of return activity. In fiscal year 1999, management did not record such a reserve. Nancy questioned Trademark’s Director of Accounting, Liz Siegel, about this and was informed that management was concerned that their policy in prior years of accruing a reserve at the time of sale was too conservative and might be perceived as a form of “earnings management” by the SEC. Accordingly, in fiscal year 1999, management determined that unless a specific contractual arrangement exists permitting such returns, a reasonable accrual for returns is not estimable at the time of sale. Management intends to accrue for the returns at the time the returns are negotiated with the customer.

Although Nancy was uncertain about the conceptual basis for accruing for these types of special returns, based on the audit evidence examined and audit testing performed, Nancy concluded that if a reserve was appropriate under GAAP, the sales subject to return ranged from a minimum of $1.692 million to possibly as much as $2.0 million based on fiscal year 1999 gross sales activity.

“Slotting Allowances”

Beginning in the fourth quarter of 1999, as an inducement to certain customers to expand the shelf space available for Specialty Gifts’ merchandise, Trademark offered to purchase, at full price, all competitors’ merchandise in the existing shelf space in exchange for a one-year agreement from the customer to stock Specialty Gifts’ merchandise in the location. Ms. Siegel explained to Nancy that this was similar to a “slotting allowance,” in that Trademark has paid for shelf space for a defined period of time. Accordingly, Trademark has capitalized these expenditures and is amortizing them over the period of benefit. At year-end, the amount capitalized on Trademark’s balance sheet was $1.525 million. Ms. Siegel also indicated that Trademark has and will continue to scrap all competitors’ inventory acquired; therefore, no value is assigned to the inventory.

Specialty Gifts’ Sales Incentive Program

In an effort to increase the sales from the Specialty Gifts division, a new incentive program for that division’s sales force was implemented in January 1999. Sales representatives were offered up to three times the normal commission rate for sales to new customers between January and June 1999. The actual multiple was dependent on the dollar amount of the sale. For existing customers, sales representatives were encouraged to increase annual sales amounts to that customer over the customer’s prior year purchases, and in return, the sales representatives were offered double the commission on the incremental sales dollars.
The new incentive program was very successful, resulting in a significant increase in Specialty Gifts’ sales in the second half of fiscal year 1999. Specialty Gifts’ Sales Manager, Howard Soon, indicated to Nancy that he was hopeful that Specialty Gifts’ success would be attributed to his leadership and that he would be promoted to Director of Sales for Trademark, a vacant position under Ms. Hartman. Mr. Soon explained that he had been diligent in keeping Ms. Hartman apprised of all of the new customers brought in by his sales representatives during the latter half of 1999. In fact, in the last week of June alone, Mr. Soon and his team brought in 25 new customers! And in January, right after the incentive program was announced, Mr. Soon bragged that he had worked directly with another sales representative to bring in Sunshine Cards & Gifts, one of the largest specialty gift retailers in the Midwest.

Nancy recalled noticing a significant amount of sales activity at the Specialty Gifts division during the last week of June from her audit work to date. In fact, just a few days earlier, she had even commented to the audit manager, Louis Sanchez, that the postage charges billed to Trademark this year for mailing the accounts receivable confirmations were going to be pretty steep because there were so many accounts in her sample. She remembered noticing Sunshine Cards & Gifts on her list of sample accounts and had recognized the name immediately from the area shopping centers. Sunshine owed Trademark a substantial balance as of June 30, 1999 – about $125,000. The invoice dates spanned the January through June timeframe. Nancy mentioned the aged balance to Mr. Soon and asked for his reaction to Sunshine’s slow payment history. Mr. Soon assured Nancy that he was personally in contact with Sunshine on a weekly basis and payment would not be an issue. Mr. Soon noted that Trademark’s specialty gifts really took off in the Sunshine stores in May and June because of the mother’s and father’s day holidays and the graduation season; therefore, he expected Sunshine’s account to become current shortly.

**Back in the Audit Room**

Nancy is in the process of sorting through the information she has gathered. Barry Green, a staff auditor with one year of experience, has been assigned to audit Trademark’s inventory accounts. During the second week of final fieldwork, Barry commented to Nancy during lunch that the physical count he observed on June 30th at the local Trademark warehouse was one of the easiest counts he had ever observed because stock levels were low and a lot of merchandise did not have to be counted since it had already been sold to customers and was just being stored in the Trademark warehouse. Barry bragged that he finished by 1:00 PM and was able to sneak in 18 holes of golf that day! A bit agitated, Nancy replied that she did not think there would be much time for golf during this audit — the engagement team really had their hands full with Trademark. Nancy already had a list of questions for the client relating to Trademark’s revenue recognition policies.
Required:

- What revenue recognition issues should Nancy consider?

- Evaluate the propriety of the company’s accounting treatment for each of the issues identified. What potential misstatements, if any, related to the issues identified should Nancy consider?

Additional Case Study Facts

Included as Handout 5-1-1, Handout 5-1-2, and Handout 5-1-3 are additional case study facts in order to resolve certain issues.
ADDITIONAL CASE STUDY FACTS—TRADEMARK, INC.

Specialty Gifts’ Sales Incentive Program

Bothered by Barry’s comments, Nancy made a mental note to herself to reevaluate the audit team’s risk assessment with respect to inventory cut-off and revenue recognition. Later that afternoon, she met with Howard Soon again to talk about sales activity at Specialty Gifts. Mr. Soon boasted about the new customers and the record sales level at the division. He explained that although many of their new customers did not have the storage space for large orders, the sales representatives accommodated the customers by offering to delay shipment until the customer was ready to take delivery. Mr. Soon said this arrangement worked out great for everyone – the customer was able to take advantage of Specialty Gifts’ standard volume discounts, Specialty Gifts was able to increase sales, and Mr. Soon’s sales representatives earned their extra commissions. Mr. Soon explained that he even instructed his representatives to offer to delay shipment for existing customers if the customers agreed to increase their normal orders. Space at the warehouses was not a problem – Trademark had contracts with lots of public warehouses that could provide the needed storage space with almost no notice, and at little added insurance and storage cost to Trademark.

Nancy called Louis Sanchez that evening to discuss her concerns about the year-end sales at Specialty Gifts. Louis instructed Nancy to collect the appropriate audit evidence and perform audit testing procedures to determine the terms of the sales and the dollar amounts.

Based on her audit testing, Nancy learned that $9.4 million in sales to both old and new customers were recorded at Specialty Gifts during the last week of June. Of this amount, inventory representing $3.7 million in sales was shipped to customers prior to June 30, 1999, on normal terms. (Our audit procedures confirmed the validity of these sales.) Inventory representing $1.5 million in sales was shipped to public warehouses pending the customers’ preferred shipment dates. Inventory representing $4.2 million in sales was packed, labeled, and set aside in Trademark’s warehouses pending the customers’ preferred shipment dates.

A very nervous Mr. Soon provided Nancy with a copy of an e-mail message from Ms. Hartman indicating that the practice of delaying shipment to customers was acceptable as long as the inventory was packed, labeled, and segregated in the warehouses. Sales representatives were to be instructed to explain to customers that title to the inventory would pass to the customer once their order was filled and segregated in the Trademark warehouse or shipped to the public warehouse. Mr. Soon assured Nancy that the inventory had been appropriately segregated in both the public warehouses and company-owned warehouses, and his sales representatives had fully explained the terms to each customer. Each customer order was supported by a purchase order or sales agreement signed by the customer, and the shipping and payment terms were printed on the invoice sent to the customer.
Customers were invoiced on the date the order was shipped to the public warehouse or completed and packed in the company-owned warehouse. Customers were required to specify a shipping date within 30 days of invoice, and the shipping date could not exceed 90 days after the invoice date. Payment terms were extended to 15 days after actual shipment. Upon Nancy’s request, Barry reviewed his inventory audit workpapers and determined that the average gross margin on the inventory sold during that last week in June was 65%.
ADDITIONAL CASE STUDY FACTS—TRADEMARK, INC.

Sunshine Cards & Gifts

The next week, the accounts receivable confirmation from Sunshine Cards & Gifts was received at the auditor’s office. The full balance of $125,000 was confirmed by Sunshine; however, a notation written by Sunshine’s accounts payable clerk indicated that the payment terms had been extended to September 30, 1999. The extended terms appeared to be unusual for Trademark, so Nancy called Mr. Soon to see if he knew anything about this; Mr. Soon confirmed that he was aware of the extended payment terms. Because this account was such a significant win for Specialty Gifts, they were really trying to accommodate Sunshine and build customer goodwill. Trademark’s credit department and Trademark’s Controller, Maia Walker, approved the extended payment terms. Sunshine’s credit was excellent and the company was in great financial shape, so neither Ms. Walker nor Mr. Soon were concerned about collectibility.

After confirming that the payment terms had been approved by the credit department and Maia Walker, Nancy performed additional audit procedures to test the validity of the balance, including reviewing purchase orders, shipping documents, and invoices. Based on the audit evidence reviewed, Nancy concluded that the Sunshine accounts receivable balance was not misstated.
ADDITIONAL CASE STUDY FACTS—TRADEMARK, INC.

The “Side Agreement” with Sunshine

Nancy still felt a little uneasy about the extended payment arrangement, so she arranged to meet with Maia Walker to discuss Sunshine. Ms. Walker indicated that this type of arrangement was not the sort of practice Trademark intended to continue; however, Sunshine was a terrific win for the division and Trademark really wanted to maintain this customer and grow the relationship. Ms. Walker said she was certain that Sunshine’s payment stream would become more constant once Specialty Gifts’ products were established in the Sunshine stores. Until then, however, she and Mr. Arnold, the CFO, both agreed that this type of arrangement with Sunshine would be beneficial for both companies.

Ms. Walker gave Nancy a copy of a signed agreement between Trademark and Sunshine, which stipulated the sales terms. Merchandise was to be invoiced on normal terms when it was shipped to Sunshine; however, actual payment was not due until the merchandise was sold by the Sunshine stores. If the merchandise did not sell within six months, Sunshine could return the goods to Trademark and no payment would be owed.

Ms. Walker explained that the September 30, 1999 due date noted on the confirmation from Sunshine was really an arbitrary date and was only used by Sunshine because their accounts payable system required a due date. Payment was not expected until the merchandise was actually sold.

With this “side agreement” in hand, Nancy returned to the audit room and dug out her records on the Sunshine account. She determined that, to date, Sunshine’s balance of $125,000 was still outstanding, and the merchandise had not been returned to Trademark. The related cost of sales totaled $43,750.
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