

SALTWATER IMPORTS

“Crazy” Henry Mason is a somewhat eccentric yet enthusiastic businessman who believes in the social responsibility of business. Incidentally, he is also interested in making enough money to live a comfortable life. As a supporter of the ecology movement, he is very concerned with the hunting of animals for industrial purposes, such as the making of furs, shoes, and ladies' handbags. As a consequence, he formed Saltwater Imports Enterprise (SIE), a company with a mission of promoting crocodiles as household pets. (The choice of the animal was purely coincidental.) He plans to catch crocodiles in Southeast Asia and sell them in the United States.¹

The senior leadership team of the company consists of Mr. Henry Mason (President), Michael Lee (Vice President of Production, who is in charge of catching crocodiles), Bruno Santos (Vice President of Sales), and Mary Grace (Vice President of Operations, who is in charge of administrative functions including cash collection from customers).

Facilities Planning

The first task facing Mr. Mason was to raise capital. This required estimating future capital needs by projecting the physical facilities and working capital needed for the business. Mr. Mason's estimates showed that he would need a fleet of boats to catch crocodiles in Southeast Asia and a holding tank in the State of Gould to keep them alive in captivity after they are shipped. Because of the need to extend liberal credit terms to skeptical customers, the company needed working capital to carry inventories and receivables. Finally, the company needed a large start-up investment for sales and an advertising campaign. The firm also needed funds to hire new employees and to rent office space in the State of Gould. Mr. Mason asked Mary Grace to prepare a forecast of activity to plan facility needs and to translate it into capital needed to start the business.

First Year Results

Based on the forecast provided by Ms. Grace, Mr. Mason and his ecology minded friends raised the capital for acquiring the facilities. He leased ten boats in Southeast Asia, a 20,000 square feet warehouse with a holding tank for the crocodiles in the State of Gould, and a 2,500 square feet office in the State of Gould. Both the warehouse and the office were leased from Andrew Property Management (APM) for three years, beginning January 1, 2008.

The company opened its door for business on January 1, 2008. Bruno Santos launched an aggressive sales and advertising campaign built around the slogan that crocodiles were warm, friendly and greatly misunderstood creatures that deserved loving care. He designed a slick marketing campaign built initially around the slogan: "Crocodiles -- don't handbag them, handle them with love."

During its first year, the company spent approximately \$390,000 to catch 600 crocodiles. Of these, 400 crocodiles were sold and shipped to customers at a selling price of \$1,250 per crocodile. Shipping costs of \$100 per crocodile were paid for during the year. Customers were given liberal credit terms and only \$300,000 from an equivalent 300 customers was collected during the first year. Ms. Grace estimated that as much as 20% of the sales price will be spent on collection costs and bad debts expenses.

At the end of the first year, Mr. Mason consulted with his other two colleagues and estimated that he could catch and sell 700 to 900 crocodiles for the next year. Because of the company's apparent success, Mr. Mason wanted to expand its facilities. This meant getting funds to rent more boats and warehouse space. He believed that he could now overcome the skepticism of banks and ask for a loan. On January 2, 2009, Mr. Mason notified Andrew Property Management that he no longer needed their

¹ Assume that Mr. Mason has somehow managed to obtain permits to sell live crocodiles legally.

current warehouse and office space. He would be vacating the properties by January 30th in order to move into larger facilities.

He asked Ms. Grace to prepare an income statement for the bank in accordance with generally accepted accounting principles (GAAP). In addition, since the executives were on a profit-sharing scheme, it was necessary to determine profits in order to pay year-end bonuses.

Ms. Grace entrusted this task to her young staff accountant, Omar Daniel, who had only recently graduated from college and was on his first job. After he familiarized himself with the facts, Daniel realized that he needed to look up the GAAP accounting rules for preparing an income statement. At that same moment, he also realized with some consternation that he had sold his college accounting textbook when the course was over. Daniel headed to his college library to find the relevant reference material.

A review of his old accounting textbook told him that two GAAP principles were particularly relevant for his current task. The first was the *matching principle*, which requires that costs and revenues be matched by time periods. The other was the principle of *revenue recognition*. His next step was to copy and read the relevant sections of these principles from the pronouncements of the Financial Accounting Standards Board. Attachment 1 shows the results of Daniel's research into the appropriate GAAP rules for preparing income statements.

On first reading the material, Daniel thought it was going to be easy to prepare an income statement. He remembered learning that for most businesses' revenue was earned when goods were sold (that is, when title passed from the seller to the buyer). However, as he read the statements of the FASB, he realized that revenues could be recognized when production was complete or when cash was collected. According to the FASB standard, "revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues."²

Daniel realized that in order to determine the revenues for 2008, he must first determine when the earning process is complete. This, however, was not a usual business. Therefore, Daniel was not sure when Saltwater Imports Enterprise was "entitled to the benefits represented by the revenues". In order to determine the critical point in the operations cycle when the business could do this, he decided to talk to the three top executives.

His first conversation was with Michael Lee, V.P. Production. Michael told him that catching crocodiles was the most critical activity for the business since "it is difficult to trap them suckers and you can lose a few limbs in the process if you are not careful."

Daniel next spoke to Bruno Santos, V.P. Sales. Bruno pointed out that while catching may be a dangerous activity, no one is likely to buy a crocodile because it is risky for us to catch them. He felt the company's success this year was largely due to his clever holiday season advertising campaign with its theme of: "this year give that special someone something live! Someday they can produce their own shoes, handbags, and belts."

Daniel's final conversation was with Mary Grace, V.P. of Operations. She told Daniel that, in her opinion, the crucial activity for the business was cash collection. As she put it: "Michael and Bruno have never tried collecting cash. If they did, they would find out in a hurry that it is difficult to collect cash from people who keep crocodiles as pets. Besides, we don't have a collection agency that is willing to repossess live crocs!"

²Financial Accounting Standards Board, Statement of Concepts # 5, Paragraph 83.

The Lawyers Call

Even as Omar Daniel was puzzled over how to proceed, he received a call from Ms. Mary Grace. "Omar, I just heard from our lawyers. Apparently, Andrew Property Management (the property management

company that leased us the warehouse and office space) is claiming that we had no right to break the lease. We are being sued for an amount equal to the balance of the lease term and for punitive damages. Later that day, Omar received the memo from the lawyers that is summarized in Attachment 2.

Required

Assume that you have been hired as a consultant by Mary Grace to help her and Omar Daniel. She has asked you for your help on the GAAP income statements and the legal issues arising from the lease cancellation. Please write a *business report* using the case writing guidelines and *report format guide* from the Gateway website.

To prepare an answer to this case you may want to review the following top ten concepts from the LDC Review material:

1. **Financial Accounting # 3.** Know the basic concepts underlying financial reporting (e.g. matching, consistency, etc.).
2. **Financial Accounting # 4.** Know how to record and read a simple business transaction.
3. **Financial Accounting # 8.** Understand the timing of revenue and expense recognition.
4. **Business Law # 5.** Understand the duty to mitigate damages.
5. **Business Law # 9.** Understand the differences between compensatory and punitive damages.

Attachment 1
Excerpt of Relevant GAAP Principles for Income Statement Preparation

I - ACCOUNTING PRINCIPLES STATEMENT # 4. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES-- PERVASIVE PRINCIPLES²

Footnote 43. The term matching is often used in the accounting literature to describe the entire process of income determination. The term is also often applied in accounting, however, in more limited sense to the process of expense recognition or in an even more limited sense **to the recognition of expenses by associating costs with revenue on a cause and effect basis.**

Associating cause and effect. Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue . . . Although direct cause and effect relationships can seldom be conclusively demonstrated, many costs appear to be related to particular revenue and recognizing them as expenses accompanies recognition of the revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and costs of products sold or services provided.

II - STATEMENT OF CONCEPTS # 5. RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES³

Revenues and Gains -- Paragraph 83. Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.

- a) Realized or realizable. Revenues and gains generally are not recognized until realized or realizable. Revenues and gains are realized when products (goods or services), merchandise, **or other assets are exchanged for cash or claims to cash.** Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash.
- b) Earned. Revenues are not recognized until earned. An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and **revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.**

Paragraph 84. In recognizing revenues and gains:

- a) The two conditions (being realized or realizable and being earned) are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities and gains and losses from sales of other assets are commonly recognized at time of sale (usually meaning delivery).
- b) If sale or cash receipt (or both) precedes production and delivery (for example, magazine subscriptions), revenues may be recognized as earned by production and delivery.

² Financial Accounting Standards Board, APS 4: *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, APS 4, October 1970.

³ Financial Accounting Standards Board, *Statement of Concepts # 5*, Paragraph 83, December 1984.

- c) If product is contracted for before production, revenues may be recognized by a percentage-of-completion method as earned--as production takes place--provided reasonable estimates of results at completion and reliable measures of progress are available.
- d) If products or other assets are readily realizable because they are salable at reliably determinable prices without significant effort (for example, certain agricultural products, precious metals, and marketable securities), revenues and some gains or losses may be recognized at completion of production or when prices of the assets change
- e) If collectability of assets received for product, services, or other assets is doubtful, revenues and gains may be recognized on the basis of cash received.

Attachment 2
Lawyer's Memo on Saltwater Imports' Legal Liability

M E M O R A N D U M

TO: Mary Grace
Saltwater Imports Enterprise

FROM: Robert Gil

RE: Saltwater Imports Enterprise

DATE: January 3, 2009

I just spoke with William River, the attorney for Andrew Properties. According to Mr. River, his client leased to Saltwater Imports Enterprise 2,500 square feet of office space and 20,000 square feet of warehouse space.

According to Mr. River, Andrew is prepared to sue Saltwater Imports Enterprise for \$258,000. [This amount includes \$108,000 in lost rent and \$150,000 in punitive damages.] The claim is itemized below:

Warehouse:

Monthly rent	\$3,000	
Balance of the lease	24 months	
Total rent for warehouse		72,000

Office space:

Monthly rent	1,500	
Balance of the Lease	24 months	
Total rent for warehouse		<u>36,000</u>

TOTAL RENT 108,000

PUNITIIVE DAMAGES 150,000

TOTAL RENT AND PUNITIVE DAMAGES 258,000

We need to discuss this right away! Please call at your earliest convenience.