

SUPERIOR BUSINESS PRODUCTS, INC.
(Year 2001 Update)

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Angela Norris looked over her new office at Superior Business Products, Inc. (SBP) with a feeling of accomplishment. After graduating from the University of South Florida with both a Bachelors and a Masters degree in accounting, she had quickly passed the CPA exam. Following a five year stint in public accounting, she had moved on to a series of different accounting positions in a variety of publicly held businesses. Now she had been named the new Vice President of Finance for Superior, replacing Melvin Smith who had recently retired.

SUPERIOR'S HISTORY

Angela reflected on what she knew about her new employer. SBP was created in Harrisburg, Pennsylvania in 1973 as a family-owned business. After seven years of steady growth, the family decided to take the company public to raise additional working capital funds. The initial public offering (IPO) took place in June, 1980 with 300,000 shares of common stock being sold in the over-the-counter market. Later sales, plus a 2 for 1 stock split, brought the outstanding shares currently to approximately 900,000.

SUPERIOR'S BUSINESS

Historically, Superior, through its own operations and those of two wholly owned subsidiaries, has been involved in a variety of business activities. Superior itself is primarily a marketer of business forms used in electronic data processing equipment. Until recently, the company also controlled a subsidiary (Unique, Inc.) which was engaged in the web-offset printing business. Unique's

business activities lay in two specific areas: (1) printing of business forms, and (2) a book binding operation.

In addition to Unique, SBP operated a second subsidiary, Altech Publishing, which specializes in producing, selling and servicing computer based interactive graphics systems used in the design and drafting process by architects and engineers. Altech produces both the hardware and necessary software which is sold in appropriately packaged configurations.

The original product of Altech had been known as the System Z line of computers. After a relatively successful four year life span, the System Z had become technologically obsolete. Executives at Altech had recognized the emerging obsolescence problem in early 1993. Through a major research and development effort, the company had developed a more competitive graphics system which it had named the GraphBest System. By mid-1994, System Z was no longer produced and all production and sales efforts focused on GraphBest.

The development and production of GraphBest had consumed a significant amount of cash from both Altech and Superior. The product required a large increase in production capacity, warehouse space utilization and inventory carrying costs. To replenish its bank accounts, Superior was planning to issue additional common stock in a public offering that would take place in the first half of fiscal 1995.

CURRENT ACCOUNTING ISSUES

As Angela sat down at her desk, she began to think about the complex accounting issues which she was facing at the outset of this new position. She and her staff were going to have to wrestle with the facts quickly and come up with recommendations for John Herrington, SBP's CEO. John wanted the accounting for certain recent transactions to be acceptable to the current external auditors (Able & Zorn). Just yesterday, John had told Angela that he wanted any accounting questions raised by the CPAs to be resolved in favor of SBP, while still allowing the auditors to express an unqualified audit opinion on the company's financial statements. Angela knew that, as a public company, the external auditors were not the only ones who would have to accept the company's accounting decisions. The resulting financial statements for the fiscal year ending on August 31, 1994 would be filed in the near future with the Securities and Exchange Commission as a part of the company's annual 10-K filing requirement.

ISSUE NUMBER ONE

The first significant issue involves the sale by SBP of Unique's bindery assets. For the 1993 fiscal year, Unique had shown an operating loss of \$1.9 million. That loss had led Superior's outside auditors (Burley & Holbrook, who had served as outside auditors since 1980) to raise a serious question as to whether Unique could be considered a "going concern." After considering a variety of factors, the auditors concluded that Unique was still a going concern. However, they informed SBP management that, in their opinion, if Unique continued to incur operating losses, it should no longer be viewed as a going concern and should be liquidated.

Because of the heavy losses at Unique last year, SBP's consolidated financial statements for 1993 reflected a net loss of \$334,000, or \$.39 per share of common stock. Management had hoped that through a combination of sales improvement and cost control, Unique would return to profitability in 1994. However, despite management's efforts, the bindery portion of Unique's operations continued to produce significant losses. In fact, such losses were estimated to be

running between \$120,000 and \$150,000 per month. Finally, in March of 1994, management decided to shut down the bindery operation completely.

In April, 1994, John Herrington had met Jerry Zorn (managing partner of Able & Zorn) at a Rotary Club meeting. During their conversation, Herrington had asked Zorn whether he could sell certain bindery assets, which had a current appraised value in the range of \$1.4 million to \$1.8 million) in exchange for a small amount of cash and a large note and still recognize any gain on the transaction in the current accounting period. Zorn replied that, so long as the notes were fully collectible, he saw no reason why the total gain could not be recognized immediately. On August 2, 1994, Herrington terminated the relationship between SBP and its former auditors and hired Able & Zorn.

On August 29, 1994, SBP sold all of its bindery assets to Quality Bindery, Inc. (QBI). QBI had been created two days earlier by Dan Malone, a former Vice-President of Unique. Malone, who resigned from Unique on August 26, is the sole owner of QBI, having invested \$20,000 of his own funds to establish the business. The sale of the bindery assets involved the following events, conditions and results:

1. The sale price was \$2.9 million.
2. QBI gave SBP \$900,000 in cash and a note for \$2 million. The note was to pay interest at the current prime rate. Under the terms of the note, the first payment of principal and interest will occur 13 months from the date the note was signed. The note will mature in six years with a balloon payment of \$1.3 million due at the maturity date.
3. The \$900,000 cash was borrowed by QBI from a local bank. The bank required that the bindery assets be put up as collateral for the loan and that SBP guarantee full payment of the loan in the event of a default by QBI. Under this agreement, Dan Malone, as an individual, made no personal guarantee with respect to either payment or collection of the loan. However, SBP guaranteed that it would direct enough bindery business to QBI on an annual basis to enable QBI to make its debt payments. In addition, SBP subordinated its security interest in the bindery equipment to the bank's security interest.
4. Based on the cost of the bindery assets, the agreed sales price, and the comments of Jerry Zorn regarding recognition of gain, Herrington has expressed a desire to recognize \$1.8 million of the \$2.5 million gain produced by the sale. The remaining \$700,000 will be deferred because of the interest rate differential between SBP's borrowing rate (prime plus 3%) and the rate specified in the note (prime). This \$700,000 deferred gain will be recognized on a pro-rata basis as interest payments are received on the note.

Angela thought about the current relationship of Dan Malone to SBP. Through a consulting agreement with SBP, Dan has continued to manage the remaining printing operations of Unique. Since QBI operates out of the same bindery facilities originally utilized by Unique (located next door to the SBP facilities), this arrangement is very convenient for both parties. In this capacity, Dan is also able to direct the flow of work from the printing operations to the bindery.

Angela also thought about the importance of the sale of the Unique assets to the current fiscal year results of SBP. Without the gain on the sale, SBP would report a consolidated net loss of \$1.2 million. By recognizing the gain, however, a net income of \$213,000 would be reflected in

SBP's income statement for 1994.

ISSUE NUMBER TWO

The second critical issue facing Angela and her staff involves the recognition of revenue on two significant transactions in which customers had ordered GraphBest systems on a "bill and hold" basis. In a bill and hold transaction, a customer agrees to purchase inventory items but the selling company retains physical possession of the items until the customer instructs the seller to ship them to a specified location or locations (See the U. S. Securities and Exchange Commission Staff Accounting Bulletin 101 "Revenue Recognition in Financial Statements." referred to in the Suggested Reference Material at the end of the case).

The first transaction involved the Altech subsidiary and Zebra Systems, a leasing company with expertise in placing computers and other electronic equipment. The second transaction involved the sale of two GraphBest systems to a company called Atlantic Systems, Inc.

The Zebra Transaction. Angela knew that Zebra frequently leased computer systems and other electronic equipment to users who did not wish to purchase such equipment and run the risk of rapid technological obsolescence. By December 1, 1993, Zebra had ordered 15 of the GraphBest systems on a "Bill and Hold" basis. The terms of the purchase were as follows:

1. Zebra would make a down payment of \$250,000 in cash.
2. Altech would assist Zebra in locating potential end-user lessees for these systems.
3. Final payment for each system would be made within 30 days of the date that Zebra placed the system with a lessee and made the system operational at the lessee's site.

The Atlantic Transaction. Atlantic is in the business of buying and selling computer systems in the retail market. In order to become a Southeastern States distributor for the GraphBest line, an Atlantic Systems' Vice-President of Marketing had agreed that Atlantic would acquire no less than 25 of the GraphBest systems during the period from September 1, 1993 through August 31, 1995. Failure to order this number of systems would disqualify Atlantic as a distributor.

On June 27, 1994, Atlantic had ordered two GraphBest systems, both under bill and hold terms. The purchase contract for the first system contained the following stipulations:

1. Atlantic had bid on a U. S. Government contract which, if awarded to Atlantic, would lead to the government acquiring this Graphbest system.
2. The contract award decision was to be made within the next four months.
3. Altech would retain physical possession of the system until delivery was called for by Atlantic.
4. Payment would be made by Altech upon delivery and installation of the system.
5. The purchase order would be rescinded with no liability by Atlantic to Altech if Atlantic

did not win the government contract.

The second GraphBest system ordered by Atlantic had already been sold to Critical Design, a sole proprietorship which operates a tool design business. Angela had seen a memo from the sales department at Altech which noted that the owner of Critical Design had an oral understanding with an Atlantic salesman to the effect that closure on the purchase agreement was dependent on Critical Design receiving necessary bank financing. Angela also knew that this system was still in the Altech warehouse as of August 31, 1994.

QUESTIONS

Answer the following questions, assuming that you are the CFO of Superior Business Products, Inc. and you have all of the information stated in the case.

Questions Related To Issue Number One:

1. Would you concur with your CEO's proposed accounting treatment for the sale of Unique's bindery assets to QBI? If so, why? If not, in what way(s) would you suggest that the proposed accounting be changed? Cite authoritative accounting support for your answer.
2. Is the transaction between SBP and QBI a "related party" transaction as defined by *Statement of Financial Accounting Standards No. 57*? If the answer to this question were "yes," what would be the implications, if any, for the proper accounting treatment and/or disclosure of facts related to the transaction? Draft the footnote which you believe should be presented in Superior's 1994 financial statements.
3. In your opinion, is it appropriate for the management of SBP to seek an opinion regarding proper accounting for a proposed transaction from a CPA firm which is not serving as the outside auditor? Why or why not?

Questions Related To Issue Number Two:

1. Under what circumstances, if any, is it appropriate for a seller to recognize revenue when the sale has been made on a bill and hold basis?
2. If you were Angela, would you support the recognition of revenue on the Zebra transaction in fiscal 1994? Explain why.
3. If you were Angela, would you support the recognition of revenue on either of the Atlantic transactions in fiscal 1994? Explain why.

SUGGESTED REFERENCE MATERIAL

Accounting Principles Board. APB Statement No. 4 "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises" (New York: AICPA, 1970).

Auditing Standards Board. Statement on Auditing Standards No. 50 "Reports on the Application of Accounting Principles" (New York: AICPA, 1986).

Financial Accounting Standards Board. Statement of Financial Accounting Concepts No. 2 "Qualitative Characteristics of Accounting Information," (Stamford, Conn.: FASB, 1980).

_____. Statement of Financial Accounting Concepts No. 5 "Recognition and Measurement in Financial Statements of Business Enterprises," (Stamford, Conn.: FASB, 1984).

_____. Statement of financial Accounting Standards No. 48 "Revenue Recognition When Right of Return Exists," (Stamford, Conn.: FASB, 1981).

_____. Statement of Financial Accounting Standards No. 57 "Related Party Disclosures," (Stamford, Conn.: FASB, 1982).

Jaenicke, Henry R. Survey of Present Practices in Recognizing Revenues, Expenses, Gains, and Losses: a Research Report (Stamford, Conn.: FASB, 1981).

Linden, Dana W. "Dial F for Fishy," Forbes (November 25, 1991), pp. 158-9.

United States Securities and Exchange Commission. Staff Accounting Bulletin 101, "Revenue Recognition in Financial Statements." Available at <http://www.sec.gov>.

_____. Staff Accounting Bulletin 40, Topic 5E "Accounting for a Divestiture of a Subsidiary or Other Business Operation" Published in SEC Accounting Guide (Chicago: Commerce Clearing House, 1989).

Superior Business Products, Inc.**TEACHING NOTES**

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EXECUTIVE SUMMARY AND CASE OBJECTIVES

This case is concerned with three primary financial accounting issues - substance versus form, related party transactions and revenue recognition under bill and hold contracts. In addition, the case allows for discussion of the topic of opinion shopping by a reporting entity. The case was written primarily for use in financial accounting courses such as Intermediate II (Financial II) or Accounting Theory. However, it could also be effectively used in Auditing courses. With adequate out-of-class preparation by members of the class, the case discussion should not require more than one and a half to two hours of class time. Total class time required would depend on the number of issues covered and the depth of discussion of each issue.

BACKGROUND OF THE CASE

The content of this case has been adapted from the information in two Accounting and Auditing Enforcement Releases (AAER) issued by the Securities and Exchange Commission. These Releases are AAER No. 86 "In the Matter of Frantz, Warrick, Strack & Associates, P.C., and Joseph A. Becker" issued February 10, 1986 and AAER No. 108 "In the Matter of Stewart Parness" issued August 5, 1986. In these releases, the SEC alleged that the reporting companies were guilty of:

1. Recording transactions based on their form rather than their economic substance.
2. Recording revenue prior to completion of the earnings process.

Although the views of the SEC on the accounting issues of this case are clearly evident in the Enforcement Releases, this information does not appear in the case as written. We did not want the SEC's views to bias student judgments as they sought to answer questions raised by the case.

CLASSROOM USE OF THE CASE

At the undergraduate level, this case is well suited for the Financial II (Intermediate II) course and the first Auditing course. In courses which normally precede these, accounting majors are typically exposed to revenue recognition concepts, the concept of representational faithfulness (substance versus form) and disclosure guidelines. As an Auditing case, it would fall naturally into the discussion of the auditor's responsibility to understand a client's accounting methods, determine whether compliance with GAAP has been achieved, negotiate audit adjustments with the client, render an opinion on the application of accounting principles and report on the client's financial statements.

At the graduate level, the case would fit well into an MBA financial accounting course, an Accounting Theory course or an Auditing course.

TEACHING METHODOLOGY

It is not uncommon to find that student recall of prior course material is below the instructor's expectations. To deal with this problem, we recommend that appropriate advance readings relevant to the case be required prior to the assignment of the case or coincident with its assignment. (Suggested readings were identified at the end of the student version of the case.) This reading requirement would help to equalize the students' knowledge base and enhance the quality of class participation.

A classroom technique which should increase student input is to divide the class into teams of three or four students and have them corporately develop their views of the issues in the case prior to the in-class discussion. A potentially effective variation on the team approach involves role playing -- i.e., one student takes the part of the company controller, another is a bank loan officer who is considering a loan application from the company, a third team member could be a current stockholder, etc.

The case raises several interesting questions which can be addressed by the class. They include at least the following:

1. How important is the issue of substance versus form in determining proper accounting treatment of a transaction?
2. How should a related party transaction be accounted for and what financial statement disclosures are applicable to the transaction?
3. At what point in a bill and hold transaction is it appropriate to recognize revenue?
4. Is it appropriate for a company's management to seek the opinion of one or more CPA

firms other than its present auditor regarding proper accounting for a proposed transaction?

THE SUBSTANCE VERSUS FORM ISSUE

The Accounting Principles Board spoke to this issue in its Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," which was issued in October 1970. In paragraph 127, the Board noted that the economic substance of transactions should be emphasized even if their legal form implied a different treatment. Although this viewpoint is well recognized in the accounting profession, the FASB, in Concept Statement No. 2 has observed that "Substance over form is, in any case, a rather vague idea that defies precise definition" (para. 160).

In its 1994 financial statements, Superior recognized \$1.8 million of the \$2.5 million gain on the sale of the bindery assets of Unique to QBI. The legitimacy of Superior recognizing this gain was challenged by the SEC on the grounds that the transaction lacked economic substance. The SEC cited the following factors in support of its conclusion:

1. The sale was transacted at approximately \$1 million above the appraised value of the property. The SEC viewed the differential price as an "unnegotiated premium price based on the bindery successfully operating in the future."
2. QBI's ability to pay off its note to Superior was dependent on QBI being able to operate at a profitable level in the future. Such profitable operations in the future were unlikely given the bindery's past operating loss history.
3. The purchasing company was newly formed and had no operating history of its own.
4. There was no significant investment in QBI by its founder.
5. There was a continuing involvement in the operations of QBI by Superior. Through Malone's consulting agreement with Superior, he continued to function in a supervisory capacity at Superior and direct the flow of product from Superior to QBI.
6. Superior's guarantee of QBI's loan, its subordination of its interests in the bindery assets to the interest of the bank, QBI's dependence on Superior for business in order to generate cash by which to make loan payments and the existence of delayed payment terms for the note, all demonstrated that Superior had not actually transferred its risks related to these assets to QBI.

In Staff Accounting Bulletin No. 40, Topic 5E, "Accounting for a Divestiture of a Subsidiary or Other Business Operation," the SEC sets forth its views on factors that are necessary for a transfer of assets to be considered as a divestiture:

In assessing whether the legal transfer of ownership of one or more business operations has resulted in a divestiture for accounting purposes, the principal

consideration must be an assessment of whether the risks and other incidents of ownership have been transferred to the buyer with sufficient certainty.

Elements of a transaction which would raise doubts as to the certainty of risk transfer include:

1. Continuing involvement by the seller in the transferred business,
2. Absence of significant financial investment in the business by the buyer, such as a token downpayment,
3. The buyer's ability to repay debt created by the transfer being dependent on successful future operations of the business, or
4. A continuing necessity for the seller to guarantee the buyer's debt or its ability to perform under its contracts.

After discussing the substance versus form merits of Superior's transfer of Unique's bindery assets to QBI, the instructor might wish to ask the following question: If for legal purposes, QBI now holds title to the bindery assets, but under economic substance the accountants should ignore that fact, how should these "transferred" assets be treated on Superior's consolidated balance sheet?

In SAB 40, Topic 5, the SEC argued that they should appear in the seller's balance sheet under a caption such as "Assets of business transferred under contractual arrangements (notes receivable)." Any related liabilities would be disclosed as "Liabilities of business transferred." A footnote to the financials would provide information related to legal and financial arrangements and reasons for the accounting treatment accorded to these items.

If the acquiring business were to suffer future operating losses, the SEC argues that these should be used, as a minimum, to support a valuation allowance adjustment to the account representing the transferred assets on the seller's books. Any future operating profits by the acquirer would be ignored by the seller. The SEC's argument for this position is that the seller has transferred the right to benefits from the assets to the buyer but has not transferred the risks of exposure to losses.

THE RELATED PARTY ISSUE

The first question to be addressed in this area is whether or not the sale of the bindery assets by Superior to QBI is a related party transaction. SFAS No. 57, "Related Party Disclosures," provides the relevant guidance for this question. The definitions of two terms in this Standard would be applicable to this discussion:

Affiliate. A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise.

Control. The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise.

A portion of the Board's definition of the term "related party" would also be important to this discussion. In part, the Board defined this term to include "... other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests."

Given that the business activities of QBI and its management are identical to those that previously existed when the business was known as Unique, it certainly could be argued that, in substance, QBI is just as much an affiliate of Superior as Unique was. In like manner, it seems that Superior has just as much control over the operations of QBI as it had over Unique, through the consulting agreement with Malone. There is a legal veil of separation, but is that veil really meaningful? The SEC considered QBI and Superior to be related parties but did not state specific reasons for that conclusion.

The class might be tempted to focus its argument on the fact that QBI's ultimate financial viability and its ability to repay Superior are completely linked to Superior's business involvement with QBI. Here it is important to note that SFAS No. 57 does **NOT** stipulate that economic dependency of one enterprise on another creates a related party situation. That fact alone would be insufficient to invoke the disclosure requirements of this Standard.

The second question that might be addressed in this area is whether or not a related party transaction should be accounted for any differently from one which is at arm's length. The accounting literature seems to be quite clear on this point. Codification of Statements on Auditing Standards, Section AU 334, "Related Parties" notes that "...established accounting principles ordinarily do not require transactions with related parties to be accounted for on a basis different from that which would be appropriate if the parties were not related." There is a heightened risk, however, that the reporting company's accounting for the transaction will follow form rather than substance. SFAS No. 57 recognizes this concern when it states that "[t]ransactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist."

Assuming that the identified related party transaction has been accounted for properly, the primary financial statement issue becomes one of adequacy of disclosure. Here the rules are very precise. The required disclosures are (per SFAS No. 57):

1. The nature of the relationship(s) involved.
2. A description of the transactions ... for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements.
3. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.

4. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.

The following footnote might be offered by the instructor to generate class discussion:

RELATED PARTY TRANSACTION. On August 26, 1994, the Company sold all of its bindery assets formerly held by Unique, Inc. to another entity for \$2.9 million. The buyer paid \$900,000 down and issued a note for the remaining \$2 million. The terms of this sale were not materially different from those which would have been produced if the sale had been to an arm's length party.

Questions which could be generated by a discussion of this footnote would include:

1. Should the name of the buyer be disclosed? The apparent answer is no, unless the identity of the buyer is necessary for users of the financial statements to understand the transaction. (See note 3 in FAS No. 57.)
2. Should the terms of the \$2 million note be disclosed? Yes, either in this note or elsewhere in the financial statements. (See FAS No. 47.)
3. Should the portion of the gain which was recognized and the portion which was deferred be disclosed? Yes, either in this note or elsewhere in the financial statements.
4. Should the last sentence be included in the footnote? According to SFAS No. 57, such "equivalence" comments are permissible only if the content of such comments can be substantiated.

THE BILL AND HOLD ISSUE

The discussion of this issue could appropriately begin with a discussion of the meaning of critical terms such as "revenue," "earnings process," and "significant obligations by the seller." According to Statement of Financial Accounting Concepts No. 3, "Elements of Financial Statements of Business Enterprises," revenues are defined as inflows of assets or settlements of liabilities that arise from such activities as delivering or producing goods or rendering services when these are part of an entity's ongoing primary operations during a specific period of time. Such revenues are considered to be earned when the selling entity has substantially completed those tasks which it must complete in order to be entitled to the benefits that will flow from these revenues. Thus, the earnings process would not be deemed to be completed if the seller has continuing obligations to the buyer, such as assisting the buyer to find customers for resales of the product.

The impact of such obligations on revenue recognition was made very clear in Statement of Financial Accounting Standards No. 48, "Revenue Recognition When Right of Return Exists." In this Standard, the FASB stated six conditions all of which must be met for revenue to be recognized when the buyer has a contractual right to return the product. One of those six is that the seller must "not have significant obligations for future performance to directly bring about resale of

the product by the buyer."

Although the topic has not been addressed widely in accounting literature, "bill and hold" transactions have been at issue in several accounting releases issued by the SEC. This topic was most recently addressed by the SEC in Staff Accounting Bulletin 101, "Revenue Recognition in Financial Statements." Earlier, in Accounting Series Release No. 292, "In the Matter of Arthur Andersen & Co.," the use of bill and hold procedures by Mattel, Inc. was criticized by the Commission. The Commission believed that Mattel had recognized such revenues prematurely because:

1. The merchandise was not shipped prior to recognizing revenue.
2. The customer did not have to make any payments to the seller until specific goods were shipped to the customer and accepted.
3. Mattel failed to segregate the bill and hold goods from its regular inventory and failed to identify the inventory as belonging to a customer.
4. The customer could cancel the purchase without penalty at any time prior to receipt and acceptance of the merchandise.
5. Risks of ownership (such as loss due to damage, theft or destruction) remained with Mattel.
6. Content of many shipments, and related invoices, were made by Mattel without any input from or consultation with the customer.

As a result of these elements of the transaction, the Commission argued that Mattel simply had given the customer an option to purchase the merchandise. There was no risk for the customer and, consequently, no sale.

An additional enforcement release by the Commission provided the basis for the bill and hold component of the present case. As identified above, this was AAER No. 108. In this Release, the Commission set forth the following specific requirements that should be met before a seller could recognize revenue in a bill and hold transaction:

1. The risks of ownership must have passed to the buyer;
2. The customer must have made a fixed commitment to purchase the goods, preferably reflected in written documentation;
3. The buyer, not the seller, must request that the transaction be on a bill and hold basis. The buyer must have a substantial business purpose for ordering the goods on a bill and hold basis;
4. There must be a fixed schedule for delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer's business purpose (e.g., storage periods are customary in the industry);
5. The seller must not have retained any specific performance obligations such that the earning process is not complete;

6. The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders; and
7. The [ordered goods] must be complete and ready for shipment.

The Commission considered the above listing to be important conceptual criteria to be utilized in determining whether a bill and hold transaction has produced earned revenue for the seller. The listing was not intended to be a checklist where compliance with all seven requirements would guarantee that revenue should be recorded. In fact, the Commission specifically stated that a bill and hold transaction could meet all seven of the criteria and still fail to meet the requirements for revenue recognition.

In addition to the above seven criteria, the Commission identified several other factors that financial statement preparers should consider in evaluating a bill and hold transaction:

1. The date by which the seller expects payment, and whether it has modified its normal billing and credit terms for this buyer;
2. The seller's past experiences with and pattern of bill and hold transactions;
3. Whether the buyer has the expected risk of loss in the event of a decline in the market value of the goods;
4. Whether the seller's custodial risks are insurable and insured;
5. Whether APB No. 21, pertaining to the need for discounting the related receivable, is applicable; and
6. Whether extended procedures are necessary in order to assure that there are no exceptions to the buyer's commitment to accept and pay for the goods sold, i.e., that the business reasons for the bill and hold [purchase] have not introduced a contingency to the buyer's commitment.

The issues that were highlighted by the SEC in previous enforcement actions have been somewhat codified in SAB 101.

In light of the criteria discussed above, recording of revenue by Altech on the "sales" of the GraphBest Systems was inappropriate. In the Zebra transaction, there were two critical conditions that had to be met before Altech could say that the earnings process had been completed. First, Zebra had to locate an end-user lessee (with potential assistance in this process by Altech) and, second, the system had to be made operational at the lessee's site. Only after these conditions were met would Zebra have any payment obligation to Altech.

Contingent elements of the contracts between Altech and Atlantic would also negate revenue recognition on those "sales." In the case of the secondary sale by Atlantic to the U. S. Government, it was unknown as of Altech's year end whether Atlantic's bid would win the

government contract. Absent that decision, Atlantic's purchase from Altech would be rescinded. Clearly, the earnings process on this transaction was not complete as of Altech's year end.

Sale of the second system to Atlantic hinged on the ability of Atlantic's customer (Critical Design) to receive bank financing to support its purchase. The case does not indicate whether such financing had been obtained by August 31, 1994. If it had not, the oral contract between Atlantic's salesman and the owner of Critical Design would preclude Atlantic from having a completed sale. If there is an understanding between Altech and Atlantic that Atlantic's obligation to Altech is dependent on Atlantic's subsequent sale of the product, then Altech would not meet the revenue recognition criteria on its transaction with Atlantic.

The class may ask whether there are positions other than that of the SEC which could be used to determine proper accounting for a bill and hold transaction. Although there appear to be no specific rules that directly address this transaction type, the instructor might want to illustrate the use of analogous reasoning to define GAAP in a given instance. An appropriate vehicle for this purpose would be the accounting rules contained in Statement of Financial Accounting Standards No. 66, "Accounting for Sales of Real Estate." Paragraph 105, which describes conditions that must be met before revenue may be recognized, paragraph 118, which deals with the seller's continuing involvement in the property, and paragraph 132, which describes "sales" which are really options to purchase the property, would be particularly helpful in a discussion of defining GAAP by analogy.

THE OPINION SHOPPING ISSUE

The instructor might begin this discussion by asking the class to identify reasons why management of a company would seek an opinion on proper accounting for a transaction from an accountant other than the company's present outside auditor. An appropriate reason would be to seek alternative viewpoints in areas where generally accepted accounting principles are not well defined.

Another possibility, of course, is that management is seeking an opinion which is more consistent with its financial reporting goals. To illustrate an extreme case of this type, the instructor might want to discuss the Broadview case as described in AAER No. 54, "In the Matter of Broadview Financial Corporation," which was issued in April of 1985. This case involved a company which had a disagreement with its present auditors over proper accounting for a real estate transaction which Broadview had financed. Broadview, a savings and loan holding company, had indirectly supplied the funds ultimately used by the buyer of a tract of land to pay Broadview a \$4 million fee related to financing of the transaction. Because of the circular nature of the cash flows, Broadview's current auditor refused to allow recognition of the \$4 million fee as current revenue. Broadview, which badly needed the revenue in order to report current earnings, then sought the opinions of four other large CPA firms. Three of the four objected to current revenue being recorded as a result of the transaction. The fourth firm was willing to accept that accounting result. Broadview then severed its relationship with its existing CPA firm and hired the firm which would permit revenue recognition. As a public company, Broadview had to file an 8-K with the SEC related to the change in auditors and identify whether any accounting disputes had occurred between the company and its old audit firm. This filing led to an SEC investigation which

ultimately caused Broadview to file restated financial statements which omitted the \$4 million of revenue.

In its enforcement release, the SEC articulated its views on the potential impact of the "opinion shopping" process in the following words:

Certainly it is not *per se* illegal or improper for an issuer to change the independent accounting firm which conducts an audit of its financial statements. However, if the manner in which the issuer changes its auditors restricts the independence of the new auditors or calls into question their objectivity, such conduct erodes the public's belief in the integrity of both the financial markets and the independent audit function.

The release went on to note that "[a]uditors should act cautiously when approached by an issuer in search of an opinion which differs from that given by its existing auditors." After noting these views, the instructor could have the class consider the professional responsibilities of the approached auditing firm as described in Codification of Statements on Auditing Standards, Section AU 625 (SAS No. 50). This statement notes that when the approached auditor is asked to give a written or oral opinion regarding the application of accounting principles to either a completed or a proposed transaction, he/she should consider such factors as:

1. who is the requester of the report,
2. the circumstances under which the request is made,
3. the purpose of the request, and
4. the requester's intended use of the report.

Furthermore, the approached accountant, as an aid to reaching an informed conclusion, should perform certain procedures:

1. obtain an understanding of the form and substance of the transaction,
2. review applicable generally accepted accounting principles,
3. if appropriate, consult with other professionals or experts, and
4. if appropriate, perform research or other procedures to ascertain and consider the existence of creditable precedents or analogies.

The Standard also notes that the approached accountant "should consult with the continuing accountant ... to ascertain all the available facts relevant to forming a professional judgment. Some of the relevant facts identified by the Standard include:

1. the form and substance of the transaction,
2. how management has applied accounting principles to similar transactions, and
3. whether the method of accounting recommended by the continuing accountant is disputed by management.

OTHER ISSUES

Although not directly addressed in the case itself, there are a number of other issues which the instructor may wish to bring out during the class discussion. Some of these issues include:

1. Factors to consider in valuing the note from QBI, if the transaction as a sale was allowed to stand.
2. In relation to the bill and hold discussion, other revenue "enhancers" such as channel stuffing, purposeful overshipping to customers, etc. See the "Dial F for fishy" article in the suggested readings.