Profitability MiniCases

Attached find the following cases:

O.M. Scott
Biovail
Haverty
Witco

Barry M. Frohlinger

O. M. SCOTT

O. M. Scott sells grass seed, fertilizer and related equipment through a nationwide dealer organization of independent businessmen.

Scott has used three different methods of revenue recognition:

(i) Prebilling--To obtain more efficient and economical control of production, a dealer is billed when the product has been made ready to fill the *dealer's firm order*. The sale is recognized and the cost is charged to cost of sales at the time of the billing.

(ii) Time of Shipment--Subsequently, Scott changed its policy to recognize sales at the time of shipment.

(iii) Revenue Reserve--After a successful selling season, the Company's data on dealer inventories indicated that these inventories had grown during the year. The Company, accordingly, began the policy of providing a "revenue reserve". The effect of the "revenue reserve" was to defer the recognition of earnings on sales made to dealers until the dealers had made their sales to the retail customer.

O.M. Scott has negotiated the following terms of sale with its dealer network:

- **Certain independent dealers provide O.M. Scott with firm orders and agree to pay 30 - 90 days after shipment.**
- **Other independent dealers are shipped merchandise under a "trust receipt" arrangement**

A summary of Scott's operating performance is shown on the next page.

DISCUSSION QUESTIONS

1. Considering only sales to those dealers whose credit terms were 30 to 90 days after shipment, which of Scott's *three* methods of revenue recognition best measures ***economic performance*** for O. M. Scott?

2. Considering only sales to those dealers whose credit terms were under a "trust receipt" policy, which of Scott's *three* methods of revenue recognition best measures economic performance for O. M. Scott?

   (The "trust receipt" policy provides that the dealers receive immediate title to the merchandise with payment to be made when the merchandise is sold at retail; no right exists to return the merchandise.)

3. Briefly comment on each of the three methods from the viewpoint of generally accepted *accounting* principles.

4. Calculate O. M. Scott's sales for years 9 through 14 assuming that trust receipt receivables are not recognized as sales until cash is collected.

Scott's operating results for several years were as follows (000's omitted):

Year	Sales	Net income (loss)	Trust receipt receivables at year end[1]	Revenue recognition method[2]
1	8,149	142	-	P
2	9,446	169	-	P
3	10,385	259	-	P
4	11,465	211	-	P
5	12,495	322	-	P
6	18,676	451	-	P
7	23,400	901	-	P
8	30,564	1,485	-	P
9	38,396	1,785	6,100	S
10	43,140	1,571	16,000	S
11	28,886	(1,522)	13,700	S
12	26,211	(999)	7,100	S
13	30,191	573	4,800	S
14	36,240	1,685	-	S
15	41,734	2,012	-	S
16	48,353	2,508	-	S
17	59,818	3,677	-	RR

End of the O.M. Scott case

[1] Trust receipt policy was introduced in year 9 and, under pressure from lenders, curtailed beginning in year 11
[2] P =Prebilling; S = Shipment; RR = Revenue Reserve

Biovail

Read the following regarding Biovail and comment on the economic reality versus the accounting reality of Biovail's revenue recognition.

TORONTO -- Shares of drug maker Biovail Corp. sank 18% after the company slashed its third-quarter earnings and revenue forecasts, citing various factors including an ***accident*** involving a shipment of its new depression drug.

The projected shortfall added to investor anxiety about Biovail's future sales and earnings trends in the wake of a federal investigation into the company's sales practices.

Biovail, of Mississauga, Ontario, said a truck containing a large shipment of Wellbutrin XL was involved in a major traffic accident near Chicago on Oct. 1. **Biovail** said it is assessing the extent of damage to the products to determine whether they remain saleable, but the accident cost it $15 million to $20 million of expected third-quarter revenue. **Biovail** supplies Wellbutrin XL, a once-daily drug for treatment of depression, to GlaxoSmithKline PLC, which last month began marketing the product.

Biovail also said its third-quarter earnings were hurt by as much as $15 million due to a distributor's move to cut prices to wholesalers retroactively on a generic version of heartburn drug omeprazole, affecting Biovail's share of revenue from that product. The price cut will also hurt fourth-quarter earnings by $15 million to $20 million, the company said.

Further, **Biovail** said it suffered a shortage of Cardizem CD, a cardiovascular drug made by Aventis that **Biovail** markets. **Biovail** said it received some needed shipments of the drug from Aventis after the third quarter ended, and so the unexpected delay will hurt third-quarter revenue by $10 million to $15 million.

All told, **Biovail** said it expects third-quarter revenue in the range of $215 million to $235 million, compared with its earlier forecast of $260 million to $300 million.

Any disruption to Wellbutrin XL sales is jarring since "everybody's betting so big on it," and investors are "worried it won't sustain the decline of the other products" in Biovail's portfolio, said Serge Depatie, an analyst with Montreal money manager Natcan Investment Management. A **Biovail** spokesman said some of the company's products have shown a "modest decline" in sales, but sales of Cardizem CD remain strong and **Biovail** has a deep pipeline of drugs under development.

Shares of **Biovail** dropped $6.67 to $31.10 in reaction to the earnings warning. Previously, investors had largely shrugged off news of a U.S. government investigation into Biovail's sales practices and focused on Wellbutrin XL's sales potential. The Wall Street Journal and Barron's had previously reported **Biovail** had been giving as much as $1,000 to doctors prescribing Biovail's Cardizem LA heart drug.

Critics said Biovail's earnings warning may signal deeper problems. "We would argue that the revenue and earnings shortfall is a result of underlying weakness in Biovail's base business that has been veiled in the past by aggressive accounting practices," Andre Uddin, an analyst with Research Capital Corp. in Toronto wrote on Friday. In previous reports, Mr. Uddin has pointed out that **Biovail** posted a loss under standard accounting methods while touting a separate line of earnings that excludes various charges and write-downs.

A **Biovail** spokesman said "we don't believe our accounting is aggressive at all," and that its reported results conform with generally accepted accounting principles.

There's life in sell-side stock research yet.

David Maris, a pharmaceutical analyst from Bank of America, and his team issued a tough piece of research on the Canadian drug company Biovail Wednesday, sending its stock down almost 14%. Mr. Maris, who did critical research for years on the scandal-plagued Irish drug company Elan when he was at CSFB, raises questions about Biovail's accounting and its bizarre earnings warning from last week.

A **Biovail** spokesman said the BofA report was "filled with inaccuracies and written irresponsibly." Mr. Maris stood by the report.

On Friday of last week, **Biovail** said a truck filled with roughly $10 million to $20 million of its depression medicine Wellbutrin XL was involved in a serious traffic accident outside Chicago on Sept. 30. **Biovail** also decided that day to tell investors about other problems with two other products. The combination of events contributed to the earnings and revenue warning.

For years, **Biovail** has attracted short-sellers who assail the company's accounting practices, product hype and acquisition strategy. Nevertheless, **Biovail** had singed the shorts, stringing together years of financial reports that appeared strong and drove the stock higher. Alas, when these story stock fevers break, they often break for good.

The truck crash story was, er, unusual. So Mr. Maris and his team decided to call the Illinois cops about it. They studied the video of the accident. Strangely, the pictures seem to show that the truck was "nearly empty," the BofA report says. The spokesman says the company now knows "exact inventory of what was on the truck" and stands by its assessment.

If so, what was the company doing shipping that much on the last day of the quarter? "That in and of itself is a yellow flag," says Mr. Maris. The amount of merchandise in that truck equates to roughly 5% to 10% of the company's quarterly product revenue, according to BofA. The **Biovail** spokesman says that the company got a big order and produced and shipped it as quickly as it could.

BofA's report also raises questions about whether the company creates economic value. According to the report, despite rising pro forma income, from 1998 through the first half of 2003, the company had negative free cash flow of $695 million, adjusting for capital expenditures and acquisition expenditures. **Biovail** asserts its acquisitions have and will create value. But the evidence is thin.

Haverty Furniture

Haverty reports the trend of net income as follows:

	2002	2001	2000	
Using Lifo	**$7,793**	**$7,654**	**$8,702**	**<= used for fin. state.**
Using Fifo	**7,018**	**8,309**	**9,220**	**<= footnote disclosure**

Which amounts represent the true trend of profitability? [Note: no Lifo liquidation occurred.]

NOTE B – INVENTORIES

Current costs exceeded the LIFO value of inventories by approximately $8,026,000 and $9,254,000 at December 31, 2002 and 2001, respectively. The $1,228,000 decrease was principally due to declines in merchandise prices in 2002.

The Company uses the LIFO method of inventory valuation because it results in a better matching of current costs and revenues. A number of the Company's competitors use the FIFO method of inventory valuation. Had the Company reported its LIFO inventories at values approximating current cost, as would have resulted from using the FIFO method, had a 37% tax rate (37% in 2001 and 43% in 2000) been applied to changes in income resulting therefrom, and had no other assumptions been made as to changes in income, net income would have been $7,018,000 ($1.22 per share) for 2002, $8,309,000 ($1.43 per share) for 2001 and $9,220,000 ($1.57 per share) for 2000.

Haverty Furniture Income Statement

(in thousands)	2002	2001	2000
Net sales	$ 232,081	227,997	217,467
Cost of Goods Sold	123,191	124,340	119,152
Gross Profit	108,890	103,657	98,315
Other Customer Revenues,			
Principally Credit Service Charges	10,893	11,971	11,822
	119,783	115,628	110,137
Costs and Expenses:			
S, G & A	101,013	97,330	89,457
Interest (net of $73, $51 and $210 capitalized			
interest in 2002, 2001 and 2000, respectively)	8,298	7,442	5,709
Losses on Accounts	2,097	2,196	2,327
	111,408	106,968	97,493
	8,375	8,660	12,644
Other Income, Net of Other Deductions			
Income Before Income Taxes	2,528	2,245	1,987
	10,903	10,905	14,631
Income Taxes - Note F			
Current	7,781	6,552	8,517
Deferred	(4,671)	(3,301)	(2,588)
	3,110	3,251	5,929
Net Income	**7,793**	**7,654**	**8,702**

Witco

1. How can Witco justify including interest expense in the cost of assets under construction?
2. What would Witco's 2001 "Total costs and expenses" have been if Witco had never capitalized interest?
3. Write the journal entries for all interest costs during the year 2001.
4. What interest amount should be used in the denominator of Witco's 2001 "times interest earned" ratio?

	2001	2000
Consolidated Balance Sheets		
Total Current Assets	576,849	562,907
Property, Plant and Equipment, less accumulated depreciation of $517,171 and $493,845	474,755	471,026
Intangible Assets, less accumulated depreciation of $18,922 and $14,010	69,397	73,180
Deferred Costs and Other Assets	77,275	71,772
Total Assets	1,198,276	1,178,885

Consolidated Statements of Income	2001	2000	1999
Cost of Goods Sold			
Cost of goods sold (exclusive of depreciation)	1,278,951	1,314,708	1,266,052
Selling and administrative expenses	178,573	167,686	167,229
Depreciation	59,625	55,297	52,679
Interest	16,027	16,400	13,289
Other expense (income) - net	(1,930)	(9,074)	53,368
Total Costs and Expenses	1,531,246	1,545,017	1,552,617

Note 5 - Long-term Debt (continued)

Following is a summary of interest (in thousands):	2001	2000	1999
Interest expense	16,027	16,400	16,289
Capitalization interest	1,164	1,807	1,353
Total interest incurred	17,191	18,207	17,642
Total interest payments	16,792	18,068	17,767