

Mitchem lethbridge Ltd

Finance



An Introduction Mitch Leathering Ltd. Is an individual franchise of the parent company Mitch Office Corporation, which holds a contest every third year to award the franchise with the greatest Improvement In net Income. This year the Leathering franchise has won the contest, however the Halifax franchise, who had a net income to reflect higher net income numbers.

The Mitch head office has asked us to look at the financial records and interview the Leathering management to determine if an audit is required because of suspect manipulations to the statements. We also have been required to suggest some improvements to the contest rules to the Imitate head office. The Leathering franchise is currently solely owned by Lisa McGovern and had been going through a tough year in 2010. At the end of the period they made many adjustments that had negative effects on the net income in the 2010 year and positive effects towards the net income of the 2011 year.

These issues and the effects they had on net income will determine if there is a need for an audit. They will also help provide insight to determine any improvements that can be applied to the rules of the contest to ensure the future winners are indeed complying with the rules. Improvements would also help curb franchises towards the purpose of the contest, which is to be continually improving net income each year. After determine Mitch Leathering Ltd.

Financial statement, we comment on some issues they may address, and Issues Commissions Expense At the end of the 2010 reporting period Mitch Leathering Limited decided to pay expected commissions of January 2011 to

employees in December to help offset the poor sales year they just had in 2010. This practice is neither acceptable by GAAP ironically nor is it ethical in regards to the competition. Lisa has disregarded the revenue and expense recognition criteria by recognizing the commissions' expenses in one period when the sales that those commissions belong to will not be recognized until they occur during January 2011.

The Leathering division also appears to have favorably bolstered their expectations for January to \$150,000. This estimate is far too high despite the upcoming discount sale, especially considering that the December sales were \$90,000. That is a \$60,000 increase in expected sales when there is not even a seasonal change. If the Leathering division wanted to give the employees a bonus for having a poor sales year when they expect a better year in the next period that is acceptable, but that was not the case.

Lisa and Mitch Leathering decided to recognize commission's expenses that belonged to sales that were yet to occur in 2011. This influenced net income by decreasing the expenses in 2011 while the sales remained the same and vice-versa for the previous year. This increased net income by \$9120 since actual sales were only \$114,000 in January and they decreased net income by the full \$12,000 in 2010. By over exaggerating the losses in 2010 and the revenue in 2011 the Leathering division destroys the credibility of their financial records.

The representational faithfulness of Lettering's records will also come into question now and in future contests the Mitch Corporation puts on. Show below: \$77,250 Inventory Write-down The Leathering division again appears

to have ignored GAP principals when they wrote down inventory at the end of the 2010 period. According to inventory write-down information, when a write-down occurs is a Judgment of management, but how you write inventory down is not.

When write-downs occur inventory needs to be written down to Net Realizable Value, which is what the inventory is worth in the market now as opposed to when it was purchased. However, Jeff wrote inventory down to liquidation value which is what the inventory could be sold for immediately. This value is much lower than what it should have been written down to had the inventory value decreased since its purchase. Jeff also mentions in his notes that he was not sure that they were going to be able to sell the abnormally high level of inventory in the following months.

This is a contradicting statement considering that Lisa had mentioned in her notes that she had planned the bulk sale in late 2010 and had even begun advertising in December. She also estimated sales to be \$1 50, 000 in January which would have exceeded the inventory account before the write-down. This exaggerated write-down affected net income by decreasing the value of the inventory when the sales occurred in the following period. This would have reduced the cost of goods sold expense while sales and revenues remained unchanged by the write-down.