

Case 95-1

Toys in the Attic

Love Those Toys, a private company, manufactures and markets an assortment of high-quality disposable toys through a home-based network of independent distributors. The distributors are generally husbands or wives, grandparents, or aunts or uncles that have many children in their family and have a desire and the opportunity to develop their own business. These individuals almost always place small orders each month, suggesting that the toys received are being used and replaced on a regular basis.

Different lines of disposable toys and selections within each line change regularly so that a new toy is always available. For the parent who travels regularly and has little time to shop, one line consists of toys that are common in different parts of the world.

The distributors may elect to become "Santa Claus" class distributors, allowing them to purchase toys at reduced prices. "Santa Claus" distributors also have the opportunity to "sign-up" other distributors, allowing the "Santa Claus" distributor to receive bonuses based on the purchases by these recruits.

A "Santa Claus" distributor agrees to purchase at least \$15 of toys each month. As part of the agreement, Love Those Toys is authorized to debit the distributor's checking account or credit card in the amount of \$15 if the distributor fails to purchase the minimum amount of toys during the month. In these circumstances, the distributor receives (based on a predetermined election) either a certificate redeemable for \$15 in toys or an automatic shipment of toys (known as a Santa's Elf pack). The Santa's Elf pack contains a selection of toys that are featured that month and has a value of slightly more than \$15.

During the first week after each month-end, Love Those Toys:

- Determines which "Santa Claus" distributors failed to purchase a sufficient amount of toys to fulfill their commitment for the month.
- Produces a report that lists the distributor's bank or credit card accounts to be debited, and sends deposit or credit card slips to the appropriate financial institutions.
- Ships Santa's Elf packs to the appropriate distributors on F.O.B. shipping point terms. A sufficient inventory of Santa's Elf packs is on hand at month-end and the majority is pre-packaged, segregated and ready to be shipped (awaiting only the shipping label).

Love Those Toys has a "money back if not satisfied" return policy on all toys sold to distributors. However, a return of toys by a "Santa Claus" distributor can jeopardize their status and result in a loss of their network of distributors from which bonuses are generated. Over the life of the company, sales returns have consistently run at approximately 1% of sales and generally involve the exchange of damaged product for quality product.

A small number of "Santa Claus" distributors that do not meet their commitment elect to receive a certificate redeemable for \$15 in toys. Love Those Toys records these transactions as a liability (deferred revenue). The liability is reduced and revenue is recorded when the certificates are redeemed.

The majority of the "Santa Claus" distributors that do not meet their commitment elect to receive the Santa's Elf pack and the popularity of the packs is growing rapidly. In the working trial balance given to the auditors for fiscal year end June 30, 1992, Love Those Toys recorded revenue of approximately \$5.0 million and costs of approximately \$3.5 million relating to Santa's Elf packs that were shipped in the first week of July 1992. Total revenue recorded for fiscal year 1992 was \$57 million.

Required:

- Should the shipments of Santa's Elf packs in the first week of July be recorded as revenue in fiscal year 1992?