GRAINIACS: A CASE STUDY

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***Abstract*— Grainiacs is a diversified commodity merchandising company that operates multiple storage facilities across the Mid-West. The company buys and sells grain and each separate facility is individually registered as a Licensed Federal Warehouse with the USDA. This licensing allows each facility to sell grain for cash while maintaining physical control of the asset. Thus acting as a consignee. The buyer transfers cash to Grainiacs and receives a Federal Warehouse Receipt in return. Grainiacs records the sale and removes the grain from the inventory account. When the grain is transferred, the Federal Warehouse receipt is cancelled and the grain is shipped.**

At the beginning of the year, Bubba Bean (the executive in charge of the storage facilities) was assigned the task of reducing the carrying value of the inventory by 20% and his bonus hinged upon completion of this task. Near the end of the year, it appeared that this goal would not be met so he devised a plan to meet the goal. He sold $70 million of existing inventory at cost and issued the Federal Warehouse Receipts in return with the understanding that he would buy back the grain after the first of the new year. The buy-back price would include a 1% premium. This plan allowed him to reduce the carrying value of inventory owned by Grainiacs and assured him of his bonus.

The transactions were completed but soon came under scrutiny during a routine internal audit and top management was notified.

Grainiacs, Inc. is a diversified commodity merchandising company located in the upper mid-west with fiscal operations conducted on a calendar-year basis. The company primarily buys and sells corn and soybeans and operates multiple storage facilities in several states. Each storage facility is individually registered as a Licensed Federal Warehouse with the US Department of Agriculture. This licensing allows each facility to legally sell all or a portion of its physical grain inventory for cash, effectively shifting ownership of those particular stocks to the purchasing company while maintaining physical control of the assets (hence becoming consigned goods belonging to the purchaser).

Each sale is consummated at arms-length. That is, the purchaser transfers cash to Grainiacs equal to the value of the grain purchased and Grainiacs in-turn transfers to the purchaser a Federal Warehouse Receipt (a federally issued negotiable instrument representing ownership of the inventory). At this point, Grainiacs will record this transaction as a sale of the inventory and will no longer formally recognize the inventory on its financial statements. However, Grainiacs is required by law to maintain a report showing owned and non-owned inventory located at the facility.

In addition, the facility cannot allow total physical stocks to fall below the amount owned by the purchaser until it is shipped to the purchaser. Once the purchaser receives all the grain, the Warehouse Receipt is cancelled and returned to Grainiacs. The entire transaction is supported by a formal written sales/purchase contract outlining all the specifics of the trade including quality and volume amounts and pricing conditions.

Bubba Bean is Grainiacs' senior executive responsible for storage facility operations. At the beginning of the year, Bean was assigned the task of reducing the carrying value of inventory by 20%. As an incentive, completion of this task was tied to a performance bonus of 15% of Bean's annual salary (a bonus amounting to over $35,000). Therefore, completing this task and meeting the goal would prove to be very lucrative to Bean. As of the middle of December, the goal had not been achieved, falling short by around $60 Million.

Realizing that the goal might not be realized which would result in no bonus, Bean devised a plan to solve his problem. Bean entered into a verbal agreement with another grain merchandiser stipulating that on December 30th, Grainiacs would sell at cost $70 Million of existing inventory (located at several locations) for cash and issue Federal Warehouse Receipts (one from each facility affected), all supported by binding written contracts in accordance with legal requirements. This would effectively reduce the inventory on Grainiacs' December 31st Balance Sheet to the desired goal (although the inventory would physically remain in place), and allow Bean to earn the bonus. Then, on January 2nd, Grainiacs would repurchase the inventory at the original selling price plus a premium equal to 1% of the original selling price ($700,000). Once the repurchase was executed, the issued Federal Warehouse Receipts would be cancelled and the inventory would be reinstated to Grainiacs' financial statements at the new, higher value.

Approval of grain contracts was stratified according to the size of the contract. Contracts of $1 million or less could be approved at the local level. Contracts between $1 million and $5 million had to be approved at the next level on the organizational chart. Bean's contract went to the fourth level due to the size of the transaction and Bean himself was responsible for approving contracts at this level. Although several of Bean's subordinates questioned the validity of the contract, Bean told them that "we can't do this" was not a justification for cancelling the contract and the transaction was completed. Bean's transaction came under scrutiny during a routine internal audit and top management was notified.

Required:

- Analyze Bean's plan of action.
- In particular, were the transactions recorded in accordance with GAAP? Does the transaction have economic substance?
- Can the inventory be recorded at the new price that is 1% higher? If not, how should the 1% premium be treated?
- Discuss any ethical issues present.
- Assume you are the CEO of Grainiacs. How would you handle this case?

GRAINIACS
TEACHING NOTES

SUMMARY:

Grainiacs is a diversified commodity merchandising company that operates multiple storage facilities across the Mid-West. The company buys and sells grain and each separate facility is individually registered as a Licensed Federal Warehouse with the USDA. This licensing allows each facility to sell grain for cash while maintaining physical control of the asset. Thus acting as a consignee. The buyer transfers cash to Grainiacs and receives a Federal Warehouse Receipt in return. Grainiacs records the sale and removes the grain from the inventory account. When the grain is transferred, the Federal Warehouse receipt is cancelled and the grain is shipped.

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TEACHING OBJECTIVES AND TARGET AUDIENCE:

Teaching Objectives: The student should be able to:

- Apply the revenue recognition principle to determine if the transaction resulted in a sale.
- Discuss the proper treatment of the premium paid on the buy-back of the grain.
- Determine if the transaction lacks economic substance.
- Identify any weaknesses in internal control that allowed the transaction to occur.
- Discuss measures to correct such weaknesses.
- Discuss whether the transaction resulted in occupational fraud, occupational abuse or merely an unethical action by Bean.

Target Audience:

This case could be used in a variety of upper level classes such as Intermediate Accounting, Auditing, Fraud Examination or an Ethics class.

It could be used in Intermediate Accounting to explore the issues of revenue recognition and inventory valuation for financial statement purposes, including the accounting treatment of the premium paid.

Questions for an Intermediate class:

- Does the transaction adhere to the Conceptual Framework's guidelines for faithful representation (economic substance over form)?
- Does the transaction meet the requirements for revenue recognition according to US GAAP?
- Should the premium paid be included in the cost of the repurchased inventory or expensed?
- If expensed, how should it be classified?

Questions for an Auditing class:

- Was this transaction properly recorded? If not, describe how it should have been recorded.
- Was the repurchased inventory properly valued?
- Was the premium properly recorded?
- Identify and discuss any internal control deficiencies that allowed this transaction to occur.
- Suggest any measures to correct any internal control weaknesses.

Questions for a Fraud Examination or Ethics class:

- Apply the fraud triangle to the transaction.
- Were Bean's actions merely unethical or occupational fraud and abuse?
- Was the premium paid to repurchase the grain a commercial bribe?

ANALYSIS:

- Does the transaction adhere to the Conceptual Framework's guidelines for faithful representation (economic substance over form)?

  ANSWER: Economic Substance (or Substance over Form) is an underlying belief of the Conceptual Framework. It is pertinent to the Faithful Representation Fundamental Quality that the numbers and descriptions match what really existed or happened.

  Substance over form is not considered a separate component of faithful representation because it would be redundant. Faithful representation means that financial information represents the substance of an economic phenomenon rather than merely representing its legal form. Representing a legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation.

Source: FASB Statement of Financial Accounting Concepts No. 8, September, 2010, BC3:26.

The following analysis can answer the questions related to the proper accounting treatment and recording of the transaction.

- The transactions were initially accounted for as a sale and then purchase of inventory. Since the initial sales price was at cost, the transaction increased revenue and cost of goods sold in the same amount. Therefore, gross profit and net income were not overstated. However, the buy-back price included the premium. The inventory was overstated by the amount of the premium and if subsequently sold, cost of goods sold would be overstated by the amount of the premium. The transaction was in essence a repurchase agreement.
- A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component. ASC 606-10-65-1. In the above case, Grainiacs has an obligation to repurchase the asset at a price above the original selling price. Therefore the contract should be accounted for as a financing arrangement in accordance with ASC 606-10-55-70 which states, "If the repurchase agreement is a financing arrangement, the entity should continue to recognize the asset and also recognize a financial liability for any consideration received from the customer. The entity should recognize the difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer as interest and, if applicable, as processing or holding costs.

Identify and discuss any internal control weaknesses that allowed this transaction to occur.

- There appeared to be weaknesses in the control environment. Bean made the final decision and the individuals working with him and for him did not have a process for challenging his decisions.

- Transactions were not reviewed prior to being initiated or recorded by someone independent of the transaction with the authority to deny the transaction be recorded.

Suggest any measures to correct any internal control weaknesses.

- Provide training to develop an appropriate control environment. Appropriate control environment begins with "tone at the top."
- Implement procedures requiring all transactions be reviewed by an individual with the authority to deny the transaction and that is independent of the transaction. Could also require someone at a management level one level above the person initiating the contract to approve it.

Apply the fraud triangle.

Cressey's fraud triangle is based upon three factors that contribute to fraudulent activity. The three legs of the triangle are a perceived nonshareable financial need, perceived opportunity and rationalization.

- Pressure is generally present when the perpetrator feels there is an unshareable problem. In this case, there is no specific mention of any particular pressure other than the desire for the bonus.
- Bean clearly had the opportunity to cause the transaction to occur since he had the authority to approve the transaction.
- Rationalization actually occurs before a fraud takes place. Bean rationalized that he deserved the bonus.

Were Bean's actions unethical or occupational fraud and abuse?

According to the Association of Certified Fraud Examiners, occupational fraud and abuse is defined as: *the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's or resources.* Bean's actions certainly meet this definition. Actions that meet this definition are inherently unethical.

Was the premium paid to repurchase the grain a commercial bribe?

Commercial bribery is offering something of value to influence a business decision. The premium Bean offered is indeed a commercial bribe to get the buyer to purchase the grain. However, there was another payment involved - the bonus. The bonus might be considered a type of payroll fraud since it would not have been paid had the transaction not occurred.

Assume you are the CEO of Grainiacs. How would you handle this case?
Grainiacs has several options:

- Fire Bubba.
- Demand repayment for the stolen funds along with any fees incurred.
- Call the authorities.