Inventory Mismanagement at Tandy Leather Factory - CEO and CFO value inventory

Tandy Leather Factory, Inc. (Tandy) is the world's leading distributor of premium leather and supplies. Its mission is "to teach and inspire the art of leathercrafting, one person, one class, one neighborhood, one community at a time." The company sells quality leather, tools, hardware, supplies, kits, and teaching materials to inspire the art and trade of leatherworking.

Originally formed as the Hinckley-Tandy Leather Company in 1919, the company sold leather shoe parts to shoe repair shops in Fort Worth, Texas. While serving in the Navy during WWII, Charles Tandy, the oldest son of one of the founders, saw that military hospitals provided leathercraft programs for the recreation and rehabilitation of injured military personnel. Realizing the potential, he decided to reimagine the company into a leathercraft business. Charles Tandy is also credited with starting Pier1 Imports and for the massive expansion of Radio Shack in the 1970's.

Following Charles' unexpected death in 1978, the president and divisional VP left to establish the Leather Factory which became a public company through a reverse merger in 1993. The Leather Factory later bought the operating assets of Tandy Leather in 2000 and in 2005, the company rebranded as the Tandy Leather Factory.

By December 31, 2016, Tandy Leather Factory operated 111 stores in North America, 2 stores in the United Kingdom, and 1 store in Australia and Spain. The company had nearly $83 million in Net Sales and was listed on the Nasdaq Stock Exchange.

Tandy Accounting Policy for Inventory

Given the nature of its business, Tandy's inventory represents a significant asset. Between 2004 and 2016, inventory fluctuated between 35% and 65% of the company's total assets. The accounting policy regarding its inventory is that inventory is stated at the lower of cost or market and is accounted for on the "first in, first out" method (i.e., FIFO). The logic of the FIFO method is that a company sells its oldest inventory items first and maintains the newest items in inventory. In addition, Tandy had the policy to reduce the value of slow-moving or obsolete inventory based on a review of items compared to their estimated future demand. Most of Tandy's inventory items have no restrictive shelf life.

Inventory Tracking System

From a financial reporting perspective, if inventory is not recorded correctly, inventory, cost of sales, gross profit, operating expenses, operating income, net income, and EPS will all be improperly stated. Tandy's inventory tracking system dated back to 2000. It generated a SKU for each item that contained cost, price, vendor, size, color, and other information. Tandy personnel would update the pricing amounts for the SKUs when there were additional purchases. Interestingly, the system could hold only one cost per SKU at a time and did not retain any historical information. As such, when a new cost was inputted for a SKU, the updated cost applied retroactively to all pre-existing products associated with items of that particular SKU. This implied that every time new inventory was purchased, the historical cost for all earlier purchases was changed.

To alleviate the potential issues related the tracking system, Tandy used a manual process whereby inventory purchasers were supposed to track inventories for all SKUs across all stores and change the price after existing inventory was sold. While in theory, this could correct the issue, nothing was done to ensure the manual process was implemented correctly. Management believed that "the risk of improper inventory valuation is mitigated due to the history of Tandy's operations, the fact that Tandy's inventory does not become obsolete, and given its turnover."

Leadership Changes

In October 2018, Shannon Greene the CEO and Mark Angus, the President resigned from Tandy Leather. Greene, who is a certified public accountant, served as CEO from February 2016, as a director from January 2001, and as the CFO from May 2000 until February 2017. Angus served as President from February 2016, as a director from June 2009, as the Senior Vice President from June 2008 until February 2016 and as a Vice President from January 1993 until June 2008.

Greene argued that "controls associated with the financial reporting processes rely on the heavy involvement of the CFO and CEO because of the company's size and organizational structure" and that "the company's financial statements and reporting structure lack complexity which contributes to the probability of more accurate, complete and timely financial statements."

New management believed that the inventory tracking systems in place were inadequate. In response, the Audit Committee began an internal investigation on July 26, 2019. The investigation was disclosed to investors on August 14, 2019.

Internal Controls over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over our financial reporting. The internal control system is designed to provide reasonable assurance regarding the reliability of the preparation and fair presentation of published financial statements. In 2018, Tandy stated that it had assessed the effectiveness of its Internal Controls over Financial Reporting and concluded that the systems in place were adequate. However, management did not properly assess, nor maintain sufficient evidence to support its annual review, of the effectiveness of Tandy's internal controls over financial reporting.

According to the 2018 annual report, Weaver and Tidwell LLP, the auditors of Tandy since 2003, stated: "the Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits, we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control over financial reporting. Accordingly, we express no such opinion."

Aftermath

On October 21, 2019 the company disclosed that its financial statements, dating back to 2016, could not be relied upon due to material misstatements in inventory, net income and gross profit. The chart below shows the originally reported and restated amounts for inventory, net income and gross profit for Fiscal Years 2017 and 2018:

Inventory			
Fiscal Year	Reported	Restated	%
2017	37,311,197	34,546,084	-7.40%
2018	33,867,276	33,302,549	-1.70%

Gross Profit			
Fiscal Year	Reported	Restated	%
2017	4,451,751	2,478,444	-44.30%
2018	1,963,828	4,398,365	124.00%

Net Income			
Fiscal Year	Reported	Restated	%
2017	52,113,829	49,085,661	-5.80%
2018	50,580,191	50,940,945	0.70%

On October 18, 2019, Tina Castillo resigned as the Chief Financial Officer, Principal Financial Officer, Principal Accounting Officer and Treasurer of the Company. Tandy stated that Tina's resignation was not the result of any dispute or disagreement with the Company relating to the Company's operations, policies or practices.

On November 18, 2019, Tandy received a notice that it was not in compliance with the continued listing requirements of the Nasdaq. Due to Tandy's inability to timely file its quarterly and annual financial reports, Nasdaq suspended trading in the Company's stock on August 13, 2020 and formally delisted it on February 9, 2021. In June 2021, Tandy issued financial statements for the year ended December 31, 2019, as well as restatements of the following previously filed periods. As part of their remediation efforts, Tandy installed a new accounting system, hired qualified accounting personnel, and engaged experts to improve internal controls over financial reporting. Despite this, as at December 31, 2021, Tandy has yet to conclude that their internal controls are effective.

In July 2021, Tandy entered into a settlement with the SEC whereby it agreed to pay a civil monetary penalty of $200,000, and Shannon Greene agreed to pay a civil monetary penalty of $25,000. The Company's common shares currently trade on the OTC Pink Market.

Questions:

1. If an inventory-tracking system requires the personal involvement of the CEO and CFO to compute cost of goods sold and inventory valuations for a major company, what possibilities should occur to a professional accountant demonstrating reasonable professional skepticism?
2. Why would a company maintain an inventory tracking system that produced a mis-valuation of inventory?
3. Why would Tandy refuse to address the Nasdaq filing requirements in a timely manner? Is this indicative of other potential issues?
4. From the above noted table, what does the restatement suggest about the price of leather?
5. Given the importance of inventory in Tandy's business, should the auditors have used additional oversight in their assessment of inventory? Why are they not responsible to assess the effectiveness of the internal controls?
6. Do you agree with Shannon's assessment that the risk of misvaluing inventory is reduced given that the inventory does not become obsolete?
7. Why would the company's size and organizational structure cause controls associated with the financial reporting processes to rely on heavy involvement of the CFO and CEO? Is this sustainable?

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