

HIGHLAND MALT: ACCOUNTING POLICY CHOICES IN FINANCIAL STATEMENTS

Erik Stein wrote this exercise under the supervision of Vaughan Radcliffe and Mitchell Stein solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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In January 2020, after having recently graduated from a prestigious MBA program, Katharine Mackinnon was working as a financial accountant for a renowned private equity firm in Glasgow, Scotland. Although the work hours were long, Mackinnon enjoyed her new job and the learning experiences that accompanied the role. She knew that if she worked hard and developed a thorough technical expertise, a promotion was within reach.

One evening, Mackinnon was up late reviewing a valuation model, when a calendar reminder popped up with a notification of her father's retirement the coming week. Mackinnon's father, who had enjoyed success in the private equity industry, was a key inspiration behind Mackinnon's career path. She had to find the perfect gift to show her appreciation for his guidance. While considering the ideal gift for her father, an email appeared in her inbox from Highland Malt Inc. (Highland), offering a unique opportunity for a premium whisky. Mackinnon had forgotten all about signing up for this newsletter, but was grateful for the perfect timing. Her father was a whisky connoisseur, and he would be proud to own such a unique product.

The email announced the introduction of the company's new Highland whisky.¹ The Scotch whisky, which would only be offered in a limited quantity, was promoted as an investment. Unlike ordinary bottled whiskies, Highland was selling this new line solely by the barrel. Collectors would have to pay the full amount upfront, but could request a full refund within 180 days if unsatisfied with the product. The refund period allowed the collector to visit the distillery and inspect the purchase to ensure it met all expectations. Mackinnon wondered if the purchase would make a great investment and gift for her father.

WHISKY INDUSTRY

In 2018, the global whisky industry was valued at US\$59 billion,² and was projected to grow to \$84 billion by 2025.³ This increase in demand, combined with a recent supply shortage from Scotland, had raised the

¹ The term whisky was derived from the Scottish Gaelic *uisge beatha*, which meant "water of life." Although the spelling of the word "whisky" had been altered to "whiskey" in Ireland and in the United States, Scots and Canadians still used the original spelling; The Editors of Encyclopaedia Britannica, "Whiskey: Distilled Liquor—Alternative Title: Whisky," Encyclopaedia Britannica, January 6, 2020, accessed February 23, 2020, www.britannica.com/topic/whiskey.

² All currency amounts are in US dollars unless otherwise specified.

³ "Whiskey Market Size By Product (Scotch Whiskey, American Whiskey, Canadian Whiskey, Irish Whiskey, Other Whiskey), By Distribution Channel (On-Trade, Off-Trade) Industry Analysis Report, Regional Outlook, Growth Potential, Price Trends, Competitive

value of whisky considerably. The surge in popularity had led to a rising trend of whisky barrels being purchased by collectors and investors around the world, particularly in Asia. Whisky barrels were considered a status symbol that increased in value over time, which explained their appeal to whisky connoisseurs. Some distilleries had noticed the trend and encouraged it by making the purchase of barrels more accessible to private buyers. With sales to collectors and investors expected to grow, the timing was ideal for distilleries to enter the whisky market.

Highland Malt Inc.

Highland was appropriately located in Inverness, a city in the Highlands of Scotland. As a low volume producer, Highland aimed to differentiate itself from the market through the quality of its whisky. Although competitors traditionally produced Scotch whisky in American bourbon barrels, Highland decided to use the much rarer—and thus, more valuable—Spanish sherry barrels. Ultimately, Highland's production volumes would be limited by the availability of these barrels, further emphasizing the exclusivity and premium nature of the whisky.

Highland decided to adapt to these consumer trends and exclusively offered Scotch whisky by the barrel, thereby skipping the final step in whisky production (see Exhibit 1). The decision was intended to appeal to investors, who would not only collect the whisky but also own an exclusive sherry barrel.

Each barrel, which was priced at \$10,000, produced 175 bottles of 40 ounces (approximately 1.2 litres).⁴ At approximately \$60 per bottle, the initial price of Highland's whisky was lower than notable premium whiskies. However, collectors also had to cover annual storage costs for the 12-year period, which placed Highland in a class of its own. Investors reserved the privilege to inspect and evaluate their whisky as it aged over the 12-year period, thus making a reserve barrel of whisky a unique opportunity.

Highland's Internal Processes

Customers could place orders for barrels by calling a toll-free telephone number or by using the company's e-commerce website. Highland's management had developed a working relationship with Spencer's Spirits (Spencer's), a global corporation that owned many leading brands of beer, wine, and spirits. Spencer's agreed to manage all online marketing and e-commerce services for Highland, having gained considerable expertise in this area over the years. In exchange for handling all online sales, Spencer's received a 10-per-cent commission on each customer order.

Spencer's was responsible for receiving whisky barrel orders and collecting the \$10,000 payment from each customer. Once the order was received, Spencer's notified Highland, who reserved the specified number of barrels for the customer. After the order was filled and the reserved barrel was set aside, a certificate of purchase and authenticity was prepared and sent to the customer. At the same time, a notification was sent to Spencer's requesting a transfer of funds. Spencer's would then transfer \$9,000 to Highland for the order, keeping 10 per cent of the order as commission. If a collector returned the product within the 180-day refund period, Highland would send a cheque for the full amount of \$10,000 to the customer, but the 10-per-cent commission would not be requested from Spencer's.

Market Share & Forecast, 2019 – 2025," Global Market Insights, accessed April 1, 2020, www.gminsights.com/industry-analysis/whiskey-market?utm_source=globenewswire.com&utm_medium=referral&utm_campaign=Paid_globenewswire.

⁴ Barrels were initially filled to a volume of 250 bottles of 40 ounces (approximately 1.2 litres). However, 2–3 per cent of the whisky evaporated annually. After 12 years, the volume would be reduced by as much as 40 per cent. The whisky lost through this evaporation process was known as the *angels' share*; Jonathan Houston, "What Is the Angel's Share?," The Whiskey Wash, April 20, 2016, accessed February 23, 2020, <https://thewhiskeywash.com/whiskey-styles/american-whiskey/what-is-the-angels-share>.

Contributing to the uniqueness of the Highland whisky was its production's oversight by renowned master distiller Fraser Adger. Highland had paid a fee of \$50,000 to Adger in 2019 for his services as master distiller, and a second fee of \$30,000 was due and payable to Adger in 2020 for his continuing services provided subsequent to 2019. After thoroughly deliberating on the production method, Highland's management decided to produce batches of 50 barrels every six months, beginning in January 2018, and to increase production starting in 2019 (see Exhibits 2 and 3). However, due to a shortage of skilled labour, higher material expenses, and rising overhead costs, Highland was increasingly paying significantly more for the production of whisky batches (see Exhibit 3).

INCORPORATION AND START-UP

Highland was incorporated in January 2018. The company's stock was sold for a total of \$750,000 to a group of private investors, some of whom were involved with the internal management of the company. One significant investor was master distiller Adger, who added credibility to Highland's quality and acted as a catalyst for investors. In addition to raising equity to fund start-up costs, Highland obtained a \$50,000 two-year bank loan at 10 per cent interest to cover short-term cash needs. The term loan, which was backed by a personal guarantee from Adger, was extended in January 2019 and regular payments consisting of interest were due on the 25th day of each month. Principal did not have to be repaid until the start of the next fiscal year.

With the necessary capital in place, Highland signed a five-year lease at a disused shipyard for \$7,500 per month beginning January 1, 2019. Although the location was unconventional, it was ideal for warehousing barrels and instilling the flavour of the ocean in the whisky. In addition to the lease, Highland had several other overhead fixed cost accounts for expenses incurred in 2019 (see Exhibit 4). Second-hand equipment was leased at the beginning of January 1, 2019 through a neighbouring city, resulting in a total annual cost of \$50,000. In 2019, a local advertising agency was commissioned for all promotional responsibilities for a one-time fee of \$75,000. This work included corporate branding and logo design, which added value to the Highland brand.

PRODUCTION

Production began in 2018⁵, with two batches of 50 barrels of whisky produced throughout the year. Sales started in 2019 and Highland ramped up production to two batches of 100 barrels to adjust for sales. Of the 300 barrels produced, a total of 250 barrels were sold. Finished barrels were stored in the Highland warehouse, where they would be inspected and evaluated for the duration of the aging process.⁶ Production input purchases (e.g., malted barley, peat, and yeast) and payments to suppliers were made during the production month.

By year end, Spencer's had not remitted payment for 10 barrels purchased in 2019. Additionally, no barrels were returned from customers by year end, however 10 barrels were returned in early 2020. These barrels were all returned within the 180-day timeframe of Highland's refund policy.

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⁵ The early production in 2018 was done using borrowed equipment at no cost for one year to test if it was viable to make the desired whiskey for this venture.

⁶ Warehousing costs, which were the responsibility of the buyer, were not reflected in Highland's financial statements.

EXHIBIT 1: WHISKY PRODUCTION PROCESS

Standards tended to vary by country, but whisky production generally followed five basic processes: mashing, fermentation, distillation, maturation, and bottling.

Mashing

Mashing was the process whereby the starches contained within the grains were converted into fermentable sugars. Warm water was combined with milled grain to create a “mash.” The mash was fed into a large cylindrical container known as a “mash tun.” Rotating blades agitated and stirred the mash to ensure all of the starches were converted to sugar. Once fully converted, the mash formed into a sugary liquid called “wort,” which was then ready for fermentation.

Fermentation

The wort was pumped into a fermentation tank, called a “washback,” where yeast was added. The yeast and wort combined in a chemical reaction that converted the sugars in the wort into alcohol. After several days, the liquid was converted into “distillers’ beer” or “wash.” At this stage, the liquid was approximately 10 per cent alcohol by volume (ABV).

Distillation

Distillation was a process of concentrating a component of a liquid by converting it into a gas. In the case of whisky distillation, the process concentrated the alcohol contained within the wash. The wash was then fed into a *still*, which heated the wash to the point where the alcohol evaporated. Because the alcohol had a lower boiling point than water, the alcohol rose to the top of the still, where it was collected and cooled in a condenser. The leftover wash was discarded. Typically, whisky was distilled at least twice. The first distillation converted the wash into “low wine.” The second distillation further concentrated the liquid into “high wine” or new whiskey. At this stage, the liquid would have reached approximately 90 per cent ABV (i.e., 180 proof).

Maturation

The final stage of the production process was maturation, whereby the new whisky was combined with water and stored in wood barrels. Typically, the barrels were made of American or European oak. The whisky entered the barrel colourless. During this aging process, however, the barrel expanded and contracted due to changes in barometric pressure and temperature. When the barrel expanded, it forced water out of the barrel such that, after seven years, as much as 50 per cent of the whisky had evaporated. When the barrel contracted, it imparted colour, flavours, and aromas into the whisky. As a result, each barrel had a unique set of characteristics.

Bottling

After the whisky had aged for the optimal period, it was ready for bottling. Depending on the desired characteristics, the whisky may have been bottled from a single barrel or blended with whisky from other barrels. Once the whisky was bottled, its characteristics no longer changed.

Source: Created by author with information from “How Is Whisky Made?,” Whisky for Everyone, accessed February 23, 2020, www.whiskyforeveryone.com/whisky_basics/how_is_whisky_made.html.

EXHIBIT 2: HIGHLAND MALT INC. STATISTICS FOR 2019

	Amount
Barrels produced	200
Barrels in opening inventory	100
Barrels ordered	250
Barrels in closing inventory	50
Barrels returned	0
Barrels for which cash was received from Spencer's Spirits	240
Barrels sold but not paid for by Spencer's Spirits	10

Source: Company documents.

EXHIBIT 3: HIGHLAND MALT INC. PRODUCTION SCHEDULE AND COST (IN US\$)

Batch Number	Date	Units (Barrels)	Cost per Unit	Total Cost
1	January 2018	50	\$6,000	\$300,000
2	July 2018	50	\$6,500	\$325,000
3	January 2019	100	\$7,000	\$700,000
4	July 2019	100	\$7,500	\$750,000
Total		300		\$2,075,000

Source: Company documents.

EXHIBIT 4: HIGHLAND MALT INC. ANNUAL FIXED COST SCHEDULE (IN US\$)

Other Expenses	Amount
Office and administrative	\$10,000
Salaries and wages	\$130,000
Repairs and maintenance	\$25,000
Supplies	\$25,000
Utilities	\$40,000
Total	\$230,000

Note: These expenses are all out-of-pocket.

Source: Based on the author's calculations from information in the case.