GAP - Games Accountants Play

Some Foundation

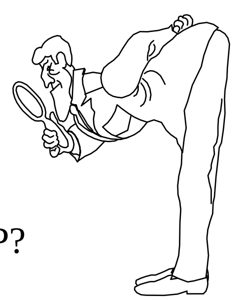
- Who is responsible for the firm's annual report — management or the auditors?
- An understanding of a firm's financial statements requires:

  Understanding of accounting

  Close investigation of

  GAAP vs. GAP

  What is GAAP? What is GAP?



FIN 551: Fundamental Analysis 2

GAAP vs. GAP?

- GAAP
  - – Generally accepted accounting principles
  - – Issued by FASB; ultimate regulation is by the SEC
- GAP
  - – Games accountants play
    - » *Actions or omissions intended to hide or distort the real financial performance or financial condition of an entity.*

FIN 551: Fundamental Analysis 3

Why Does GAP Exist?

- *It pays to do it*. Executive bonuses are usually tied to reported profits — not cash flows
- *It's easy to do.* The real GAAP is flexible and liberal
- *It's unlikely management will be caught.* Quarterly statements are unaudited and there is much *opinion shopping*.

FIN 551: Fundamental Analysis 4

Characteristics of a Company Likely to Use GAP

- A weak internal control environment exists
- Extreme external competitive pressures exist
- Management is of questionable character
- A fast-growing company whose real growth is slowing
- A “basket-case company” struggling to survive
- A new public or private company.

A Summary of GAP

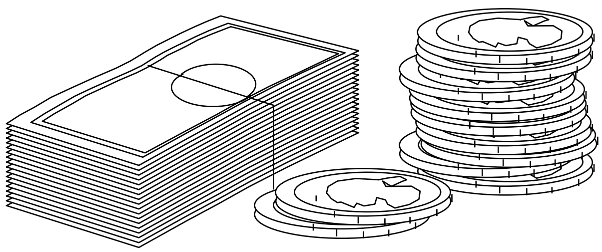
No. 1 Record revenue too soon
No. 2 Record bogus revenues
No. 3 Boost income with one-time gains
No. 4 Shift expenses to a later period
No. 5 Fail to record/disclose all liabilities
No. 6 Shift current income to a later period
No. 7 Shift future expenses to the current period

Let’s look at each of these GAPs.

GAP No. 1: Record Revenue Too Soon...

The Guiding Principle Should Be:

Record revenue after the earnings process is complete and the occurrence of an exchange.



Record Revenue Too Soon...

- Ship goods before a sale is finalized. Done by:
  - Billing in advance
    - » *Datapoint Corporation*
      - Ignored delivery schedules; partial shipments; overshipped
  - Shipping defective goods
    - » *Miniscribe Corporation*
      - Defective hard drives, bricks, etc...
  - Using an aggressive revenue approach
    - » *Organogensis Inc.* (biotech firm)
      - Percentage completion method — yet no salable product.

Record Revenue Too Soon...

- Important uncertainties exist

  Is the sale with or without recourse?

  » *Traditional Industries*

  - Installment sales over 48 months; total revenue booked at sale but high default rates

  Does the buyer have financing to pay?

  » *Stirling Homex Corporation*

  - Booked sale before home buyers approved by HUD

  Is there an obligation by the buyer to pay?

  » *Storage Technology Corporation*

  - Computer equipment installation not completed until customer says so.

FIN 551: Fundamental Analysis 9

Record Revenue Too Soon

- Record revenue when future services still due

  Watch franchisors

  » *Jiffy Lube*

  - Area developer paid upfront fee — all recognized as income
  - Should be recorded as unearned income and amortized as units open.

  Booking future revenue

  » *Enron*

  - Booked PV of differences between 5 year sales contract to utility & 5 year purchase contract from supplier at time of inception.

FIN 551: Fundamental Analysis 10

GAP No. 2: Record Bogus Income...

The Guiding Principle Should Be:

Record revenue after completion of the earnings process and the occurrence of an exchange.

Record Bogus Income...

- Management records income on the exchange of similar assets

  GAAP does not permit gains/losses on exchange of similar property

  » *MDC Holdings*
    - Sold property in CA and bought in AZ the same day
    - Booked a gain: $2.2 million.

  » *Charles Keating — sham sales*
    - Sale of property in a circle with each seller carrying paper.

Record Bogus Income...

- Management records refunds from suppliers as revenue
  - Accounting entry should reduce inventory and reduce payables
    - » *L.A. Gear:*
      - $4.7 million in vendor credits classified as income
      - Credits were for misshipments or inventory returned to suppliers.

FIN 551: Fundamental Analysis 13

Record Bogus Income...

- Some other inventory games
  - Artificially create inventory
    - » Crazy Eddie
      - Fictitious invoices
      - Copied auditors' inventory tallies to cover scheme
    - » Comptronix
      - Fictitious inventory & sales
      - Eventually transferred "inventory" to fixed assets.

FIN 551: Fundamental Analysis 14

Record Bogus Income...

- Management uses bogus estimates on interim financial statements
  - Gross profit method often used to estimate margins
    - » *Kaypro Computer*
      - Used 43% margins in 2nd and 3rd quarters in 1987
      - Year-end audit determined total year's margin was 26%
    - » *Woolworths*
      - Inflated gross margins in 1st three quarters in 1994
      - One quarter misstated by $16 million.

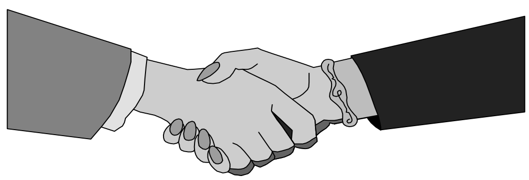
Record Bogus Income

- Watch out for redeemable preferred stock
  - Is it debt or is it equity? If debt, shouldn't the dividend be an interest expense?
    - » *Ecolab*
      - $110 million of redeemable preferred stock on the balance sheet in 1990.

Gap No. 3: Boost Income with One-Time Gains...

The Guiding Principle Should Be:

Record revenue after the earnings process is complete and an exchange has occurred. Similarly, report gains only after an exchange has taken place.



FIN 551: Fundamental Analysis 17

Boost Income With One-Time Gains...

- Management sells undervalued assets
  - Merge using the pooling of interests method (as opposed to purchase method)
    - » *GE's purchase of Utah Int'l*
      - GE suppressed $1.4 billion of value in its balance sheet
  - Dip into LIFO inventory pools
    - » *Stauffer Chemical Company*
      - Used lowest cost pool when it needed income
  - Sell real estate acquired several years ago
    - » *TIE/Communications*
      - 30% of 1983 profits were one-time gains.

FIN 551: Fundamental Analysis 18

Boost Income With One-Time Gains...

- Management can boost profits by retiring debt early
  - Retire debt with market value below book value and replace with more expensive debt
    - » *America West Airlines*
      - Bought back debt with a 7% coupon rate, which was below the market rate for the issue
      - Issued debt with an 8.5% coupon rate
      - Result: Booked income but incurred larger future cash outflows for interest.

Boost Income With One-Time Gains...

- Management co-mingles nonoperating and operating amounts
  - Fail to segregate unusual and nonrecurring gains or losses from recurring income
    - » *Time, Inc.*
      - Reported a 89% profit improvement over the prior year
      - Adjust for nonrecurring gains: Profits down 35%
    - » *Cineplex Odeon*
      - $48 million gain from sale of production company
      - Ignore gain: Result is a $14.5 million operating loss.

Boost
Income With One-Time Gains

- Management buries losses under noncontinuing operations
  - Non-continuing activities shown in a separate section of the income statement
  - Section includes discontinued operations, extraordinary gains and losses, and effect on income of changing accounting principles
    - » *Primerica Corporation*
      - October '87: Incurred $61 million loss on some brokerage activity
      - Recorded as "nonrecurring item".

FIN 551: Fundamental Analysis 21

GAP No. 4: Shift
Expenses to a Later Period...

The Guiding Principle Should Be:

Capitalize costs that produce a future benefit and expense those that produce no such benefit.

FIN 551: Fundamental Analysis 22

Shift Expenses to a Later Period...

- Management improperly capitalizes costs
  - Capitalize start-up costs
    - » *Lockheed* hid $.5 billion in the balance sheet
  - Capitalize R&D costs
    - » *Savin* classified $42 million as an asset
  - Capitalize advertising expenditures
    - » *L.A. Gear* treated $3.9 million as an asset
  - Capitalize administrative costs
    - » *De Laurentiis Entertainment* allocated $1.3 million costs as inventory.

Shift Expenses to a Later Period...

- Management depreciates or amortizes costs too slowly
  - Excessively long amortization periods
    - » *Cineplex Odeon* amortized leaseholds over 27 years
  - Increases in depreciation/amortization schedules
    - » *GM* lengthened period to improve income
  - What is normal industry practice?
  - Is the industry experiencing rapid technological change?

Shift
Expenses to a Later Period

- Management fails to write-off worthless assets
  - Bank loans and uncollectibles
    - » Banks underestimated reserves in the late 1980's
  - Worthless investments
    - » *First Executive Life Insurance Corporation*
      - Appearance of shifting risk to another company
  - Under reserve
    - » *Miniscribe*
      - Allowance for doubtful accounts grossly understated.

FIN 551: Fundamental Analysis 25

GAP No. 5: Fail to
Record/Disclose all Liabilities...

The Guiding Principle Should Be:

A firm incurs a liability if it has an obligation to make future sacrifices.

FIN 551: Fundamental Analysis 26

Fail to Record/Disclose all Liabilities...

- Management reports revenue rather than a liability when cash is received
  - Many businesses receive cash before they earn it
    - » Franchisers
      - Provide continuing services over many years
    - » Airlines
      - Frequent flyer miles and other gifts.

FIN 551: Fundamental Analysis 27

Fail to Record/Disclose all Liabilities...

- Management fails to accrue expected or contingent liabilities
  - Accrue loss when:
    - » There is a probable loss
    - » The amount is reasonably estimated
      - *Miniscribe* knowingly understated warranty reserves.

FIN 551: Fundamental Analysis 28

Fail to Record/Disclose all Liabilities...

- Management fails to disclose commitments and contingencies
  - Take-or-pay contracts
    - » *Columbia Gas* obligation: $125 million although the spot market for gas was much less
  - Accounting rule changes
    - » Often an option to expense immediately or defer recognition
      - • *IBM, GE, ... vs. others* re: pension rules
  - Tax accounting vs. financial accounting
    - » Expense on tax books; asset on financial books.

FIN 551: Fundamental Analysis 29

Fail to Record/Disclose all Liabilities

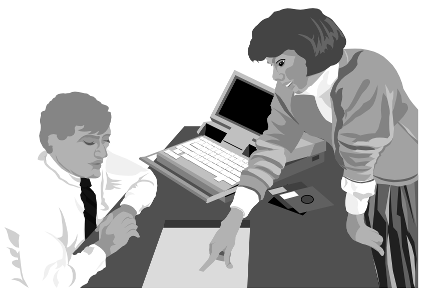
- Management engages in transactions to keep debt off the books
  - FASB attempting to correct:
    - » Swaps
    - » In-substance defeasance of debt
    - » Defined-benefit pensions
    - » Operating leases
    - » Subs & joint ventures.

FIN 551: Fundamental Analysis 30

GAP No. 6: Shift Current Income to a Later Period...

The Guiding Principle Should Be:

Record revenue/expenses in the period in which it is earned.



FIN 551: Fundamental Analysis 31

Shift Current Income to a Later Period

- Management creates reserves to shift income to a later period
  - Smooth income through the use of reserves
    - » Warranty, doubtful accounts, etc...
  - Be critical of companies with large reserves
    - » Cash flows may not accompany higher profits.

FIN 551: Fundamental Analysis 32

GAP No. 7: Shift Future Expenses to the Current Period...

The Guiding Principle Should Be:

Charge expenses against income in the period in which the benefit is received.

FIN 551: Fundamental Analysis 33

Shift Future Expenses to the Current Period...

- Management accelerates discretionary expenses into the current period
  - Prepayment of operating expenses
    - » Advertising, rent, etc...
  - Decrease of the depreciation/amortization period
    - » Shorter "life" means higher expense each period.

FIN 551: Fundamental Analysis 34

Shift Future Expenses to the Current Period

- Management has the firm "take the big bath"
  - New management often writes-off old projects to relieve future periods of the expenses
    - » *IBM* shifted billions of dollars of 1992 expenses into 1991
  - Large nonrecurring gains offset with large expenses, or vice versa
    - » *Exxon* booked large gain to offset oil spill problems.

The End