# Stirling Homex (C)

On July 10, 1972, Stirling Homex Corp. filed for bankruptcy under Chapter X of the federal bankruptcy law. In an article published some three and a half months after Stirling Homex's demise, *Business Week* described the company as one whose brief life encompassed "questionable accounting practices, corporate high living, clandestine operations, hamstringing by local and federal bureaucracies, overly aggressive publicity, and a lack of corporate planning. . . . a classic example of how not to run a company."

The early stages of the investigation into the activities of Stirling Homex revealed a corporation that had been a pioneer in the manufacture and installation of modular housing. However, it would appear that the management had developed a greater interest in the reception on Wall Street accorded the securities of the corporation than in the execution and completion of contracts for the sale of the modular housing units manufactured.

When the company collapsed, some 10,000 modular units valued somewhere between $35 million and $65 million were discovered sealed in plastic and stored in fields around the country. Full purchase and payment existed for only 900 of these units. The backlog of uninstalled modules had grown from 3500 at April 30, 1971 to 6700 at year end and ultimately to the 9,000 plus level at the date of the collapse.

Corporate high living included costs in excess of $900,000 annually for corporate aircraft, $116,000 for limousine service in New York City, Continental Mark IVs for each of the Stirling brothers and $25,000 to send employees to "mind control" courses in New York and Rochester.

In short, the evidence gathered in the initial months following the Chapter X filing suggested that Homex was a badly managed company, one in which stock market performance was more important in the executive suite than was the fabrication and installation of the company's product.

The policy of recognizing revenue on the completion of the production stage of a unit "assigned to a specific contract" may be considered aggressive but is quite defensible as being in accordance with generally accepted accounting principles. The contracts are long term in nature and a percentage of completion method of accounting for revenue is, in many cases, a preferred alternative.

However, as the investigation continued over the years it became more and more evident that Stirling Homex's management had engaged in a number of activities the propriety and legality of which was at least questionable.

An SEC investigation revealed that in October and November of 1971 David and William Stirling disposed of 83,800 shares. The shares had initially cost 1.7¢ each. Additionally, between

*This case was prepared by Visiting Associate Professor, David A. Wilson, as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.*

October 1, 1971 and February 19, 1972 Harper Sibley, one of the charter members of the Stirling Homex group, unloaded some 265,000 of his shares yielding him a net profit of $10 million. On March 17, 1972, Stirling Homex announced second quarter losses of $2 million. It further appeared that other parties privy to inside information liquidated substantial portions of their Stirling Homex holdings prior to the March announcement.

While, as noted above, there is a strong defense to the adoption of the percentage of completion method of accounting for revenue on long term construction contracts, there were three unique dimensions to the typical Homex contract.

1. The purchaser of the units made no progress payments as work was completed;

2. Homex loaded most of the profit on the contract into the initial manufacturing stages; and

3. Stirling Homex's determination of when a contract became enforceable could be defined as optimistic at a minimum.

Delving further into Homex's activities in Mississippi, the SEC discovered that $100 million of the $179 million backlog of orders reported in a July 1971 prospectus related to the provision of housing in Mississippi for families who had lost their homes during hurricane Camille in 1969. Homex and the non-profit housing project sponsor reached an understanding under which the modular unit manufacturer would provide 20,000 housing units and would arrange government mortgage financing for it.

Evidence offered in support of the validity of the reported backlog was a letter of commitment for $15 million in mortgage financing on the letterhead of the Farmers Home Administration, dated February 22, 1971, and signed by W. T. Richardson, Assistant Director of the F.H.A. for the state of Mississippi.

Mr. Richardson denies signing the letter and notes that he is only authorized to commit the agency to a maximum of $350,000 in mortgage financing.

Footnote 11 of the financial statement of the company dated July 31, 1971 alluded to a commitment to acquire on a financing lease basis a $4,900,000 plant in Harrison County, Mississippi. The note stated that "Harrison County. . . . has agreed to take the steps necessary to authorize the issuance and sale of tax exempt industrial revenue bonds in an amount necessary to meet the cost of constructing and equipping the plant."

The bond issue was voted down on February 1972.

In addition to the investigation by the SEC of the company's financial statements and insider trading, a federal grand jury in Rochester, New York is studying allegations that Homex arranged $200,000 in bank loans that enabled at least six officials of the United Brotherhood of Carpenters and Joiners to buy Homex stock at prices considerably below market. When called to testify at SEC hearings, six union officials pleaded the Fifth Amendment.

Finally, it appears that $100,000 was paid in corporate checks to David Stirling's chauffeur. The SEC investigation was attempting to determine the ultimate destination of these funds.

In Accounting Series Release No. 173 (July 1975) the SEC summarized some of their findings as follows:

"The consolidated statements of income of Stirling Homex for the seven month period ended February 28, 1971 included in the registration statement for the preferred stock and the consolidated statements of income of Stirling Homex for the year ended July 31, 1971 contained in the Annual Report to Shareholders and Annual Report on Form 10-K for such fiscal year were false and misleading in that among other things:

-all modular sales of $12,493,000 for the February 28, 1971 period and $25,292,600 out of total modular sales of $29,482,271 for the July 31, 1971 period were improperly recorded in that the purported sales were not supported by required financing commitments;

-installation sales were overstated by approximately $3,723,000 out of a total reported installation sales of $5,137,000 for the February 28, 1971 period and $2,443,000 out of total installation sales of $7,200,000 for the July 31, 1971 period through the inclusion of sales from projects for which there were no commitments of financing and through Stirling Homex's improper reporting of approximately $1,000,000 as of February 28, 1971 and approximately $2,000,000 as of July 31, 1971 of excess installation costs as "cost overruns" reimbursable to the Company; and

-general administrative and other expenses were materially understated by approximately $832,000 as of February 28, 1971 and approximately $1,000,000 as of July 31, 1971, as a result of the improper capitalizing of such expenses. Additionally, certain other expenses and construction costs were improperly capitalized."

On January 29, 1977 the following former officials of Stirling Homex Corp. were all found guilty on nine counts of fraud:

David Stirling Jr., former chairman of the board;
William G. Stirling, former president;
Harold M. Yanowitch, former general counsel;
Edwin J. Schulz, former chief accounting officer;
Ruben L. Phillips, former vice president, southern division

They were sentenced on March 11, 1977.