Class #7
“How Companies Cook the Books”

Announcements

- Optional Review Session for Quiz #1:
  - Tentatively scheduled for Wednesday, March 5
- Quiz #1: In Class on Thursday, March 6. The quiz will be approximately 50 minutes long.
- Team Projects:
  - Provide hints/guidance today and during Tuesday's class.
  - E-mail me and your due diligence counterparty part 1 of your Team's Project Report by noon on Friday, March 7.
  - **I will be in on Sunday starting by noon, to answer questions about Part I of the project**

Guidance on Part I of Project

Cash Flow Projections & Earnings Quality

- Provide an descriptive analysis of your company, its strategy for generating profit/cashflow growth, potential competition, technological risks, etc.
  - Ie: How cashflows will be generated
- Then, based on this strategic analysis, use techniques we discussed in class and for the Dell case to provide estimates of FCFE for:
  - Current Year
  - Next 5 Years
  - Years 5-10 (or 20) …. If necessary
  - Cash flows in perpetuity (growing perpetuity)

Guidance on Part I of Project

Cash Flow Projections & Earnings Quality

- Provide robustness analysis CF projections:
  - Differing growth rate estimates
  - Different assumptions on Working Capital Accruals, CapEx, Depreciation, Financing changes
- Analyze Earnings Quality using techniques discussed in this and next class.
  - Excessive accruals
  - Wedge between CFO and Operating Income
  - Growth in receivables that exceeds growth in sales
  - Aggressive accounting techniques compared to competitors

- SEE PROJECTS FROM PRIOR YEARS ON WEB

Cooking the books and earnings management/manipulation

- Central theme: Firms & managers often have incentives to misstate earnings/balance sheet items:
  - Contracting incentives:
    - Avoid violating accounting covenants in loan agreements
    - Avoid taxation (Progressive tax scheme)
    - Maximize bonus (managers)
    - Avoid regulatory/government/union intervention (understate profits)
    - Avoid detection of managerial shirking or outright "stealing"
  - Stock market incentives: Meet analysts' targets
    - Stock options; issuing equity in near future

Outcome of Accounting Manipulation at Oracle in early 1990's

- What happened after the revelation of overly-aggressive accounting:
  - Stock market impact
  - What happened to executives
  - Litigation
  - SEC fines

    …. In the end, there usually is a "settling up."
- Do companies learn from mistakes of others?
  - Fast-forward to now:
    - 2001: Lucent Technologies
    - 2002: Worldcom

Types of Possible Manipulation

- Unacceptable methods: Too “liberal”:
  - Not writing off the cost of unsaleable inventory.
  - Depreciation of long-lived assets over longer period than they will be useful to the business.
  - Recording sales before they final (or failure to recognize the likelihood of returns or bad debts)

- Unacceptable methods: Too “conservative”:
  - Expensing cost of inventory that will not be sold until future.
  - Over depreciating assets with long lives.
  - Delaying recording sales that have already occurred.

Red Flags

- Warnings signs to watch out for:
  - Reported NI grows faster than CFO.
  - AR growth faster than sales growth.
  - Sales slow while inventories pile up.
  - Bad debt reserves debt cut.
  - Methods for calculating revenue & costs change.
  - Sales are booked before payments received.
  - Dramatic change in gross margin.
  - Turnover of auditor, key execs or lawyers.

Industry-Specific Manipulation:
Warnings for your company analysis!

- Computer/Telecom Hardware:
  - Technological change: impact on receivables & inventory, appropriate depreciation allowances?
- Retailing:
  - Are accounts receivables questionable?
  - Do sales factor on rebate programs?
  - Warranties liabilities
- Subscription Services:
  - How are promotion costs treated (capitalizes? i.e AOL)
  - Subscriptions paid in advance: quality of deferred revenues
- Real Estate:
  - Carrying values for real property

Problems with “New Economy” Firms

- Recognizing sales before they exist (iVillage)
- Net vs Gross (Priceline)
- Barter transactions (Starmedia)
- Coupons/discounts/loss leaders (AOL)
- Fulfillment costs (Amazon.com)
- Swap Transactions:
  – See Handout

"Tricks of the Trade"

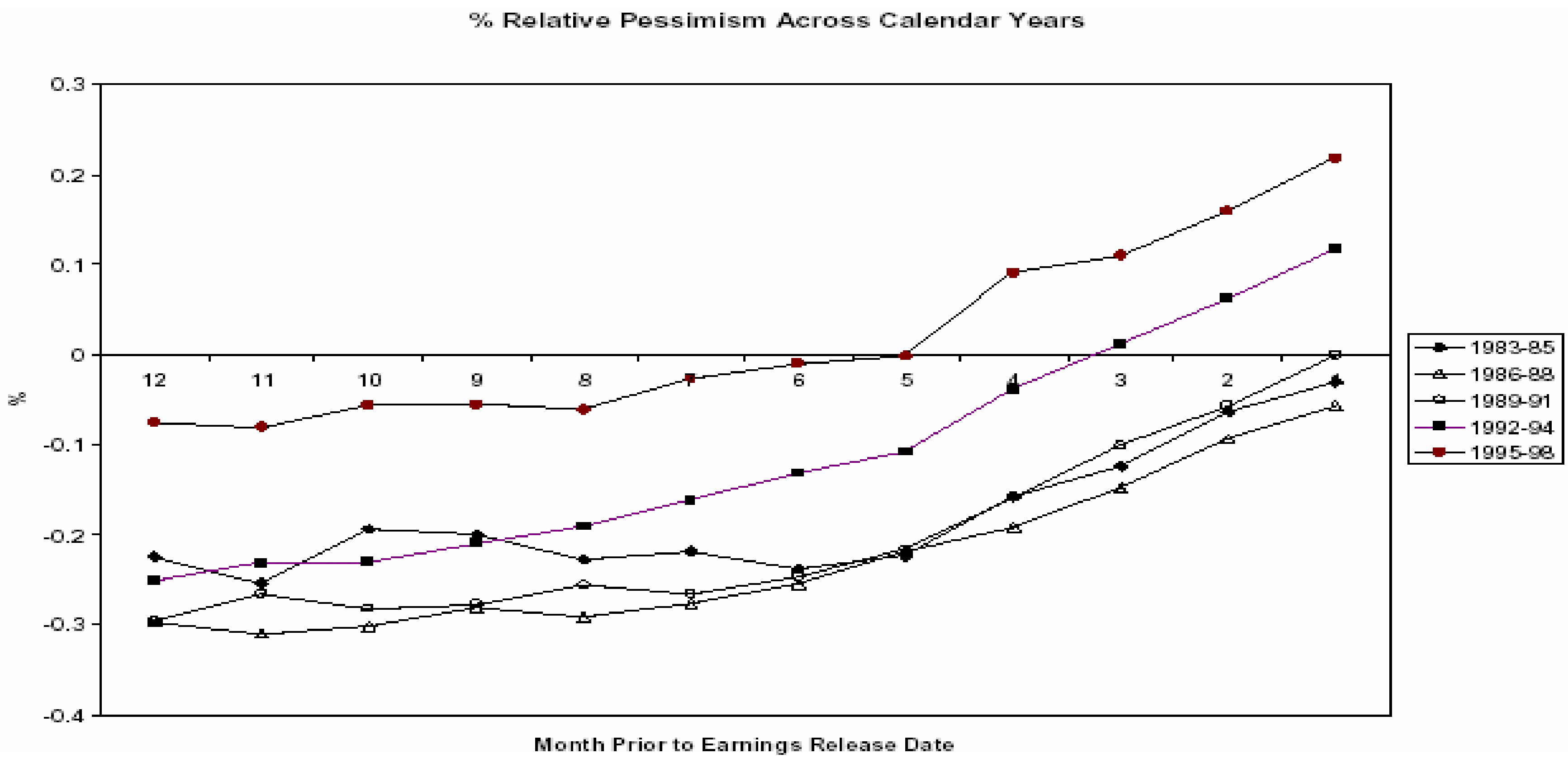
- Big Bath:
  - Take big write-off today to set up the books for the future
  - PROBLEM: Investors may forget write-off, Expenses are understated in the future and earnings are overstated.
  - Example of Kodak with "Special items"
- Vendor Financing:
  - Make loans to customers with questionable ability to repay loans
  - Understate bad debt reserves (ie Lucent)
  - Profits too high today …. Big potential losses in future.
- Booking Revenues Too Early:
  - Check again SEC SAB 101 Statement!
  - Classic cases of Cendant and Microstrategy

"Tricks of the Trade"

- Defined Benefit Pension Plan Games:
  - What is a defined benefit plan?
  - Fund assets are separate from the company. Funds are used to pay present and future pension obligations to retirees. It must be properly funded! (ERISA ACT 1974).
  - Is there enough money? Need to know:
    - Who are beneficiaries and amount required
    - Rate of return of investments
    - Attrition rate
    - Growth rate in future retiree benefits
  - Company must make periodic payments if plan is "underfunded"
  - BIG QUESTION: Is it underfunded or overfunded
  - This vagueness creates the "cookie-jar" for managers

Expectations Management of Analysts' Earnings Forecasts

Forecast Error= (Actual EPS – Forecast EPS)



Continue with Earnings Management

- Next Class: We will discuss actual techniques for detecting earnings management for your team project.
- Reminder about Review Session for Quiz #1 on Wednesday.