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)

% Relative Pessimism Across Calendar Years

Month Prior to Earnings Release Date

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Continue with Earnings Management

• Next Class: We will discuss actual techniques for detecting earnings management for your team project.

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