Restructuring and Impairment Charges, 1/13/00

Background

The Securities and Exchange Commission ("SEC") has become increasingly concerned with apparent increases in inappropriate earnings management activities by public companies. One such problem area relates to restructuring and impairment charges. Such related activities include inappropriate recording of restructuring charges and general reserves for future losses, reversing or relieving such reserves in inappropriate periods, and recognizing or not recognizing an asset impairment charge in the appropriate period.

General Guidelines

Companies are required to take a “charge” to write off assets when such assets have become permanently impaired. Increasingly, however, companies have improperly included normal operating costs in their restructuring charge and thereby “clean up” their balance sheet. Such excessive and inappropriate charges are often referred to as “the big bath.”

Why are companies tempted to overstate these charges? Quite simply, when earnings take a big hit, Wall Street typically looks beyond the one-time loss and focuses on future earnings. If these charges are conservatively estimated with a little extra cushioning (i.e., inflated), then that “conservative estimate” may be miraculously reborn as income when the company needs an earnings boost.

What Questions Should Be Raised Concerning Restructuring Charges?

At Time of Restructuring -- Are any normal recurring operating costs being bundled into the restructuring charge? Specifically, is the company using the restructuring as a way to clean up its balance sheet? Does the restructuring include writing off such assets as goodwill, inventory, or accounts receivable? If so, the company may be inflating the restructuring charge by writing off current or future normal operating expenses. What’s the point of inflating the current period restructuring charge? Future period net income will be inflated because expenses that would have been charged during the current period had already been written off in the previous period. Thus, Sunbeam’s 1996 gross margin “miraculously” improved by 900 basis points in the period following a massive restructuring charge.

During Periods Subsequent to Restructuring -- Were there any changes in estimates or revisions in restructuring assumptions that reduced reserves and increased net income? Did the Company release any of the reserve into net income? Did they increase the reserve by taking additional restructuring reserves? Pay close attention to big declines in restructuring reserves, particularly when operating expenses (such as cost of goods sold and selling, general, and administrative) unexpectedly plummet.

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Recent SEC Initiative: Staff Accounting Bulletin No. 100

On November 24, 1999, the SEC issued SAB No. 100 to provide guidance on the accounting for, and disclosure of, certain expenses and liabilities reported in connection with both restructuring activities and business combinations as well as recognition and disclosure of asset impairment charges. A summary of the key points in SAB No. 100 follows:

I. Restructuring Charges. The term “restructuring charge” is not defined in the existing authoritative literature. While the events or transactions triggering the recognition of what are often identified as restructuring charges vary, these charges typically result from the consolidation and/or relocation of operations, or the disposition or abandonment of operations or productive assets. Restructuring charges may be incurred in connection with a business combination, a change in an enterprise’s strategic plan, or a managerial response to declines in demand, increasing costs, or other environmental factors. Some types of restructuring charges, such as “exit costs” are recognized as liabilities and charged to operations when management commits a restructuring plan, while other types of restructuring charges contemplated by the plan may not be recognized until they are actually incurred.

II. Characteristics of an Exit Plan: Authoritative guidance is found in Emerging Issues Task Force (“EITF”) Issue No. 94-3. Accrual of certain involuntary employee termination benefits and exit costs requires a commitment by the company to a termination or exit plan that specifically identifies all actions to be taken. Not all plans qualify for recognizing a liability for exit costs or involuntary employee termination benefits. In order for the plan to qualify, the following factors must be present:

1. Plan must specifically identify all significant actions to complete the exit plan and the period of time to complete the exit plan indicates that significant changes to the plan are not likely.

2. The level of detail and precision of estimation should be comparable to other operating or capital budgets that the company prepares. Thus, the absence of procedures to detect or explain variances would indicate that the plan’s authenticity to serve as the basis for recognizing a liability for exit costs.

3. Repeated material changes in the nature timing or amount of estimated costs may create a problem in accruing the restructuring liability.

III. Characteristics of Exit Costs

1. not associated with or does not benefit activities that will be continued

2. not associated with or is not incurred to generate revenues after commitment date

3. meets one of the following criteria:

   a. it is incremental to other costs incurred in the company’s conduct or activities prior to commitment date and will be incurred as a direct result of the exit plan or,
b. the cost will be incurred under a contractual obligation that existed prior to the commitment date and will either continue after the plan is completed with no economic benefit to the company or be a penalty to cancel the contractual obligation

IV. Subsequent period issues to consider. At each balance sheet date, exit costs and involuntary employee termination benefit accruals should be evaluated to ensure that any accrued amount no longer needed for its original purpose is reversed in a timely manner. When an exit, termination, or other loss accrual is no longer appropriate, reversal of the liability should be recorded through the same income statement line item that was used when the liability was first recorded. Generally accepted accounting principles (“GAAP”) do not permit unused or excess liability accruals to be either retained as general accruals or to be used for purposes other than that for which liability was originally established. In addition, costs actually incurred in connection with an exit plan should be charged to the exit accrual only to the extent those costs were specifically included in the original estimation of the accrual. Costs incurred in connection with the exit plan, but not specifically contemplated in the original estimate, should be charged to operating expense in the period incurred.