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?
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.*

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.
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.*

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.

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.
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.*

- 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.

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.
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
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.*

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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.
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.

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”.

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.*
Shift Expenses to a Later Period...

- Management improperly capitalizes costs
  - Capitalize start-up costs
    » *Lockheed* hid $0.5 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 Laurentis 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
    - Minscribe
      - Allowance for doubtful accounts grossly understated.

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.
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.

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.
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.

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.
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.*

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.
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.*

- 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.
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