

Financial Warnings

Introduction

“Forewarned is Forearmed”

What’s an Earnings Surprise?

Causative Factors

The Financial Numbers Game Questionnaire

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What's an Earnings Surprise?

Selected events accompanying various earnings surprises are provided below.

For each event, identify a) the causative factor(s) and b) how the earnings surprise is reported in the company's financial statements.

a) Causative factors.

1. Changing economic fundamentals
2. Aggressive application of accounting principles
3. Fraudulent financial reporting

b) Financial reporting of earnings surprises.

1. Reduced operating profit exclusive of nonrecurring charges
2. Nonrecurring charges
3. Restatement of prior-year financial statements

What's An Earnings Surprise?

The Topps Co.

The Topps Company, Inc. today announced that shipment of sports cards during the fourth quarter will be significantly lower than the Company anticipated. As a result of lower shipments as well as the Company's decision to increase provisions for obsolescence and returns, the Company will report a net loss for its fourth quarter.

Source: The Topps Co. press release.

MiniScribe

The highflying MiniScribe had announced seven consecutive record-breaking quarters, and its stock had quintupled in the past 18 months. But MiniScribe's superlative record was actually fabricated: Some shipments were booked as sales; reserves were manipulated; and growth figures were grossly exaggerated.

The company had "perpetrated a massive fraud," according to an investigation by its outside directors two years later. MiniScribe then restated its profits, slashing them to \$12.2 million from the \$22.7 million that Coopers . . . had certified.

Source: The Wall Street Journal.

What's An Earnings Surprise?

Diamond Foods, Inc.

Some walnut growers have challenged Diamond Foods Inc.'s explanation of mysterious payments to them, further tangling an accounting question that has delayed the snack maker's planned \$2.35 billion acquisition of Pringles from Procter & Gamble Co.

Diamond Foods has said a sizable payment to its walnut growers in September was an advance on their new year's crop. But three growers said they told the company that they didn't intend to deliver future crops to Diamond, yet were assured by company representatives that they could cash the checks anyway. The three said they were told the checks were to top up payments for their prior year's crops.

Source: The Wall Street Journal

Chambers Development

Chambers Development Co. burst the bubble of its squeaky-clean, fast-growth image when it disclosed it was abandoning unorthodox accounting methods and taking a \$27 million after-tax charge.

Once regarded as an island of propriety, the waste-management concern has lost its luster and faces an uncertain future. Its moves trimmed net income to \$1.5 million . . . from previously reported net of \$49.9 million.

Before revising its figures, earnings were up 36% from prior-year levels. Now, Chambers expects to post a 9% earnings increase.

"We're not convinced that the company's accounting practices are completely cleaned up," . . . the company's "aggressive capitalization of interest . . . may be the next shoe to drop."

Source: The Wall Street Journal.

What's An Earnings Surprise?

Groupon, Inc.

Shares in Groupon sunk by nearly 17 per cent on Monday as investors reacted to a restatement of revenue figures by the offers website as well as the company's admission of "material weakness" in its internal controls.

Revenues for the largest online offers website by sales were lowered \$14.3m to \$492.2m, the company said late on Friday after trading. Groupon blamed the revision, which wiped out its operating profits for the final months of last year, on its failure to account properly for the increased likelihood of customers seeking refunds in its newest markets.

Source: The Financial Times

Olympus, Inc.

Olympus on Wednesday submitted a delayed earnings report for its fiscal second quarter and restated its figures for the first quarter and the previous five years in order to book properly more than \$1.5 billion in investment losses that the company had been hiding for decades.

Source: The Wall Street Journal

What's An Earnings Surprise?

Crown Crafts, Inc.

Both the fourth quarter and full year operating results were negatively impacted by an unanticipated inventory write down of approximately \$1.4 million at the company's comforters and accessories facilities.

Our conclusion, after reasonable investigation, is that a significant portion of the inventory shortage is probably the result of theft.

Source: Crown Crafts, Inc. annual report.

Presidential Life

Presidential Life Corp. agreed Monday to restate financial results for three years to settle allegations it masked on financial statements \$20 million in declines in the value of junk-bond holdings.

The SEC said Presidential Life ignored general accounting standards requiring companies to reduce, or "write down" on their balance sheets The value of investment securities that have suffered "other than temporary declines."

Source: The Wall Street Journal.

What's an Earnings Surprise?

Lucent Technologies, Inc.

Lucent Technologies, Inc., continuing to pay the price for years of pushing for faster growth than it could sustain, significantly restated revenue from the last quarter and said it expects a "substantial" loss. . . We mortgaged future sales and revenue in a way we're paying for now

Source: The Wall Street Journal

Sunbeam Corp.

The people said the biggest problem was the old Sunbeam's practice of overstating sales by recognizing revenue in improper periods, including through its "bill and hold" practice of billing customers for products, but holding the goods for later delivery

Source: The Wall Street Journal.

California Micro Devices Corp.

Undetected by auditors, according to . . . testimony in a criminal trial of Cal Micro's former chairman and former treasurer, were a dozen or more accounting tricks . . . They include one particularly bold one: booking bogus sales to fake companies for products that didn't exist

Source: The Wall Street Journal.

What's an Earnings Surprise?

An unexpected turn of events.

An expense, charge or loss that was unanticipated, resulting in net earnings below forecast or trend.

- An earnings turning point
- Because of the higher costs associated with unexpected losses than gains, the focus here is on "negative" earnings surprises.

Most expectations are formed with current and prior year results in mind.

- An extrapolation of current trends.

Turning points are typically missed.

Anticipating earnings surprises is a first step towards avoiding them.

- For investment credit positions already in place:
 - Anticipating earnings surprises will provide more time for management to institute corrective action
 - A call to arms / time to sell
 - Smaller moves early can mitigate the need for larger ones later.
 - Anticipating earnings surprises will provide more time for the lender to take precautionary steps
 - Tightening terms and covenants
 - Requiring guarantees
 - Reducing loan exposure
- For investment credit positions under consideration:
 - Anticipating earnings surprises may provide reason:
 - To avoid the situation altogether
 - To raise offered prices, tighten proposed terms, or make covenants more stringent

How do Earnings Surprises Impact Future Cash Flows?

While cash from operations is a primary source of loan repayment, earnings are the basic engine behind operating cash flows.

Without earnings, cash flows can't continue in the long-term.

Cash from operations are derived:

- From the realization of amounts invested in operating-related assets
 - Accounts receivable, prepaid expenses, inventory, and fixed assets
 - Assets consumed in producing earnings
- After settlement of operating-related liabilities
 - Accounts payable, accrued expenses and taxes payable
 - Liabilities incurred in producing earnings

An earnings surprise calls into question previous expectations regarding asset realizability or amounts required to liquidate liabilities.

- Accordingly, expectations regarding future operating cash flows should be revised.

Earnings surprises result when:

- Amounts invested in assets cannot be realized
 - Asset writedowns ensue
- Liabilities are greater than anticipated
 - Additional accruals are needed

Both situations impact expectations regarding future cash flows

Potential causes of earnings surprises include:

- Changing economic fundamentals
 - Declining demand for company products and services
- Overly aggressive accounting treatment
 - Unreasonably high and unrealizable asset values
 - Unreasonably low liability amounts
- Fraud and misappropriation of company assets.
 - Writedowns for missing assets
 - Accruals for liabilities associated with litigation

A Survey of Lenders

In the space below, please list the major early warning signs you have found to be good indicators of earnings declines. See the next page for examples.

1.

2.

3.

4.

In the space below, please indicate those early warning signs, if any, that you have found to be benign. For example, a change in auditors is often provided as an early warning that a firm may be adopting less orthodox accounting principles. A benign example would be a change in auditors in an effort to reduce fees.

A Survey of Lenders

As an aid in helping you recall some of the more memorable indicators, some examples grouped into nine categories of early warnings are provided below.

1. Profitability - warnings that have a direct impact on reported earnings. Example: declining gross margin.
2. Liquidity - warnings that have a direct impact on available funds and often lead indirectly to an earnings decline. Example: increase in days receivables.
3. Management - warnings that call into question the competence, integrity, judgment and other characteristics of management that are central to a firm's success. Example: management lifestyle.
4. External environment - warnings related to circumstances and events outside the firm. Example: new competition.
5. Borrower communications - warnings that involve the nature and quality of non-financial communications between management and the lender. Example: failure to respond to phone calls.
6. Financial communications - warnings that involve the nature and quality of financial communications between management and the lender. Example: delayed receipt of financial information.
7. Strategy - warnings related to strategic moves on the part of management. Example: expansion into unrelated businesses.
8. Miscellaneous - warnings that cannot be grouped into one of the other groups. Example: decline in stock price.

A Survey of Lenders

After a survey of experienced lenders from several banks across the country, we found the following:

Most Frequently Cited Early Warnings by Category (Categories Ranked by Frequency of Mention)

<u>Category</u>	<u>Early Warnings</u>
Liquidity	<ul style="list-style-type: none"> Increases in working-capital days statistics Overdrafts Failure to satisfy line-of-credit cleanup period Inquiries to bank from borrower's creditors Late payments Rapid growth
Profitability	<ul style="list-style-type: none"> Declining gross margins Increases in working-capital days statistics Nonrecurring income Customer concentrations Loss of a major customer
Management	<ul style="list-style-type: none"> Failure to provide or meet projections Changes in management Management lifestyle Litigation
Borrower financial communications	<ul style="list-style-type: none"> Delayed receipt of financial statements Changes in accountants/auditors Changes in accounting policies Reduced quality of financial information

Most Frequently Cited Early Warnings by Category
(Categories Ranked by Frequency of Mention)
(continued)

<u>Category</u>	<u>Early Warnings</u>
Borrower non-finan. communications	Failure to respond to phone calls Management generally nonresponsive Evasive management communications
External environment	Rising interest rates New competition New technology Changing regulations
Strategy	Expansion into unrelated businesses Fundamental changes in business direction Fundamental change in industry
Miscellaneous	Lack of personal guarantees Declines in stock prices

Course Agenda

This course will examine many sources of earnings surprises, using the following agenda:

Introduction

- Causative Factors for Earnings Surprises:
 - Economic Fundamentals
 - Aggressive Application of Accounting Principles
 - Fraudulent Financial Reporting
- Evaluating Financial Reporting Flexibility: The Financial Numbers Game Questionnaire

A Collection of Creative Accounting Practices:

- Premature or Fictitious Revenue Recognition
- Aggressive Cost Capitalization and Extended Amortization Periods
- Misreported Assets and Liabilities
- Managing Earnings Perceptions
 - Income Smoothing - Less Volatile Earnings
 - Big-Bath Charges
 - Discretionary Accounting Changes
 - Income Statement Creativity
- Cash Flow Statement Creativity

A Closer Look at Management Fraud

- Assessing the Risk of Fraud
- The Accountants' Role in Fraud Detection

Causative Factors for Earnings Surprises: Economic Fundamentals

100 Largest Earnings Reversals After 4 Years of Rising Earnings

Company Name	Change in Income from Continuing Operations	Change in Revenue	Change in Operating Profit Margin	Change in Nonrecurr. Items	Change in Effective Tax Rate
Acuson Corp.	-37.08%	1.93%	-10.22%	0.00%	-0.36%
Advanced Micro Devices	-63.56%	-8.99%	-10.67%	0.00%	-197.21%
Alberto Culver	-42.31%	28.39%	1.04%	-81.82%	5.55%
Aldus Corp.	-71.43%	3.94%	-14.29%	0.00%	0.21%
Altera Corp.	-35.39%	-5.05%	-8.25%	0.00%	0.11%
Amer. Business Products	-13.58%	12.49%	-1.91%	0.00%	-1.40%
Analog Devices	-50.54%	15.11%	-4.66%	-55.88%	-0.95%
Anheuser-Busch Cos.	-40.22%	0.94%	-0.15%	-53.79%	4.90%
Arch Petroleum	-99.03%	4.35%	-20.47%	0.00%	-30.70%
ARX	-13.33%	43.07%	-5.74%	0.00%	-7.56%
Astrosystems	-42.42%	-18.26%	-12.83%	0.00%	-1.38%
Acxiom Corp.	-32.58%	8.92%	-1.65%	0.00%	2.94%
Becton, Dickinson & Co.	-53.06%	0.50%	-1.72%	-96.14%	-34.52%
Bell Atlantic Corp.	-18.40%	5.23%	-3.05%	0.00%	1.78%
Best Lock Companies	-32.04%	7.75%	-6.95%	0.00%	0.32%
Biocraft Labs	-43.84%	-14.76%	-13.27%	18.70%	-7.27%
BioLogic Systems	-33.91%	5.75%	-3.95%	0.00%	17.20%
Brock Exploration	-80.93%	10.26%	-16.55%	-70.00%	0.24%
Brooklyn Union Gas Co.	-25.62%	-2.05%	-2.19%	0.00%	-2.03%
Caere Corp.	-113.51%	-22.97%	-31.59%	-38.10%	16.18%
Caesar's New Jersey	-51.55%	-0.90%	-6.16%	-25.42%	5.83%
Caesar's World	-69.55%	-3.26%	-1.55%	-62.01%	50.02%
California Microwave	-93.42%	-4.75%	-4.15%	-8695.65%	-634.56%
Central & South West	-11.44%	2.82%	-3.26%	0.00%	-6.37%
CLARCOR	-60.78%	4.61%	-2.03%	-45.26%	20.19%
Clothestime	-45.38%	11.48%	-8.06%	0.00%	-6.52%
Cogitronics Corp.	-66.00%	6.06%	-7.47%	0.00%	0.70%
Comdisco	-32.89%	17.67%	-2.53%	0.00%	-6.09%
Computer Task Group	-222.44%	6.54%	-3.25%	-110.83%	-8.13%
Conolog Corp.	-23.64%	88.33%	-8.81%	-53.90%	-12.72%
Core Industries	-24.09%	-2.87%	-2.83%	0.00%	-0.63%
Craig Corp.	-47.20%	0.00%	-25.00%	-82.45%	5.82%
Cray Research	-43.10%	3.76%	-7.75%	-37.71%	-2.99%
Daniel Industries	-76.97%	-21.35%	-10.97%	0.00%	-55.27%
Data General	-25.23%	12.69%	-5.32%	0.00%	-0.10%
Dayton Power and Light	-15.91%	5.95%	2.30%	-23.19%	9.31%
Delta Natural Gas	-20.00%	5.45%	-2.24%	0.00%	-0.67%
DeSoto	-24.47%	-0.44%	-0.58%	0.00%	1.61%
DH Technology	-21.67%	15.75%	-5.04%	0.00%	-4.02%
Diebold	-46.75%	-13.33%	-10.86%	0.00%	-8.17%

Causative Factors for Earnings Surprises: Economic Fundamentals

100 Largest Earnings Reversals After 4 Years of Rising Earnings (cont'd)

Company Name	Change in Income from Continuing Operations	Change in Revenue	Change in Operating Profit Margin	Change in Nonrecurr. Items	Change in Effective Tax Rate
Digital Equipment	-32.02%	10.08%	-6.57%	0.00%	0.00%
Elgin Sweeper	-39.83%	18.14%	-3.48%	0.00%	0.93%
Eli Lilly	-24.19%	9.67%	-1.70%	-45.70%	-4.79%
Federal Signal Corp.	-39.83%	18.14%	-3.48%	0.00%	-0.57%
Food Lion Corp.	-13.26%	11.76%	-1.11%	0.00%	-1.05%
General Electric Co.	-14.97%	10.31%	-0.42%	-32.02%	1.43%
Great A & P Tea Co.	-53.25%	1.75%	-2.12%	0.00%	0.52%
Greentree Software	-236.40%	92.97%	95.04%	-92.55%	0.00%
HADCO	-27.27%	-5.03%	-2.36%	0.00%	-3.12%
Hathaway Corp.	-98.15%	15.07%	-12.18%	-122.70%	65.56%
Home Depot	-41.84%	61.90%	-2.29%	-100.86%	-16.69%
Houston Industries	-41.68%	24.00%	-0.07%	-129.85%	0.93%
Hughes Supply	-34.02%	5.58%	-0.92%	0.00%	1.02%
Idaho Power Company	-15.20%	5.45%	-9.91%	0.00%	-4.05%
Intel Corp.	-71.77%	-7.71%	-17.68%	0.00%	-15.71%
IPL Systems	-180.65%	-25.93%	-19.17%	0.00%	2.80%
Johnson Controls	-25.44%	4.73%	-2.09%	0.00%	2.45%
Kaman Corp.	-65.61%	4.39%	-0.48%	-135.54%	7.49%
Lancer Orthodontics	-235.57%	2.17%	-17.51%	-50.71%	-36.78%
LDI Corp.	-33.65%	-5.24%	-2.83%	0.00%	1.19%
Lin Broadcasting	-17.26%	11.18%	-0.56%	-67.26%	4.80%
LVMH Moët Hennessey	-11.94%	7.28%	-1.02%	-15.72%	0.24%
M.S. Carriers	-23.11%	27.69%	-5.15%	0.00%	0.91%
Mechanical Technology	-235.71%	-1.21%	-10.83%	0.00%	-4.52%
Medex	-38.62%	6.09%	-3.43%	-29.33%	-1.41%
Mobil Corporation	-25.64%	7.63%	-2.43%	4.52%	-2.86%
Montana Power Co.	-42.10%	7.53%	-0.71%	-9.59%	8.62%
Nat. Convenience Stores	-16.22%	13.25%	-0.76%	0.00%	-2.36%
New York Times	-57.68%	4.05%	-5.21%	-34.67%	7.56%
NYNEX Corp.	-38.59%	4.34%	-0.69%	-47.51%	2.67%
Oakwood Homes	-93.85%	3.16%	-1.65%	-2633.33%	-75.43%
Ohio Edison	-46.98%	20.40%	6.29%	-50.96%	11.68%
Pacificorp	-11.73%	11.74%	0.83%	0.00%	4.96%
Panhandle Eastern Corp.	-15.94%	3.83%	2.91%	-5.69%	-16.82%
Pharmaceutical Res.	-153.52%	49.34%	26.85%	-63.45%	-32.67%
Phillips Petroleum Co.	-17.85%	19.35%	-6.52%	0.00%	0.90%
Pinnacle West Capital	-16.21%	6.42%	-7.93%	0.00%	-6.36%
Playboy Enterprises	-13.29%	-5.19%	2.81%	-65.52%	-7.72%
QMS	-183.10%	28.58%	-14.81%	0.00%	2.11%

Causative Factors for Earnings Surprises: Economic Fundamentals
100 Largest Earnings Reversals After 4 Years of Rising Earnings (cont'd)

Company Name	Change in Income from Continuing Operations	Change in Revenue	Change in Operating Profit Margin	Nonrecurr. Items	Change in Effective Tax Rate
Revco, D.S.	-52.03%	7.54%	-3.15%	-56.39%	-0.36%
Russ Berrie & Co.	-20.00%	-1.84%	-6.82%	0.00%	-6.33%
Saatchi & Saatchi Co.	-117.58%	12.91%	-4.37%	-181.19%	105.74%
Schering Plough Corp.	-24.38%	4.03%	-3.21%	-12.91%	0.00%
Southwestern Energy	-36.19%	-20.46%	-4.28%	0.00%	-0.27%
Standard Products	-15.84%	9.95%	-1.87%	0.00%	1.67%
Stratus Computers	-70.65%	5.63%	-2.09%	-99.02%	21.60%
Sun Company	-50.09%	3.64%	-2.48%	0.00%	1.11%
Superior Industries	-23.96%	8.74%	-0.37%	-24.66%	1.00%
SuperValu	-15.38%	18.21%	0.04%	-32.52%	0.70%
Syntex Corp.	-39.00%	3.21%	-0.77%	-241.15%	-130.11%
Teradyne	-62.28%	-3.09%	-7.63%	0.00%	-24.31%
The Southern Company	-37.21%	2.39%	-2.13%	-38.64%	-2.28%
The UpJohn Co.	-31.46%	-3.54%	-2.12%	0.00%	2.53%
Thomas & Betts Corp.	-29.64%	-4.99%	-5.24%	0.00%	-2.71%
U.S. Surgical	-199.86%	-13.36%	-15.54%	-100.15%	-28.94%
UGI Corporation	-26.60%	4.72%	-2.62%	0.00%	-19.25%
Universal Health Svcs.	-48.39%	31.83%	-3.41%	0.00%	11.02%
Vishay Intertechnology	-50.00%	0.81%	-3.03%	0.00%	-14.29%
Wackenhut Corp.	-128.13%	16.91%	-1.31%	-957.14%	316.24%
Willcox & Gibbs	-69.09%	5.63%	0.43%	-144.44%	25.12%
Sample-wide mean	-54.97%	7.77%	-3.90%	-151.33%	-7.33%

100 Largest Earnings Reversals Economic Periods

Economic Period	No. of Earnings Surprise Occurrences
recession	3
recession	12
recession	12
growth	5
growth	4
growth	7
growth	5
growth	6
growth	6
growth	15
recession	4
recession	6
growth	7
growth	<u>8</u>
Total	100

100 Largest Earnings Reversals Industry Representation

Industry Classification	Number of Firms
Electric Services	10
Electronic Components	9
Computer and Office Equipment	8
Computer and Data Processing Services	7
Drugs	6
Medical Instruments and Supplies	6
Measuring and Controlling Devices	5
Crude Petroleum and Natural Gas	4
Grocery Stores	4
Telephone communications	3
Beverages	2
Communications Equipment	2
Electrical Goods	2
Gas Production and Distribution	2
Hotels and Motels	2
Motor Vehicles and Equipment	2
Petroleum Refining	2
Soap, Cleaners and Toilet Goods	2

100 Largest Earnings Reversals Reasons for Gross Profit Declines

Factor	Number of Instances
Decreased revenue due to lower selling prices	13
Changing product mix to products with lower gross margins	13
Excess capacity due to declining revenue volume	12
Increased costs associated with general cost increases	11
Unfavorable foreign currency movements	6
Capacity expansion to meet anticipated increases in revenue volume	5
Increased costs associated with new product development	2
Lower gross margin of acquired company	1

100 Largest Earnings Reversals Reasons for Increases in SG&A

Factor	Number of Instances
Increased marketing and advertising expenses	25
Increased administrative and miscellaneous expenses	14
Decreased revenue due to lower volume or prices	6
Costs of expansion ahead of sales growth	6
Increased legal expenses	5
Increased expenses of acquired company	4
Increased customer service expenses	2

100 Largest Earnings Reversals Reasons for Nonrecurring Items

Nonrecurring Item	Number of Instances
Restructuring events	10
Writedown of PP&E and intangible assets	9
Writedown of inventory	6
Writedown of accounts receivable	5
Increased interest expense	5
Other nonrecurring events	5
Writedown of investments	3
Unfavorable foreign currency movements	2

Causative Factors for Earnings Surprises: Economic Fundamentals 100 Largest Analyst Earnings Surprises

Company Name	I/B/E/S Surprise	Change in Income from Continuing Operations	Change in Revenue	Change in Operating Profit Margin	Nonrecurr. Items	Change in Effective Tax Rate
Acme-Cleveland	-188.00	-714.58%	-0.23%	0.17%	-82.01%	-72.12%
Adage	-26.30	38.71%	37.99%	-2.97%	0.00%	-0.93%
Advance Circuits	-20.30	-175.56%	-3.82%	-20.62%	0.00%	10.81%
Advance Circuits	-40.60	-975.00%	18.66%	4.15%	-126.58%	-57.26%
Air Midwest	-44.30	-325.00%	3.59%	-12.83%	0.00%	-6.57%
Alberto Culver	-18.00	25.40%	12.65%	1.07%	0.00%	6.21%
Allen Group	-9.70	-85.05%	-1.20%	-5.57%	0.00%	44.47%
Altron	-21.00	5284.62%	26.90%	4.54%	0.00%	23.03%
Amdahl Corp.	-7.30	-30.14%	16.61%	-7.44%	0.00%	-1.25%
Amerada Hess Corp.	-13.00	-253.00%	-7.56%	-3.91%	-440.74%	-154.98%
American Mgmt. Sys.	-13.50	50.00%	6.10%	3.87%	-168.18%	33.65%
American Mgmt. Sys.	-11.20	-16.22%	5.63%	-1.27%	0.00%	5.14%
Analogic Corp.	-20.00	9.27%	9.70%	-2.70%	0.00%	-1.90%
Apache Corp.	-23.50	-432.68%	-5.19%	-14.96%	-69.69%	-6.29%
Applied Magnetics	-12.10	-88.37%	43.60%	-6.92%	0.00%	-19.62%
Arvin Industries	-7.90	-65.55%	0.49%	-2.37%	-100.69%	1.06%
Atlantic Richfield	-18.10	-75.75%	-8.44%	1.27%	-517.53%	-16.53%
Avery International	-20.30	-28.60%	29.53%	-0.47%	-32.09%	10.96%
Bairnco Corp.	-7.50	44.36%	21.28%	1.05%	0.00%	-4.59%
Baltimore Gas & El.	-8.10	-8.93%	7.51%	-2.91%	0.00%	-0.60%
Bell Atlantic	-9.10	-18.40%	5.23%	-3.04%	0.00%	1.78%
Bindley Western	-9.60	-64.81%	48.41%	-0.29%	0.00%	0.37%
Bio-Medicus	-40.00	233.33%	91.84%	10.81%	0.00%	33.33%
Bolt Beranek	-132.00	-170.80%	31.46%	-0.26%	-574.36%	258.13%
Bolt Beranek	-89.70	-274.59%	-4.42%	-23.50%	-10.67%	0.11%
Bristol-Meyers Sq.	-10.00	-40.43%	7.37%	0.41%	-57.95%	7.90%
Builders Transport	-13.60	-40.00%	16.22%	-3.05%	0.00%	7.95%
Burlington Northern	-11.20	-44.69%	10.60%	2.29%	-108.38%	7.59%
California Microwave	-52.70	-263.64%	-6.42%	-19.60%	0.00%	-1.50%
Carolina Pwr & Light	-9.40	-43.59%	9.17%	0.36%	-4.53%	-1.82%
Centocor	-42.50	-1214.29%	77.27%	7.51%	-120.26%	-42.20%
Cerner Corp.	-15.67	-12.50%	21.73%	2.25%	0.00%	-8.61%
Cetus Corp.	-14.30	55.56%	27.05%	0.52%	0.00%	12.45%
Cincinnati Gas & El.	-14.50	30.52%	-8.65%	-1.94%	0.00%	-9.32%
Ciprico	-71.00	-101.77%	-5.17%	-14.84%	0.00%	-33.00%
Collaborative Res.	-13.00	43.75%	30.51%	8.56%	0.00%	0.00%
Computer Identics	-36.30	-1246.67%	-25.00%	-18.06%	-50.00%	8.80%
Cordis Corp.	-22.60	-241.67%	33.75%	4.04%	-222.22%	243.14%

100 Largest Analyst Earnings Surprises (cont'd)

Company Name	I/B/E/S Surprise	Change in Income from Continuing Operations	Change Revenue	Change in Operating Profit Margin	Nonrecurr. Items	Change in Effective Tax Rate
Corporate Software	-8.30	3.23%	0.00%	-1.40%	0.00%	0.00%
Cross and Trecker	-9.80	-755.56%	5.69%	-2.52%	-32.45%	-96.70%
Cross and Trecker	-11.60	-307.11%	5.99%	1.52%	-47.53%	28.22%
Data Card Corp.	-20.30	-8.57%	13.73%	-4.43%	0.00%	-4.77%
Data General Corp.	-14.20	-1554.39%	0.50%	-3.02%	-76.31%	-27.01%
Datapoint Corp.	-14.60	-87.23%	13.13%	-16.01%	0.00%	-2.70%
Dennison Mfg.	-10.40	-22.83%	6.79%	-2.77%	0.00%	-5.95%
Dravo Corp.	-75.30	19.78%	1.64%	0.28%	-35.21%	-11.56%
Duplex Products	-20.00	-2.22%	-0.32%	-0.93%	0.00%	-3.56%
Duplex Products	-17.30	-15.00%	21.73%	-6.68%	0.00%	-7.97%
Eastman Kodak	-15.80	-62.13%	8.01%	-3.10%	-94.59%	5.31%
El Paso Electric	-13.90	25.04%	7.87%	-7.20%	0.00%	-9.83%
Eli Lilly	-21.50	14.61%	28.75%	-1.00%	0.00%	7.94%
Evans and Sutherland	-9.20	-94.56%	-2.99%	-11.19%	0.00%	-138.03%
Fair, Isaac & Co.	-11.00	-13.04%	10.48%	-5.10%	0.00%	1.30%
Flowers Industries	-7.80	-28.67%	6.10%	-1.74%	0.00%	4.58%
General DataComm	-8.70	-2400.00%	-5.31%	-6.50%	-43.48%	-61.90%
General DataComm	-7.90	51.09%	2.55%	3.28%	-52.48%	10.89%
General Signal	-11.10	-63.69%	9.79%	-1.72%	-133.52%	23.97%
Geosource	-14.40	42.58%	35.59%	1.97%	0.00%	3.07%
Grace, W.R.	-11.50	-528.54%	4.85%	-11.36%	0.00%	-58.50%
HB Fuller	-6.60	-25.59%	9.99%	-0.65%	0.00%	7.16%
Hercules	-7.70	-88.86%	4.05%	-2.15%	-27.85%	-9.56%
Hogan Systems	-21.90	91.89%	114.12%	-4.80%	-2.61%	4.66%
Honeywell	-75.80	-271.42%	6.88%	-5.98%	0.00%	-154.78%
House of Fabrics	-13.00	7.62%	4.81%	-0.07%	0.00%	-5.61%
IBM Corp.	-12.40	-27.27%	2.40%	-6.96%	0.00%	-0.14%
Internat. Kings Table	-12.70	-6.67%	5.58%	-0.90%	-13.43%	-0.89%
Interstate Power Co.	-11.80	-38.96%	-10.61%	-2.18%	0.00%	4.96%
Justin Industries	-18.30	-66.89%	-8.99%	-5.03%	46.67%	-0.77%
Kellwood Co.	-9.40	18.97%	22.03%	0.62%	0.00%	-1.74%
KLLM Transport	-10.25	-51.72%	18.79%	-2.83%	0.00%	-0.54%
Lamaur	-12.40	-45.10%	-0.17%	-3.66%	0.00%	-2.80%
Lockheed Corp.	-19.40	-98.69%	-5.20%	-6.17%	0.00%	91.20%
Lone Star Tech.	-19.50	-359.20%	2.27%	-18.00%	-22.37%	-4.60%
Louisiana Land	-12.30	-383.06%	-12.32%	-8.66%	-84.54%	-0.34%
McDonnell Douglas	-12.27	-108.00%	-5.51%	-2.42%	0.00%	42.93%
Medical Graphics	-36.00	-466.67%	-8.51%	-22.66%	0.00%	-13.27%
MNX	-15.00	-38.46%	-19.66%	1.20%	0.00%	12.06%
National Education	-60.00	-163.99%	-12.39%	-18.08%	-82.28%	-17.54%

100 Largest Analyst Earnings Surprises (cont'd)

Company Name	I/B/E/S Surprise	Change in Income from Continuing Operations	Change in Revenue	Change in Operating Profit Margin	Nonrecurr. Items	Change in Effective Tax Rate
New England Electric	-12.10	-123.54%	4.94%	-4.67%	-289.11%	6.90%
Norfolk Southern	-11.50	-66.76%	0.89%	0.42%	-138.60%	-1.08%
Northern Telecom	-10.70	-47.24%	10.03%	-2.39%	-85.14%	-6.99%
Oxford Industries	-14.00	2.91%	3.71%	0.14%	0.00%	2.84%
Pacific Gas & Elect.	-13.50	-44.77%	-8.07%	-7.09%	-0.73%	4.15%
Pacific Gas & Elect.	-10.30	1350.24%	12.33%	3.72%	0.00%	-44.51%
Park Ohio Industries	-16.70	-66.67%	-4.71%	-3.07%	0.00%	-79.53%
Park Ohio Industries	-197.30	-10.53%	7.08%	-0.43%	0.00%	-14.68%
Petrolite Corp.	-14.30	-22.32%	-9.18%	-2.42%	0.00%	-0.50%
Raymond Corp.	-10.50	-92.86%	-10.58%	-11.45%	0.00%	-106.70%
Scan Optics Corp.	-14.30	-136.67%	46.90%	-24.74%	0.00%	7.10%
Seven Oaks Int.	-10.20	-148.21%	10.34%	-22.31%	-235.29%	-105.20%
Stepan Co.	-8.30	-41.79%	3.90%	-2.89%	0.00%	-1.37%
Sundstrand Corp.	-33.10	-249.42%	2.66%	-7.69%	0.00%	-0.59%
TNP Enterprises	-12.00	-7.06%	-17.14%	1.44%	0.00%	-0.25%
Transco Energy Corp.	-12.80	6.57%	-11.80%	-0.24%	-57.09%	30.06%
United Industrial	-21.70	-148.17%	1.15%	-4.10%	-187.50%	13.63%
UTL Corp.	-18.80	-119.61%	-40.32%	-39.15%	-16.13%	29.34%
Warner-Lambert	-179.80	-240.97%	0.71%	0.33%	-260.04%	-67.15%
Whitehall Corp.	-12.00	-390.91%	-8.67%	-7.02%	-96.36%	21.42%
Xicor	-13.80	-97.14%	0.11%	-16.76%	0.00%	25.33%
Zapata Corp.	-20.10	-292.64%	-23.87%	-22.53%	-53.94%	-38.77%
Sample-wide mean	-25.27	-101.34%	8.27%	-4.79%	-48.08%	-4.42%

Financial Numbers Game Questionnaire

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FINANCIAL NUMBERS GAME QUESTIONNAIRE

Classify each of the management actions listed below by selecting one classification from among the four options provided. In making the classifications, assume that the effect of the action is material to the financial performance or financial position of the firm. Moreover, the firm understands each of these actions; they are not simply mistakes. A reasonable definition of fraudulent financial reporting is: An intentional, material misstatement that is taken in an effort to deceive financial statement readers. If you would like to make any comments about any of the below statements, please simply write them on the copy by the relevant numbered item.

1. Goods are shipped to a customer and a sale is recognized. The purchaser is provided an oral right-of-return agreement and no provision for expected returns is recorded by the seller.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

2. An airline uses an optimistic estimate of useful life in depreciating its flight equipment.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

3. An auto company records an addition to its warranty liability for an amount that it knows to be too small.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

4. A firm over-accrues a restructuring provision in order to be able to reverse a portion of the accrual into future earnings if needed in order to meet company earnings targets.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

5. Advertising expenditures are accelerated (and expensed) in the fourth quarter of the current year so as not to exceed the earnings target for the current year and to increase first quarter earnings in the next year.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

6. Production is expanded beyond current requirements in order to capitalize more overhead into inventory and by so doing increase incentive compensation for company officers.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

7. Credit standards are relaxed at year-end in order to boost sales and with it earnings for the year just ending.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

8. A schedule of price increases, to take effect early in the next year, is announced during the fourth quarter in order to boost sales and earnings in the year just ending.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

9. Books are held open for several days after the close of the year to record additional sales in the year just ended.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

10. Shipments close to year-end are delayed in order to provide an increase in sales for the first quarter of the next year.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

11. Investments are sold to recognize a gain in order to offset a special charge arising from an asset write-down.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

12. Goods are shipped to a customer who has not yet placed an order but probably will during the next quarter.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

13. Sales are recognized on goods shipped to reseller customers who are not creditworthy.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

14. Revenues are recognized on disputed claims against customers, prior to a definitive settlement.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

15. Sales are recognized upon the shipment of goods to a company's own field representatives.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

16. Total order revenues are recognized even though only partial shipments were made.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

17. Revenue is recognized on a consignment of goods prior to their subsequent sale by the consignee.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

18. The value of an ending inventory was understated in order to decrease property taxes.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

19. Sales revenues were recognized when there were significant uncertainties about customer acceptance of the product and of their ability to pay.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

20. Sales revenues were recognized when an absolute right of return was provided by means of a "side" letter.
 1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.

21. A dealer in medical test equipment that both sells and leases equipment to its customers recognizes the same gross profit at the time a contract is signed whether that contract is for a sale or lease.
1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.
22. A chain of doctors offering orthodontic care recognizes 24% of the revenue and profit on a long-term contract to provide care at the time the braces are applied even though billings and collections will occur evenly over the contract term.
1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.
23. A software firm recognizes a third of the license fee revenue on a software sale at the time of delivery of the software.
1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.
24. A "sub-prime" lender recognized a gain on the non-recourse sale of a package of receivables.
1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.
25. A start-up firm with operating loss carryforwards reverses the valuation allowance against its deferred tax assets on the premise that new orders have raised the likelihood of future profitability and realization of the carryforwards.
1. Action is within the flexibility afforded by GAAP.
 2. Action is at the outer limits of the flexibility afforded by GAAP.
 3. Action is beyond the limits of GAAP flexibility, but is not fraudulent financial reporting.
 4. Action constitutes fraudulent financial reporting.