Financial Warnings

Misreported Assets and Liabilities

Overstated Assets

Understated Liabilities

Financial Warnings Checklist

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When Are Assets Overvalued?

Assets are probable future economic benefits owned or controlled by an entity.

Assets are valued at cost, or the present value of the resources or efforts expended in their acquisition.

Previous sections focused on assets subject to annual amortization, especially

- Property, plant and equipment
- Intangible assets
- Other assets

Also, we looked at accounts receivable in reviewing premature or fictitious revenue recognition.

This section looks at assets not subject to annual amortization, especially

- Inventory
  - Write-downs when cost exceeds market (replacement cost)
- Investments
  - Write-downs when cost exceeds market (quoted price)

Defining assets in terms of future economic benefits implies that balance sheet amounts reported for assets will be realizable.

In the absence of an expectation of realization, asset book values should be written-down to realizable amounts.

- Net realizable value (NRV) is the overriding criterion.

- Assets should not be carried at amounts greater than NRV

As noted earlier, when book value exceeds net realizable value, an asset is value impaired, a writedown and accompanying charge to income are needed.

Overstating Inventory

Convenient Fiction

Inventory Chicanery Tempts More Firms, Fools More Auditors

A quick Way to Pad Profits, It is Often Revealed Only When Concern Collapses

A Barrel Full of Sweepings

(Excerpts from WSJ Article)

"When companies are desperate to stay afloat, inventory fraud is the easiest way to produce instant profits and dress up the balance sheet."

What it means:

Inventory overstatement increases current assets, reduces cost of sales, increases net income, retained earnings and stockholders' equity.

How it's done:

To overstate inventory requires a simply journal entry,

Inventory↑	XXX	
Cost of sales↓		XXX

"Since auditors observe only a statistical sample of inventory on hand, inventory chicanery can go undetected."

"Inventory fraud has increased fourfold from five years ago."

"The recent rise in inventory fraud is one of the biggest single reasons for the proliferation of accounting scandals."

WSJ Article Excerpts (cont'd)

"Shipments between plants were recorded as stocks located at both plants. Some shipments never left the first plant, and documentation supposedly showing they were being transferred to the second plant "appeared to be largely fictitious.'"

" . . . Deloitte sent "three to five auditors with three years or less experience to the plants to check inventory. The faces kept changing and there was little continuity."

"Experts say many companies overvalue obsolete goods and supplies. Others create phantom items in the warehouse to augment the assets needed as loan collateral. Still others count inventory that they pretend they have ordered but that will never arrive."

"As critics see it, unscrupulous managers can get auditors to swallow all kinds of ruses. In one case, auditors permitted company officials to follow the auditors and record where they were making test counts of inventory . . . Then the managers simply falsified counts for inventory that wasn't being tested."

"In another case, the auditor spotted a barrel whose contents management had valued at thousands of dollars. Actually, the barrel was filled with floor sweepings. The auditor forced the company to subtract the false amount from inventory . . . but it never occurred to the auditor that this was an egregious example of intentional and pervasive fraud."

". . . the auditor test-counted two types of computer chips . . . The next day, the acquired company's controller called the auditor and told him that 'an hour after you left . . . more chips . . . arrived in a shipment . . .' But the auditor never checked back to see if the new chips were for real."

WSJ Article Excerpts (cont'd)

"Overstatement of inventory need not be only of physical quantities. Failure to write inventory down to market (replacement cost) can give the same financial statement effect."

"But after Laribee filed for bankruptcy-court protection, a court-ordered investigation by other accountants, attorneys and bankruptcy specialists showed that much of Laribee's inventory didn't exist. Some was on the books at bloated values. Certain wire-product stocks carried at $2.20 a pound were selling at only $1.70 to $1.75 a pound."

While concern regarding fraudulent overstatement of inventory is important, financial statement readers must also be alert to unintentional (i.e., non-fraudulent) inventory overstatement.

- Results in losses from inventory write-downs.

Inventory overstatement can result from:

- Overstating inventory quantities

- Failure to write inventory down to market (replacement cost). Will inventory costs be realized?

Indications of inventory overstatement, whether from fraudulent or non-fraudulent origins, will typically be found in two key measures:

- Cost of sales as a percent of sales

- Inventory in days

Both measures should be compared:

- With similar measures for competitors

- With similar measures for the company in question for earlier fiscal years and quarters

Before comparing amounts, ensure that the company in question and comparison benchmark firms use the same inventory cost flow assumptions (i.e., Lifo, Fifo, etc.)

On the Wild Side
Inventory Misstatements Can Entail Some of the More Outlandish Reporting Violations
The Stuff that Movies are Made of

Bre-X Minerals, Ltd.

The company reported a significant gold find in the jungles of Indonesia. A flurry of public announcements, including press releases and television appearances, each pointing to increased amounts of discovered gold reserves, created excitement and a buying frenzy in the company's stock.

Heads turned and questions began to surface, however, when, at the height of activity and excitement, the company's geologist committed suicide by "jumping" from a company helicopter.

Ultimately it was determined the Bre-X personnel had "salted" or added gold to, core test samples. In reality, the company owned little if any gold.

International Nesmot Industrial Corp.

According to the SEC, the company engaged in "a deliberate scheme to overstate the company's income and inflate its reported assets by including in inventory fake gold materials . . "

Apparently, the company made up brass bars to look like gold bars.

On the Wild Side (cont'd)

Centennial Technologies, Inc.

(From an SEC Enforcement Action)

The Company overstated its inventory values and levels in a variety of ways. It falsified invoices to support inflated inventory pricing, manipulated inventory counts, understated the cost of sales and included phony inventory.

For example, the company's former chief executive officer and its former chief financial officer caused 27,000 PC cards to be manufactured.

Although these PC cards looked like the typical product that the company manufactured, they consisted of outer metal casing only and had no inner circuitry. These dummy PC cards were included in inventory and counted by the independent auditors during the company's annual audit.

These empty cards constituted a material amount of the finished goods inventory, overstating it by $8.8 million, or 78%.

The company also overstated the value of its fixed assets in several ways. Nonexistent additions to fixed assets were made on the company's books and the cost of *bona fide* fixed asset additions was padded to inflate their reported value.

These additions consisted primarily of small dollar amounts (less than $5,000) which the former chief financial officer believed, based on his prior experience working for the outside auditing firm, the auditors would not check.

Moreover, the company's books and records were adjusted to falsely increase the reported value of fixed assets and certain inventory items were improperly reclassified as fixed assets.

As of year-end, the company's fixed assets were overstated by $2.7 million, or 95%.

Class Exercise
Printed Circuits, Inc.
(Comptronix Corp.)

Printed Circuits, Inc (PC) provided contract manufacturing services to original equipment manufacturers in the electronics industry. Between 2010 and 2014, the company enjoyed a period of significant growth. During that period, sales grew to $102.0 million from $14.3 million and net income increased to $5.1 million from $200 thousand.

Soon after the 2014 results were reported, however, it was learned that much of the company's sales and earnings were totally fictitious. Several members of company management had involved themselves in a spectacular fraud designed to create nearly totally fictitious financial statements.

A Wall Street Journal article is excerpted below. The article describes in good detail how the PC fraud was carried out. Following the article are selected financial statistics for the company.

As noted in the article, some outsiders indicated that despite the fraud's apparent complexity, it was full of red flags.

Required:

Review the article excerpts and financial statistics. What red flags do you see? What questions would you ask of management for clarification and understanding?

Printed Circuits, Inc. (cont'd)

Key points from the WSJ article . . .

"Company officials also acknowledged yesterday that they really couldn't say when the fraud began, but confirmed that it stretched back to at least 2012, the year the company went public."

" . . . the company sketched how the accounting maneuvers were carried out. The goal was to increase gross profits and sales. To accomplish the former, according to the company, the officers, usually on a monthly basis, inflated inventory and decreased the cost of sales by equal amounts, thus exaggerating profits."

"Periodically during the year, a portion of the amounts improperly added to inventory were shifted to the equipment line on the company's balance sheet, according to PC -- apparently because it was easier to hide them there for a long period. To document the apparent increase in the amount of equipment, fake invoices for the purchase of equipment were prepared . . . "

"To increase sales, the executive recorded phony sales out of the company's burgeoning - but bogus - inventory . . . As a complement to the phony sales, phony accounts receivable were set up as well . . ."

"Finally, the officers had to show that the money owed for the fake sales - the accounts receivable - was actually being paid. So . . . they wrote checks for equipment that was never purchased and deposited it into the company's own bank accounts."

"But PC couldn't fully explain how checks that were made out to equipment suppliers and, according to the company, never endorsed, could have been processed by Home Bank and then deposited in PC's own account. A spokeswoman said the deposit mechanism has been 'used to accomplish a legitimate business purpose' for customers that were also suppliers. Under the unusual arrangement, if PC owed money to a company that was a supplier - but the same company owed money to PC as a customer - the account was used to reconcile the difference."

Printed Circuits, Inc. (cont'd)

Selected financial statistics . . .

Y/E ($ millions):	12/14	12/13	12/12	12/11	12/10
Sales:	$102.0	$70.2	$42.4	$29.3	$14.3
COS:	$85.4	$59.3	$36.7	$24.9	$12.2
Net income:	$5.1	$3.0	$1.5	$.9	$.2
Accts. receivable:	12.6	12.3	4.7	9.3	2.1
Inventory:	$28.5	$20.7	$7.5	$9.0	$3.7
Fixed assets:	55.2	35.9	23.5	9.5	5.8
Accts. payable:	8.5	8.4	3.4	7.3	1.1
COS%:	83.7%	84.5%	86.6%	85.0%	85.3%
Receivables in days:	44.5	63.1	39.9	114.3	52.9
Industry:	47 - 87 days with a median of 74 days				
Inventory in days:	120.1	125.7	73.6	110.6	109.2
Industry:	76 - 114 days with a median of 101 days				
Payables in days:	35.8	51.0	33.4	105.5	32.5
Industry:	30 - 85 days with a median of 52 days				
Sales / fixed assets	1.8	2.0	1.8	3.1	2.5
Industry:	4.7 - 25.9 with a median of 8				

The Lifo Inventory Method
and the Lifo Reserve
Wyley Corp.

From the balance sheet and notes . . .

	2017	2016
Current Assets (in 000's):		
Cash	$ 42,299	$ 148,970
Accounts receivable, net	68,080	53,785
Inventories	46,109	40,003
Other assets	20,623	13,212
Total current assets	177,111	255,970

Inventories
Inventories are stated at cost or market, whichever is lower. Domestic book inventories aggregating $35.4 and $27.4 million at April 30, 2017 and 2016, respectively, are valued using the last-in, first-out (LIFO) method. All other inventories are valued using the first-in, first-out method.

Inventories were as follows:

Dollars in thousands	2017	2016
Finished Goods	$40,370	$ 34,485
Work-in-Process	3,537	5,325
Paper, Cloth, and Other	5,241	2,007
	49,148	41,817
LIFO Reserve	(3,039)	(1,814)
Total	$46,109	$ 40,003

The company uses the Lifo method of inventory for the majority of its inventories. In valuing inventory at older costs, is typically lower than if the Fifo alternative had been employed.

Lifo resulted in an inventory valuation that was $3,039,000 lower than if current (Fifo) cost had been employed for all inventories. The lower Lifo inventory valuation makes an inventory writedown to market less likely than under Fifo.

Lifo and the Fourth Quarter Earnings Surprise

R.R. Donnelley & Sons Company

From a letter addressed to us from the Senior Vice President and Treasurer:

"All of our inventory accounts --paper, inks, work-in-process, supplies, etc.-- are all maintained on a FIFO basis. When we review our operating results, those results reflect FIFO accounting. In addition, we have a LIFO reserve in our General Ledger. At the beginning of each year, we estimate what we think the year-end reserve will be and then periodically provide a portion of that charge during the year. For example, this year we are estimating that the reserve at year-end will be $5 million higher than at the beginning of the year. We therefore are providing, each quarter, $1.25 million of LIFO provision (expense). This expense forms part of the cost of sales in our public financial statements."

The Lifo method is applied on an annual basis. That is, the Lifo reserve adjustment is made at year-end, using actual price changes that occurred during the year.

In adjusting the Lifo reserve for interim statements, companies must estimate what the annual rate of inflation rate will be. Inaccurate estimates are corrected in the fourth quarter.

Sometimes the fourth quarter adjustment results in a contraction in earnings.

Other times it is a positive adjustment, as in the next example.

The Fourth Quarter Lifo Reserve Adjustment

Winn Dixie Stores

From the notes . . .

11. Quarterly Results of Operations (Unaudited)

The following is a summary of the unaudited quarterly results of operations for the year.

Quarters Ended (dollars in thousands)

	Sept. 18 (12 Weeks)	Jan. 8 (16 Weeks)	April 2 (12 Weeks)	June 25 (12 Weeks)
Net sales	$ 2,985,702	4,057,174	3,114,029	3,061,810
Gross profit on sales	$ 740,723	989,319	790,258	795,553
Net earnings	$ 47,033	47,687	57,343	52,380
Net LIFO charge (credit)	$ 3,666	3,666	3,055	(8,763)

The fourth quarter results reflect a change from the estimate of inflation used in the calculation of LIFO inventory to the actual rate experienced by the Company of 1.9% to 0.2%.

In this case, the fourth quarter received a boost to correct for overestimates of inflation and cost of goods sold during the preceding three quarters

Compiled Statements
and the Fourth Quarter Lifo Adjustment

Banker Testimonial:

A banker with customers in the lower end of the middle market and below reported the case of a customer who disclosed much lower year-end earnings than expected based upon the first three quarterly reports. The customer was on LIFO for annual financial and tax purposes, but apparently reported on FIFO, or a comparable basis, during the year. Only compiled statements were received by the bank. Due apparently to significant price increases across the year, a sharp year-end increase in the LIFO reserves and LIFO cost of sales was required. The account officer was clearly surprised by this development.

In confirming whether Lifo is being applied during the year, check the following:

- Compare the cost of sales % for interim periods with the annual amounts for prior years.
- Check for a change in the Lifo reserve account balance during interim period(s).
- Caution is especially warranted during periods of high inflation.

Case Assignment
Babson Tool Works

Babson Tool Works is a machine tool manufacturer. Specifically, the company manufactures precision-machined screws primarily for heavy equipment manufacturers. While there is a strong cyclical component to the company's sales, its business is not seasonal.

Babson has grown in recent years and has financed that growth with a credit line secured by receivables and inventory and a term loan secured by certain property and equipment.

Babson is new to your portfolio. In reviewing the company's compiled financial statements for the last several years, you noted that the former relationship manager had been concerned about the company's relatively low and declining operating profit margin caused, among other reasons, by chronic increases in the cost of raw materials and skilled manufacturing labor. In fact, after interest expense, the company reported a loss in 2016 - the first loss on record. Moreover, in prior years, 2016 included, the company had seldom been in full compliance with its debt covenants. But since the bank had had a relationship with the borrower for many years and because the violations had been "only minor", they had been waived.

In reviewing the file you note that in the past, only annual financial statements had been made available by the borrower. Now, however, in an effort to persuade you to increase the credit line to meet what has been termed "a short-term cash flow need", the borrower has provided you with interim statements for the nine-months ended September, 2017.

In handing you the financials, the company president noted, "While we have been in violation of some of our covenants in prior years, we're doing much better this year." "We've also returned to profitability."

Babson Tool Works (cont'd)

The company's covenants are as follows:

- Current ratio of greater than 1.0
- Total liabilities to tangible net worth of less than 1.5
- Interest coverage (earnings before interest and taxes to interest) of greater than 3.5

Required:

1. How is the company doing with respect to its loan covenants?

2. Are the financial statements for the period ended September 2017 misleading? What is causing that to happen?

3. Is the company really profitable in 2017? Are debt covenants being fulfilled in 2017?

Mason and Platt
Certified Public Accountants
Cincinnati, Ohio

To the Board of Directors
Babson Tool Works, Inc.

Compilation Report

We have compiled the accompanying balance sheet of Babson Tool Works, Inc. as of September 30, 2017 and December 31, 2016 and the related statements of income for the nine months and year then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by generally accepted accounting principles. If the omitted disclosures and the statement of cash flows were included, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

Mason and Platt

December 5, 2017

Babson Tool Works, Inc.
Income Statement
Unaudited
For the 9 Months and Year Ended
September 30, 2017 and December 31, 2016

	2017 (9 Mos.)	2016 (1 Yr.)
Net sales	$ 11,048	$ 12,716
Cost of sales	8,286	10,809
Gross profit	2,762	1,907
Selling, general and administrative expenses*	1,622	1,670
Interest expense	220	310
Other income	8	10
Income (loss) before income taxes	928	(63)
(Provision) benefit for income taxes	278	19
Net income (loss)	$ 650	$ (44)

*Includes depreciation of $513 and $1,000.

Babson Tool Works, Inc.
Balance Sheet (Unaudited)
As of September 30, 2017 and December 31, 2016

	2017	2016
ASSETS		
Current assets:		
Cash and equivalents	$ 158	$ 260
Accounts receivable	1,452	1,242
Inventory (Lifo method)	2,160	1,474
Prepaid expenses and other current assets	92	74
Total current assets	3,862	3,050
Property and equipment		
Machinery and equipment	6,848	6,420
Furniture and fixtures	1,700	1,588
	8,548	8,008 *
Accumulated depreciation	(3,248)	(2,562)
Net property and equipment	5,300	5,446
Other assets	324	96
Total assets	$ 9,486	$ 8,592

*No change in PPE cost in 2016.

	2017	2016
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	1,138	1,150
Accrued expenses	448	446
Revolving credit agreement	1,544	1,100
Current maturities of long-term debt	236	210
Income taxes payable	94	74
Total current liabilities	3,460	2,980
Long-term debt less current maturities	2,124	2,360
Stockholders' equity:		
Common stock	100	100
Additional paid-in capital	900	900
Retained earnings	2,902	2,252
Total stockholders' equity	3,902	3,252
Total liabilities and stockholders' equity	$ 9,486	$ 8,592

Lifo Liquidations

Class Exercise

Cross Co.

Cross Co. reported a lifo liquidation in its fiscal years ended December, 2017 and 2016. Excerpts from the company's financial statements are provided below.

Required:

Review the disclosures provided and identify 1) where in the financial statements the effects of the lifo liquidation will be found and 2) the financial impact of that liquidation. 3) What indicators of a lifo liquidation are apparent in the absence of the provided disclosures?

Consolidated Balance Sheets: December 31	2017	2016
Assets		
Current Assets		
Cash and cash equivalents	$ 52,822,365	$ 22,406,377
Short-term investments	18,311,963	42,804,070
Accounts receivable, net	36,960,352	39,594,495
Inventories:		
Finished goods	11,736,582	20,010,347
Work in process	3,004,261	5,849,940
Raw materials	4,222,975	8,650,570
	18,963,818	34,510,857
Other current assets	3,067,532	4,315,812
Total Current Assets	130,126,030	143,631,611

Consolidated Statements of Income Year Ended December 31	2017	2016	2015
Net sales	$164,606,391	$187,129,510	$205,248,494
Cost of goods sold	84,392,881	99,087,116	107,573,956
Gross profit	80,213,510	88,042,394	97,674,538
Operating Expenses (Other Income)			
Selling and general expenses	62,846,578	63,707,825	64,039,313
Service and distribution costs	5,042,168	5,184,115	4,958,121
Research and development expenses	2,212,851	1,236,428	1,387,538
Interest and other income	(2,516,161)	(3,197,899)	(4,674,570)
Restructuring charges-Note J	11,010,000	2,100,000	
	78,595,436	69,030,469	65,710,402
Income from Continuing Operations Before Income Taxes	1,618,074	19,011,925	31,964,136
Provision for income taxes	1,099,000	6,239,000	9,200,000
Income from Continuing Operations	519,074	12,772,925	22,764,136

Inventories
Substantially all domestic inventories are priced at the lower of last-in, first-out cost or market. The remaining inventories are priced at the lower of first-in, first-out cost or market.

Inventories Domestic inventories approximating $10,416,000 and $18,253,000 at December 31, 2017 and 2016, respectively, are priced at the lower of last-in, first-out (LIFO) cost or market. The remaining inventories are priced at the lower of first-in, first-out cost or market. If the first-in, first-out method of inventory valuation had been used by the Company for those inventories priced using the last-in, first-out method, inventories would have been approximately $13,532,000 and $15,733,000 higher than reported at December 31, 2017 and 2016, respectively.

During 2017 and 2016, inventory quantities were reduced resulting in liquidations of LIFO inventory quantities carried at lower costs prevailing in prior years as compared with the cost of current purchases. The effect of these liquidations was to increase net income by approximately $719,000 or $.04 per share and $1,563,000 or $.09 per share in 2017 and 2016, respectively. The Company believes the LIFO method of inventory valuation ordinarily results in a more appropriate matching of its revenues to their related costs since current costs are included in costs of goods sold and distortions in reported income due to the effect of changing prices are reduced.

Changing Inventory Mix
A Precursor of Falling Sales?

Topton Manufacturing

From the income statement . . .

	2017	2016	2015
Net sales	$4,650,925	$5,048,997	$5,325,942
Cost of goods sold	3,234,370	3,215,216	3,381,964
Gross profit	1,416,555	1,833,781	1,943,978

From the notes . . .

Composition of inventories	2017	2016
Raw materials	$ 35,091	$ 113,236
Work in process	181,388	96,001
Finished goods	955,499	1,370,795
	$ 1,171,978	$1,580,032

The company's sales through fiscal 2017 have been declining. A manufacturer like Topton has greatest control over raw materials inventory. That is, it is easier to shut the flow of inventory down at the receiving dock than once it is placed in-process. Once in-process, inventories are likely to be carried through to finished goods.

The significant drop in raw materials may indicate that management anticipates continuing, perhaps even accelerating, sales declines.

As an update, for the first six months of the Company's fiscal 2018, sales were down 49% when compared with 2017.

Inventory Theft and the Unexpected Inventory Writedown

Crown Crafts

From a company release . . .

Both 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 in Roxboro, N.C.

"The fourth quarter inventory write off in Roxboro reduced net earnings per share by about $.10 for both the quarter and the full fiscal year," stated Michael H. Bernstein, Crown Crafts' president and chief executive officer. "Our conclusion, after reasonable investigation, is that a significant portion of the inventory shortage is probably the result of theft.

"We have taken immediate action to improve our inventory handling procedures and add to the security of our merchandise," Bernstein emphasized.

Crown Crafts (cont'd)

It is difficult to anticipate such an earnings surprise. Amounts may accumulate over time and typically aren't large enough in any one year to affect margins sufficiently to be noticeable.

Answers to a few questions may help.

> What is the company's posture with respect to inventory controls? Is the environment strict or somewhat lax?
>
> What controls are in place to guard against theft? Do they seem adequate?
>
> When the physical inventory is taken, how does it compare with perpetual records?

- Are the amounts different by significant amounts?
- Are differences always in the same direction?
- Typically, are the books greater than the physical count, necessitating a reduction in the book inventory?
  - Are the books adjusted or are differences dismissed as errors in taking the physical inventory?

What Are Debt Securities Worth?

Even debt securities held to maturity must be written down for other than temporary declines in fair value.

Presidential Life

From the WSJ:

Presidential Life settles with SEC
after charges firm masked decline of junk bond portfolio

The SEC said Presidential Life ignored generally 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."

Such declines in Presidential life's securities portfolio totaled $25 million, or about 37 percent of pretax income, the SEC said. Of that amount, $20.7 million was due to declines I the value of Presidential Life's junk-bond holdings, it said.

The Company carried investments in such failed concerns as Eastern Airlines, Inc. and Southland Corp.

The bankruptcies of these debt issuers was evidence that the fair value of their debt securities had suffered an other-than-temporary decline.

Keep this case in mind when a company carries a large portfolio of debt securities held to maturity. Is the securities' market value less than cost? Will this value recover?

When Are Liabilities Undervalued?

Liabilities are probable future sacrifices of corporate resources or services to settle present obligations.

For reporting purposes, liabilities are valued at the present value of the resources or services to be provided.

- Liabilities reported at lesser amounts are undervalued.

Most on-balance sheet liabilities are properly valued and, accordingly, are not a potential future charges against earnings.

- Notes payable

- Bonds payable

Exception - long-term debt issued at rates significantly higher than current levels.

- Early retirement may involve a loss on early retirement.

Liabilities that are more likely to be undervalued and to result in future earnings charges involve accounts payable, accrued expenses, and commitments and contingencies.

Potential examples include:

Accounts payable - understatement is likely accompanied by an understatement of inventory purchases and cost of goods sold.

- Watch Cost of goods sold % and A/P days
- Watch changes in inventory and accounts payable

Accrued liabilities - may involve under-accruals for such items as wages, warranties, utilities, insurances, maintenance, payroll taxes, or even sick pay and vacation pay.

- Future earnings will be charged when the expense accrual is increased or a related payment is made for an item that has not been accrued.

- Watch the trend in accrued expenses payable

  - A declining trend indicates that payments exceed expenses being accrued.

- Watch selling, general and administrative expense as a percentage of revenues.

  - Declining % may mean increased efficiency, or, it may mean expenses are not being accrued.

- Caution:

  - Even though accrued expense amounts may be immaterial to the financial statements taken as a whole. Underaccruals may still be material to net income.

  - The indicators tend to be volatile - making interpretations difficult

    - An understanding of the company's business, the accounts employed and their historical relationships is useful.

  - Amortization of prepaid expenses can also raise and lower selling, general and administrative expenses and can raise or lower selling, general and administrative expense.

Accrued Expenses Payable

Note the decline in Accrued Warranty Liability - Even as Sales Grow

Disk Drive Corp.

From the balance sheet . . .

	2017	2016
Current liabilities:		
Accounts payable	$37,160	$12,228
Current portion of long-term debt	946	1,742
Accrued compensation and related expenses	2,820	1,746
Accrued warranty expense	1,374	2,083
Other current liabilities	4,386	3,274
Total current liabilities	$46,686	$21,073

From the income statement . . .

	2017	2016	2015
Net sales	$184,861	$113,951	$123,606
Cost of sales	137,936	111,445	110,577
Gross profit	46,925	2,506	13,029
Selling, general and administrative	14,459	12,217	9,798
Research and development	8,555	4,204	8,307
Total operating expenses	23,014	16,421	18,105
Income (loss) from operations	$ 23,911	$(13,915)	$(5,076)

Low Effective Tax Rate
Due to Net Operating Loss Carryforwards

Resource Engineering, Inc.

From the income statement . . .

	2016	2017
Operating earnings	$ 226,110	$ 765,804
Interest income (expense), net	(3,299)	6,875
Earnings before income taxes	222,811	772,679
Income tax expense	--	208,000
Net earnings	$ 222,81	$ 564,679

From the notes . . .

The effective rate for income tax expense (0%) for 2016 assumes full utilization of the Company's remaining net operating loss carryforward.

While the effective rate was 0% in 2016, note the increase to 27% now that the net operating loss carryforward has been used.

Failure to Accrue a Contingent Liability
Lee Pharmaceuticals, Inc.

Failure to accrue a contingent liability that is both probable and subject to reasonable estimation would result in the understatement of a liability and the overstatement of net income and shareholders' equity.

As Reported in an SEC Enforcement Action:

Management at Lee Pharmaceuticals had become aware of high levels of contamination in its soil and groundwater.

Consultants hired by the company confirmed the company's role in the contamination.

Estimates of the cost to clean up the property that ranged from $465,200 to $700,000 were available to management.

Given the probable nature of the obligation for cleanup and the availability of a reasonable estimate of the cost, the company should have accrued a loss.

In accordance with GAAP, the amount accrued should have been the lower amount of the estimated loss range.

Yet the company made no such loss accrual, significantly overstating its financial results and position.

Restructuring Reserves

SEC Probe of Lucent Is Broader (Excerpts)
The Wall Street Journal
By Jonathan Weil
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THE SECURITIES AND EXCHANGE Commission's formal investigation into Lucent Technologies Inc.'s accounting and financial-reporting practices is far broader than the company has disclosed, according to people familiar with the probe, covering possible earnings manipulations.

SEC investigators' concern is that Lucent may have improperly timed reversals of its restructuring reserves into income in order to help the company beat Wall Street analysts' quarterly earnings estimates, the people said. Lucent said in its financial statements that actual costs under the restructuring plan were lower than originally forecast.

Across a four-year period, the company reversed $540 million of the $1.9 billion in reserves it had set up with the restructuring charge, a longstanding point of criticism among some analysts. During that time, Lucent reported 14 consecutive quarters during which it beat Wall Street analysts' earnings expectations, according to Thomson First Call. But were it not for its reversals of the $540 million, the company would have disappointed expectations for at least three quarters, according to an analysis of Lucent's financial statements by Charles Mulford , accounting professor at Georgia Institute of Technology in Atlanta.

Mr. Mulford said Lucent's reserve reversals "appear to have served as an earnings support mechanism from which the company metered out profits to boost corporate performance over a four-year time frame." He said the pattern looks strikingly similar to that of other companies already disciplined by the SEC for dipping into cookie-jar reserves, including Xerox.

One key distinction in the Xerox instance is that the SEC accused the company of not adequately disclosing its reversals. Lucent's disclosure of its reserve reversals weighs in its favor, but, by itself, doesn't mean that the maneuvers complied with prevailing accounting standards, according to one person familiar with the Lucent probe.

Lucent denies that it manipulated earnings through its restructuring charge. The fact that "we disclosed the existence of the reserve, and any adjustments we made to them over time, disproves claims that there was some type of cookie-jar reserve to discreetly boost our earnings," Ms. Fitzgerald said. Many of Lucent's restructuring projects were complex, and some couldn't be completed as expected, she said, adding that Lucent reviewed the reserves each quarter and made appropriate adjustments.

Case Assignment
Haven's Building Supplies, Inc.

Haven's, a local, family-run company, sells building supplies to small contractors and to the public. The company has operated profitably for over 25 years and has built a substantial equity base. In recent years, however, Haven's has struggled as "category killers" such as Home Depot have entered the local market. The company's sales are down about 15% in the year ended January, 2018 from 2017. Bob Haven, the company's founder is pleased that even with the decline in sales, net income has been maintained at about equal with 2017. He attributes much of his success to continued investment in the latest of equipment, including state-of-the-art computer equipment and furniture and fixtures to keep his stores fresh and appealing. In his view, these investments have kept sales from falling apart totally. Also helping out was a concerted effort to reduce SG&A expenses.

As he hands you his latest compiled financial statements, he notes that overall, 2018 wasn't bad, considering.

Required:

1. How has Haven's been able to maintain net income in the face of declining sales?

2. Make necessary assumptions to calculate a revised net income figure for the year ended January 31, 2018 given the items identified in number 1 above.

3. In reviewing the company's financial statements, what other warning signs do you see?

Mary Martin
Certified Public Accountant

To the Board of Directors
Haven's Building Supply, Inc.

Compilation Report

We have compiled the accompanying balance sheet of Haven's Building Supply, Inc. as of January 31, 2018 and 2017 and the related statements of income for the years then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by generally accepted accounting principles. If the omitted disclosures and the statement of cash flows were included, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

Mary Martin

March 5, 2018

Haven's Building Supplies, Inc.
Income Statement
Unaudited
For the Year Ended
January 31, 2018 and 2017

	2018	2017
Net sales	$ 7,344	$ 8,640
Cost of sales	5,450	6,221
Gross profit	1,894	2,419
S. G. & A. (expenses)	(1,274)	(1,821)
Interest (expense)	(344)	(323)
Other income	51	42
Income before income taxes	327	317
(Provision) for income taxes	(16)	(38)
Net income	$ 311	$ 279

Haven's Building Supplies, Inc.
Balance Sheet
Unaudited
As of January 31, 2018, 2017 and 2016

	2018	2017	2016
ASSETS			
Current assets:			
Cash and equivalents	$ 86	$ 241	$ 387
Accounts receivable	1,288	1,372	1,314
Inventory	1,572	1,568	1,611
Prepaid expenses	642	428	104
Total current assets	3,588	3,609	3,416
Property and equipment			
Warehouse and store equipment	8,661	8,288	7,400
Furniture and fixtures	1,683	1,641	1,547
	10,344	9,929	8,947
Accumulated depreciation	(5,167)	(4,372)	(3,578)
Net property and equipment	5,177	5,557	5,369
Other assets	528	451	327
Total assets	$ 9,293	$ 9,617	$ 9,112
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities:			
Accounts payable	$ 627	$ 595	$ 501
Accrued expenses payable	217	423	408
Revolving credit agreement	1,502	1,450	1,173
Current maturities of long-term debt	357	347	335
Income taxes payable	18	20	24
Total current liabilities	2,621	2,835	2,441
Long-term debt less current maturities	2,503	2,431	2,349
Stockholders' equity:			
Common stock	100	100	100
Additional paid-in capital	900	900	900
Retained earnings	3,169	3,351	3,322
Total stockholders' equity	4,169	4,351	4,322
Total liabilities and s/h equity	$ 9,293	$ 9,617	$ 9,112

Hidden Obligations

Class Exercise
Personal Diagnostics and Bay Tact Corp.

Investment-related footnote disclosures for two companies are provided below. Review these disclosures and prepare to comment on the risk, if any, you see to each company's earnings and financial position.

Personal Diagnostics

From the notes . . .

Concentration of Credit and Off-Balance-Sheet Risk The Company has open future positions for silver and gold. The gains or losses are recognized in income as they occur. The contract amounts, while appropriately not recorded in the financial statements, reflect the extent of the Company's market risk which at year-end totaled $3,637,000.

Note: Personal Diagnostics is a precision-machining company specializing in replacement human hips and joints. The company reports total assets and stockholders' equity of $12.2 million and $8.7 million, respectively.

Bay Tact Corp.
(Amounts in dollars, not thousands)

Marketable Securities

Marketable securities consist of investments in equity stocks recorded at cost less the amount due on margin. A comparison with market value is as follows:

	Cost	Market Value
Total	$ 186,838	$ 198,985
Less - amount due on margin	98,583	98,583
Net marketable securities	$ 88,255	$ 100,402

Note: Bay Tact is a financial publisher. The company reports total assets and stockholders' equity of $356,112 and $142,679.

Off Balance Sheet Liabilities

Special Purpose Entities (SPEs)

Special Purpose Entity - an entity created by a sponsor to carry out a specified purpose or activity, such as to consummate a specific transaction or series of transactions with a narrowly defined purpose.

SPEs are typically established as financing mechanisms to allow companies to execute certain transactions while keeping the majority of the details and results off of the books.

By keeping incremental debt off of the books, a company may earn a higher debt rating, and possibly, an overall lower cost of capital.

Example. A company wants to acquire land and construct a building for its own use. An outright purchase with accompanying debt financing would burden the balance sheet with debt.

The company sponsors creation of an SPE that borrows specifically to acquire the land and construct the asset. The SPE leases the building and land to the sponsoring company on an operating lease. The sponsor's lease payments provide resources to the SPE to service its debt.

Consolidation Rules for SPEs (now referred to as VIEs)

Off Balance Sheet Entities
Guidance from the FASB
Codification Topic 810 Consoldiations

Primary Beneficiary

The enterprise that consolidates a variable interest entity is referred to as the *primary beneficiary* of the variable interest entity. The primary beneficiary absorbs a majority of the variable interest entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding the variable interest(s).

Consolidation

Variable interest entities must be consolidated by their primary beneficiaries if the entities *do not effectively disperse risks* among the parties involved. Primary beneficiaries of variable interest entities are thus required to consolidate under the following conditions:

1. The equity investment at risk is not sufficient (less than 10% of total assets) to permit the variable interest entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity.
2. The equity investors lack one or more of the following essential characteristics of a controlling financial interest:
    a. The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights.
    b. The obligation to absorb the expected losses of the entity if they occur, which makes it possible for the entity to finance its activities.
    c. The right to receive the expected residual returns of the entity if they occur, which is the compensation for the risk of absorbing the expected losses.

Valuation and financial reporting

Assets, liabilities, and noncontrolling interests of *newly consolidated variable interest entities* generally will be initially measured at their *fair values* except for *assets and liabilities transferred to a variable interest entity* by its primary beneficiary, which will *continue to be measured as if they had not been transferred*.

Disclosure

The *primary beneficiary* of a variable interest entity is required to disclose:

1. The nature, purpose, size, and activities of the variable interest entity.
2. The carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations.
3. Any lack of recourse by creditors (or beneficial interest holders) of a consolidated variable interest entity to the general credit of the primary beneficiary.

Financial Warnings Checklist
Overstated Assets

Are assets being carried at a valuation that can be considered excessive?

Accounts receivable

- Is the allowance for doubtful accounts sufficient to cover future collection problems?
    - Compute receivables in days for each of the last four to six quarters.
        - Is the trend steady, improving, or worsening?
        - Is the overall level high when compared with competitors or other firms in the industry?
        - What amount of receivables are "at risk"?
            - By what amount would the allowance for doubtful accounts need to be increased (reducing accounts receivable, net) such that receivables in days would be more in line with prior years, competitors or the industry?
              (No. of days reduction needed x sales revenue per day).
        - Have economic conditions for the company's customers worsened recently?
    - Are company sales declining?
    - Other general economic reasons to expect that customers are having difficulties?
    - Are sales growing rapidly?
    - Has the company changed its credit policy?
        - Have payment terms been extended?
        - Granting credit to less creditworthy customers?

Inventory

- Are inventories reported that do not exist?
- Are existing inventories carried at amounts greater than replacement cost?
    - Compute cost of sales as a percentage of sales revenue and inventory in days for the last four to six quarters
        - Is the trend steady, worsening, or improving?
        - How do the statistics compare with competitors' and other firms in the industry?
            - Are same inventory cost flow assumptions used?
- Do on-going company events and fortunes suggest problems with slackening demand for the company's products?
    - Are sales declining?
    - Have raw materials inventories declined markedly as a percentage of total inventory?
        - Does the company employ the Lifo inventory method for at least a portion of its inventory?
- Are Lifo adjustments being made for interim periods?
        - Has the Lifo reserve account remained unchanged during interim periods?
        - If the Lifo reserve account has been adjusted during interim periods, does the estimate of inflation used appear reasonable?
        - How does cost of sales as a percent of sales for interim periods compare with prior years' annual results?
    - What is the nature of the company's environment with respect to inventory controls? Lax?
        - Do controls to guard against theft seem adequate?
    - When a physical inventory is taken, how does the amount compare with perpetual records?
        - Are differences significant and always in the same direction?
        - Typically, are the books greater than the physical count, necessitating a reduction in the book inventory?
            - Are the books adjusted or are differences dismissed as errors in taking the physical inventory?

- Special warning - be particularly alert for overvalued inventory in the following situations:
  - Company uses the Fifo inventory method
  - Company's industry is experiencing price deflation (inventory replacement costs will likely be declining)
  - Company is in an industry that is experiencing rapid Technological change (obsolescence may be a problem)
  - Company has shown evidence in the past of overvaluation of inventory.
    - Is there an example of a prior year writedown of inventory that became value impaired?

Investments

- For debt securities held until maturity (carried at amortized cost) and non-marketable equity securities (carried at cost), is there evidence of a non-temporary decline in market value?
- For equity securities accounted for under the equity method, is there evidence of a non-temporary decline in market value?

Understated Liabilities

Accounts payable

- Compute accounts payable in days for each of the last four to six quarters
  - Is the trend steady, worsening, or improving?
  - How does the statistic compare with competitors' and other firms in the industry?

Notes and bonds payable

- Are coupon or stated interest rates significantly higher than the current level of rates?

Accrued liabilities

- What is the trend in accrued liabilities?
- What is the trend in selling, general and administrative expense as a percentage of sales revenue?
- What is the trend in accrued expenses in days?

Deferred tax liabilities and taxes payable

- Is the effective tax rate unsustainably low?
- Does the balance sheet disclose the existence of deferred tax items?
- Is there evidence in the footnotes of unrecognized net operating loss carryforwards?

Commitments and contingencies

- What unrecognized contingencies are noted in a careful reading of the commitments and contingencies footnote?
- Given an understanding of the company's business dealings, is there reason to believe that an unrecognized contingent liability exists?
- Does the company have a speculative investment position?
  - Futures contracts
  - Investments using margin debt

Other off-balance sheet liabilities

- Does the company have outstanding synthetic leases?
  - Future lease payment obligations will be disclosed as operating lease commitments
  - Are there other commitments, including residual value guarantees, that exist beyond operating lease payments?
- Does the company use special purpose entities (SPEs) as a source of other off-balance sheet financing?
  - What is the underlying business purpose of these entities?
  - What are the underlying obligations of the entities?
  - Has the reporting company guaranteed those obligations?