B8101 Corporate Financial Reporting II
Lecture 2

Agenda:
(1) Jenkins Committee recommendations (Info needs of F/S users).
(2) SEC/Levitt – Areas of concern regarding abusive financial reporting.

(1) Jenkins Committee report. Focus on 2 areas:

- Recommendations for improving existing financial statements (discussed in Lecture 1).
- Recommendations for improving the types of information in business reporting.
  - Management should disclose high-level operating data and performance measurements used by management.
  - Can be financial data or non-financial data. Should represent the drivers of the business. See the business through the eyes of management.
- Financial data – eg: ROA, Cash flow ratios, Core EPS, Backlog, Revenue per employee.
- Non-financial data – eg: Units of production, Units sold, Customer satisfaction, Average product development time, # of contracts, employee utilization, employee turnover.
- MDA should address analysis of changes in the key operating data, by business segment.

(2) Levitt speech regarding managing earnings. Areas of concern.

(a) Restructuring Charges.

- Criteria for separate reporting of restructuring charges.
  - Unusual in nature, not same as ongoing repositionings and redeployments of resources.
  - Costs are material.
  - Formal plan to implement changes with objective to improve future results by reducing cost structure.
  - Includes significant reduction in production facilities and workforce.
• What should be included.
  • Termination benefits (severance, pension enhancements)
  • Other exit costs.
    • Incremental costs incurred directly related to restructuring.
    • Contractual obligations existing which will continue (or penalty to buy out) AND costs are not directly associated with generation of revenues during the phase-out period.
    • Estimated loss on sale or disposal of assets.
    • Estimated operating losses during phase-out period from operations that will not be continued.

• What should be excluded.
  • Costs which will provide future benefits. For example: training, relocation, conversion from mainframe to PC technology, advertising to re-position the company, incentives to continuing employees.

• Abuses cited by Levitt/SEC.
  • Inclusion of items which provide future benefits.
  • Overstating estimated restructuring costs and later taking unused liability into income without identifying such.

• What to do/next steps.
  • SEC/FASB to provide new guidance on restructuring charges, including disclosure of unused portion of restructuring liabilities.
  • Closer scrutiny of charges by SEC.
  • Be skeptical of companies that regularly have restructuring charges.

(b) Acquisition accounting.

• Treatment of acquired R&D. Allocating a major portion of the acquisition cost to in-process R&D. The R&D is then shown as a “one-time” expense in the income statement related to the acquisition. This reduces the amount of the purchase price allocated to Goodwill, and therefore reduces future charges against income.
• Recording large liabilities at the time of the acquisition in connection with the acquired business. For example, unfavorable contracts and leases, plant closing expenses, pension liabilities, potential litigation not previously recognized. Concern relates to including inappropriate items for the purpose of cushioning future earnings and over-accruals, which later on can be taken into earnings without identifying such.
• What to do/next steps.
  • New rules/guidance by FASB on treatment of acquired R&D.
  • Closer scrutiny by SEC of allocation of acquisition price in business combinations treated as purchases.

(c) Miscellaneous reserves (Cookie Jar reserves).
• Using estimated liabilities to manage earnings, both for the current period and future periods.
• Examples include sales return allowances, loan loss reserves, warranty costs, litigation liabilities, allowance for doubtful accounts, inventory obsolescence reserves.
• What to do/next steps.
  • Look for trend in changes of balances in relation to a relevant base. For example:
    • Sales returns allowance/Sales or Sales returns allowance/Accounts receivable.
    • Loan loss reserves/loans receivable.
    • Warranty cost reserves/Sales revenue.

(d) Materiality.
• Concern that items that traditionally are considered immaterial (3-5-10%) are not disclosed or immaterial errors are not corrected in the financial statements.
• This could have significant ramifications to the responsibilities of auditors and the scope of an audit.
• Next steps/ SEC to provide guidance on materiality.
(e) Revenue recognition.

- Criteria for revenue recognition:
  - Realized or realizable – Exchange of goods or services for cash or another asset (accounts receivable) which is readily convertible into cash.
  - Earned – Seller as fulfilled significant obligations.
  - Abuses – See Cendant (right of return) and Bausch & Lomb (having significant influence over distributors) for common examples of abuses. Is SEC being too conservative with respect to Cendant situation?

- What to do/next steps.
  - SEC/FASB to address rules for revenue recognition.
  - Look for build-up of receivables, dispersion between net income and cash flow from operating activities.
  - From footnote or company (stockholder relations), determine revenue recognition policy (timing). Compare to similar companies in industry.
  - Discuss with distributors/customers.