CASE STUDY 15:

The Use of Restructuring Reserves to Manipulate Reported Income at Moonstay Corporation

Alan A. Cherry, Ph.D.
Loyola Marymount University

LEARNING OBJECTIVES

After completing and discussing this case, you should be able to

- Use the FARS system and find an EITF abstract.
- Access the SEC web site and read a speech.
- Learn about contingent liabilities.
- Consider the ethical ramification of an audit failure.

INTRODUCTION

The main focus of this case is on the fraudulent inflating of a restructuring reserve at Moonstay Corporation in late 1996. This technique was actually just one of the many aspects of the massive financial reporting fraud that took place while Moonstay was being run by controversial CEO "Whipsaw" Bill Smith. The case also deals with Moonstay's unnecessary accrual of a contingent liability. You are asked to discuss the role played by Moonstay's external auditors.

This case illustrates how a company can manipulate its reported income for two or more years through the use of an accounting game called restructuring reserves. The game was played at a very high level at Moonstay Corporation during 1996 and 1997, during which time CEO Whipsaw Bill Smith was Moonstay's chief executive officer (CEO).

INTRODUCTION

After a spectacular though brief tenure as CEO of Stormish Paper Company, which ended with the sale of Stormish to Kinter Corporation for $9.4 billion, Bill Smith, known as Whipsaw for his fondness for firing people, took some time off and then agreed to become CEO of the troubled but respected consumer products company, Moonstay Corporation. The market capitalization of Stormish had increased by $6.3 billion during Smith's time there, with Smith's net worth increasing by about $100 million, and both Wall Street and Moonstay stockholders were thrilled at the prospect of another phenomenal turnaround at Moonstay. Indeed, on July 19, 1996, the day after Smith was hired, shares of Moonstay stock were bid up nearly 60 percent, the largest one-day increase to that point in time in the history of the New York Stock Exchange. Four months later, Whipsaw outlined a restructuring plan to the Moonstay board of directors. He told the Board that he would eliminate half of the company's 12,000 employees, stop producing 87 percent of existing products, close the majority of its factories and warehouses, and divest several lines of business. He informed the board that this downsizing would save the company $225 million per year but also result in a one-time pretax charge of $300 million.

According to the Notes to the Consolidated Financial Statements found in Moonstay's 1997 Form 10-K filed with the SEC, the total restructuring charge was actually $337.6 million. This charge, which helped produce a net loss for 1996 of over $228 million, was described in the Notes as having been allocated in the manner shown below:

Restructuring, impairment, and other costs	$154,900,000
Cost of goods sold (inventory write-downs)	92,300,000
Selling, general and administrative expenses (for increases in environmental and litigation reserves)	42,500,000
Estimated loss on sale of discontinued operations	47,900,000
Total restructuring charge to earnings	$337,600,000

CREATING THE ILLUSION OF A TURNAROUND

Ed Paul is considered one of the most successful stock investors in history, and he has written a series of letters to shareholders that are both informative and entertaining. There are usually a couple of pages devoted to accounting issues, and the 1998 letter focused on restructuring charges, which Paul described as a "distortion." He indicated that restructuring was frequently a device for manipulation. A part of costs for a number of years is typically dumped into a single quarter. The timing is designed to allow future quarters to exceed investor expectation.

Sure enough, Moonstay reported successively larger profits for each quarter of 1997, culminating in earnings before discontinued operations for the year of over $123 million and a bottom line of over $109 million. This result was an apparent turnaround of over $300 million from the year before, and Wall Street responded by bidding Moonstay shares up to a high of $52 per share in March 1998. Unfortunately for many investors, creditors, and other Moonstay stakeholders, much of the miraculous turnaround was the result of creative accounting. Moonstay's chief financial officer (CFO) Robert Kurt, who also worked with Smith at Stormish, liked to remind fellow executives that he was Moonstay's "biggest profit center," and Smith stated at meetings that, "if it wasn't for Robert and the accounting team, we'd be nowhere."

Things started to unravel quickly at Moonstay in early 1998, with the stock price going down fast in reaction to a series of disappointing revenue and profit reports and projections. After an article in *Forbes* by Matthew Toast questioned the accounting practices at Moonstay, the board of directors took the extreme action of firing both Smith and Kurt on June 13, 1998. Moonstay's external auditor, the CPA firm of CPA Pintrest, then refused to allow its unqualified opinion on the 1997 financial statements to be used in connection with any securities offerings by Moonstay. The Board and the newly appointed top management team ordered a review of the company's prior financial statements. Moonstay hired the CPA firm of CPA Capital to assist the audit committee of the board and CPA Pintrest with the review. The review led to the filing of an amended 10-K with the SEC in November 1998. Included in this 10-K/A were restated financial statements. When these are compared to the originally issued statements, it is apparent that Moonstay had purposely overstated its loss in 1996 (a big bath) and followed that with an vastly overstated net income in 1997. While much of the misstatements resulted from improper accounting for revenues and various expenses, along with the use of sham transactions, the manipulation of the restructuring reserves created by the CFO in 1996 played a significant role as well. Indeed, it seems likely that Ed Paul had Moonstay in mind when he wrote about restructurings.

Meanwhile, the SEC informed Moonstay in June 1998 that its Division of Enforcement was launching an investigation. It took almost three years to complete that investigation, which resulted in the filing on May 15, 2001, of civil fraud charges against Smith, Kurt, former Moonstay controller Ron Glue, two other Moonstay officers, and the partner in charge of the CPA Pintrest audit, Phil Hart. Among the many examples of improper accounting found by the SEC was the padding of the 1996 restructuring charge with at least $35 million of improper reserves and accruals, excessive write-downs, and prematurely recognized expenses. The improper reserves were then drawn into income in each quarter of 1997, including a remarkable $21.5 million in the fourth quarter. According to the SEC, the bulk of the inflated reserves were in two areas. First, there was almost $19 million of general restructuring reserves that were clearly not in conformity with GAAP. It appears that the Enforcement Division deemed that this amount of reserve did not meet criterion found in Emerging Issues Task Force Issue No. 94-3 for recognition of such liabilities. Second, at least $6 million of a $12 million litigation reserve for environmental problems was recognized in violation of the FASB's Statement No. 5 on contingencies.

The impact of Whipsaw Bill Smith and his friends on Moonstay Corporation and its stockholders and creditors has been devastating. In February 2001, Moonstay had to file for protection from creditors under Chapter 11 of the U.S. Bankruptcy Code. The company had seen its long-term debt go from about $200 million when Smith was hired to about $2.6 billion. Positive retained earnings have been replaced by a deficit of over a billion, as massive losses had been reported each year starting with 1998. At the time of the bankruptcy, the company had just $15 million in cash and its stock was selling for a mere 51 cents per share, just one percent of its peak price in 1998 of $52 per share.

A LOOK AT THE DETAILS

Upon completion of the review by the two CPA firms, restated financial statements and accompanying notes were prepared and filed with the SEC as part of Moonstay's Form 10-K/A for the fiscal year ended December 28, 1997. Among the many restatements was a $98.4 million reduction in the pre-tax amount of the total restructuring charge taken in 1996. The allocation of the restated charge, now totaling $239.2 million, is shown below.

Restructuring, impairment, and other costs	$110,100,000
Cost of goods sold (inventory write-downs)	60,800,000
Selling, general and administrative expenses (for outsourcing and packaging redesign)	10,100,000
Estimated loss on sale of discontinued operations	58,200,000
Total restructuring charge to earnings	$239,200,000

Although greatly reduced, the first component of the restructuring charge still had a significant effect on Moonstay's financial statements. The notes explained that included in this charge were both cash and non-cash items. The cash items consisted of severance and other employee costs ($24.7 million), along with the costs of closing factories and other facilities ($16.7 million). The non-cash portion of the charge ($68.7 million) related to write-downs to the net realizable value of buildings, equipment, and other assets that Moonstay planned to dispose of as part of its downsizing. When Moonstay originally recorded these charges, their accountants estimated the employee costs to be $43 million and they wrote the assets down by $91.8 million. It appears that here was some of the padding of the 1996 charge that the SEC alleges was fraudulent.

However, even the reduced amounts, although deemed to be reasonable estimates as of the end of 1996, proved to be too high. The review of what actually took place during 1997 led to a reversal of accruals no longer required in the amount of $14.6 million. This shows up as a positive amount in Moonstay's restated income statement for fiscal year 1997. Interestingly, no such benefit appears on the originally reported income statement. Perhaps Moonstay's accountants were too busy reversing some of the purposely overstated reserves and accruals in ways that would not draw attention that they missed a legitimate opportunity to increase the 1997 net income.

According to both the notes and the statement of cash flows found in the original 10-K filing, Moonstay paid $43.4 million in cash during 1997 for costs associated with the 1996 restructuring plan. Included in this amount was a supposed $18.6 million for severance and other employee termination costs. However, the review by the two CPA firms only managed to find $21.2 million paid during 1997 for restructuring costs, or less than half the originally reported amount. In fact, the restated amount for severance and other employee termination costs was only $10 million. So it appears that Moonstay had charged an extra $8.6 million to the restructuring reserve for payments to employees during 1997 for work done that year.

Before posing a few questions to which you are to respond, shown below are some of the most important items from Moonstay's income statement and balance sheet as they were originally reported and as restated.

Selected items from Moonstay Corporation=s Income Statements
(Amounts in thousands, except for per share amounts)

	For the Year Ended December 28, 1997		For the Year Ended December 29, 1996	
	As Originally Reported	As Restated	As Originally Reported	As Restated
Net sales	$1,168,182	$1,073,090	$984,236	$984,236
Cost of goods sold	837,683	830,956	900,573	896,938
Selling, general and administrative expense	131,056	152,653	214,029	221,655
Restructuring and asset impairment (benefit) charges	0	(14,582)	154,869	110,122
Operating earnings (loss)	199,443	104,063	(285,235)	(244,479)
Loss on sale of discontinued operations, net of taxes	(13,713)	(14,017)	(32,430)	(39,140)
Net earnings (loss)	109,415	38,301	(228,262)	(208,481)
Net earnings (loss) per share of common stock:				
Basic	$1.29	$0.45	($2.75)	($2.51)

When it comes to the balance sheet, the restatement process did not result in dramatic changes in the December 29, 1996 Balance Sheet of Moonstay. There were some interesting changes, however, in the December 28, 1997 Balance Sheet, as shown below.

Selected items from the December 28, 1997 Balance Sheet (Amounts in thousands, except for per share amounts)		
	As Originally Reported	As Restated
Receivables, net	$295,550	$228,460
Inventories	256,180	304,900
Total current assets	658,005	602,242
Property, plant and equipment, net	240,897	249,524
Trademarks, trade names, goodwill and other, net	221,382	207,162
Restructuring accrual	10,938	5,186
[Restructuring accrual at 12/29/96]	[63,834]	[51,725]
Other current liabilities	80,913	118,899
Total current liabilities	198,099	233,127
Other long-term liabilities	141,109	154,300
Total shareholders' equity	531,937	472,079

QUESTIONS

1. How is the term liability defined by the FASB (see SFAC No. 6 in FARS or on the FASB's web site)? Obtain and read the speech by Walter Schuetze, "Cookie Jar Reserves," April 22, 1999, U.S. Securities and Exchange Commission and then write a brief summary of Schuetze's thoughts about restructuring reserves such as those recognized by Moonstay. (If you have access to it, you should also read EITF Abstract 94-3.) Do you think the restructuring reserves recognized by Moonstay in 1996 should have been accrued as a liability? Why or why not?

2. Describe an alternative way to communicate the potential financial impact of a corporate restructuring that would avoid giving fraudsters the opportunity to practice "creative" accounting.

3. Moonstay's accountants originally charged $43.4 million of cash expenditures made in 1997 to the restructuring accrual account established in late 1996. According to the review conducted by the two CPA firms, only $21.2 million of cash paid in 1997 actually related to the restructuring of Moonstay. What was the effect on the 1997 reported earnings of improperly charging (debiting) $22 million to the restructuring accrual account? What are some of the accounts that probably should have been debited instead? (Hint: some of the amounts charged to the restructuring reserve involved such routine items as employee compensation and maintenance.)

4. The SEC charged that Moonstay violated FASB Statement No. 5, which deals with contingencies, by overstating a litigation reserve account related to environmental problems. Read the discussion of loss contingencies found in any Intermediate Accounting textbook. What might be the nature of Moonstay's violation of FASB Statement No. 5? Why would Moonstay's management want to accrue at least $6 million more than necessary as a loss in 1996?

5. As always happens, when an accounting fraud comes to light, people ask, "where were the auditors?" Moonstay is no exception, especially with the SEC bringing civil fraud charges against the CPA Pintrest partner in charge of the audit engagement. The evidence seems to indicate that this partner was aware of various aspects of the accounting fraud, yet signed unqualified audit opinions for both 1996 and 1997. Identify the stakeholders who have been harmed by this auditor's failure. Whose interests do you think this auditor was trying to serve? Whipsaw Bill Smith and his management team or the stakeholders you have identified? Why might an auditor favor the interests of management over those of other stakeholders?

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