



Is it Okay to Buy Earnings?

By Lorri Carpenter, CPA

Had Jed enjoyed making the deals so much he'd led himself to believe they were good for Rising Star, when in fact he was damaging the long-term prospects of the company he'd founded?

Abstract

Rising Star, an online discount retailer, has achieved success in a competitive market. To sustain that success, the company has made a series of strategic acquisitions. Now chief executive officer Jed Parker is faced with the possibility of accounting problems surrounding some of these deals—and the value of the deals themselves is even being called into question. Examine the facts presented for Rising Star and determine the course of action you believe Mr. Parker should follow.

Background

Jed Parker, CEO of Rising Star, Inc., wished Quinn Walker would just go away, and take his “bean counter” problem with him. The thought raised a twinge of guilt. Despite his irritation, he knew Quinn was simply doing his job.

As chief financial officer of Rising Star, the online discount retail company Jed had founded 14 years earlier, Quinn had always been zealous in his oversight of finance, strategic planning and mergers and acquisitions. Jed was sure part of Rising Star's success was due to Quinn's deft handling of everything from analysts to write-offs.

He was equally sure that his own contribution to the success of Rising Star was that he had the vision needed to take the company into the future. He loved making deals, not getting bogged down in the details. And a merger between Rising Star and RGL, Inc., one of the biggest name-brand franchisers in the country, was the deal of all deals. Or it would be, if he could concentrate on pulling it all together, instead of being distracted by accounting issues.

But he'd promised Quinn half an hour of his time, and he was a man of his word. More than slightly impatient, but still a man of his word. He stifled his annoyance and tuned back in to the conversation.

“Rennie Conway may be the greatest thing since broadband Internet access,” Quinn was saying. “But I don't think she has the strategic insight we need in a board member. She's too obsessed with the details.”



Jed steepled his fingers. Lauren ‘Rennie’ Conway was the newest member of Rising Star’s audit committee. A retired CPA and the wife of a noted philanthropist, she’d brought to the position her experience from a long career in public accounting. Jed had thought her expertise would mesh well with Quinn’s, but the two of them had clashed from day one. After three months, Jed was tired of trying to mediate their arguments.

“Seems like you’re not giving her a chance, Quinn,” he said, eyeing his CFO. “Rennie’s probably still trying to get a handle on everything.”

Quinn shook his head. “All she’s trying to do is drive me crazy. She’s going over past financials with a fine-tooth comb, examining every item and questioning me over nickel-and-dime issues. In a multi-billion dollar industry like ours, that’s no way for a board member to act. She may know accounting, but she has no business sense.”

Jed thought Quinn’s complaints sounded exactly the same as they had the last two times Quinn had come to him grumbling about Lauren Conway.

Instead of voicing that opinion, he said, “I don’t like personality conflicts between my board and my executives, Quinn. They tend to get aired publicly. And Arnie tells me that Rennie’s appointment to the board was looked on very favorably by Wall Street.” He paused, thinking about the conversation he’d had with Arnold Hall, one of six analysts who followed Rising Star stock. “You know how I feel about that, Quinn. I expect you to keep the analysts happy.”

“They’ve been happy,” Quinn protested. “Rising Star has met or exceeded earnings expectations every quarter. That’s why I’m so concerned now. Rennie Conway is talking about lowering our expectations for next quarter.”

“She wants to do what?!” Startled out of his impatience, Jed stared at Quinn.

His CFO nodded. “Yep. That’s what she said. I told her we couldn’t do anything that gets Wall Street concerned. And missing an estimate would sure do that. We upset the analysts, and the stock price goes down, reducing our market cap. That’ll trigger more selling, making the stock price go down again. And on and on. You get the picture. The overall effect is that we lose our ability to get financing to pursue merger opportunities.” Quinn paused. “But Rennie’s going to be hardheaded about this, Jed. She thinks we need to hold off on any more mergers until we make sure we haven’t made any mistakes in the way we’ve handled the ones we’ve already completed.”

“What’s wrong with the way we’ve handled them?” Jed wanted to know.

“That’s what I asked her,” Quinn replied. “We follow accounting rules. Our auditors have never had any complaints. But Rennie says that we’re manipulating earnings, because most of the growth in Rising Star’s earnings has been generated by the acquisitions. You know we’ve been growing faster than the industry average, Jed. Well, Rennie thinks that in order to keep up the current growth rate, we’ll have to take on more and more



acquisitions, and that kind of strategy will lead to too much risk. In fact, she thinks Rising Star is at risk already--that we've paid too much for some of the companies we bought, and we can't possibly deliver value to our shareholders."

"What do you think she's basing that on, Quinn?"

"Probably the last merger," Quinn said, without hesitation. "Our post-integration efforts have fallen a bit behind our original plan. It's taken longer to combine our product lines and merge the administrative systems than I expected. But the window of opportunity to obtain those synergies hasn't closed yet. I'm confident that acquisition can still deliver value."

"Does Arnie think we can still meet the target we set?" Jed asked.

"He does," Quinn said. "But Rennie's obsessed with this. I'm warning you, Jed, she's going to cause us problems."

"That's not what I want to hear, Quinn. This is a critical time for Rising Star. We're growing, and mergers are our best option to stay with that trend. Our future looks way too bright for petty problems to jeopardize my plans. You and Rennie Conway are just going to have to work this out."

"Well, *I'm* trying." Quinn's tone was stiff. "But I'm telling you, Jed, she acts like she thinks I've been negligent in my handling of the books."

"Really?" Jed steepled his fingers and looked at his CFO. "Did she mention anything specific?"

"Well, no," Quinn admitted. "I guess maybe I'm just a bit paranoid because it's been difficult to keep our internal controls in place with the growth we've been experiencing."

Jed grinned. "You, paranoid? Never! But I'm sure that Rennie doesn't think you've been negligent. After all, I made it clear when she joined the board that I trusted you completely. She's probably just trying to understand everything we've done lately. As you say, with all the acquisitions, it's gotten a bit confusing."

"True," Quinn admitted again. "But the new management information system should take care of that, once we get the final bugs worked out. I expect it to be completely on line within the next week or two."

Jed nodded. "More than likely, this whole thing is a misunderstanding. There's never been a question about our earnings and the way they're growing." He glanced at his watch. "Sorry to rush you, Quinn, but I have a lunch appointment with Reilly Lippert."

Immediately interested, Quinn leaned forward. "You working on the merger with RGL?"



“Not officially,” Jed replied with a grin. “But you know my motto.”

“Yeah, I know.” Quinn chuckled. “I know, because it’s my motto, too. A merger a year keeps Rising Star a rising star.”

It wasn’t just a motto, Jed thought as he headed for the restaurant and his meeting with Reilly Lippert. It was the truth.

His vision had always been to bring together technology and retailing. He’d finally hit upon the idea of becoming the online middleman between manufacturers and consumers. At the Rising Star Web site, people could sign up and pay a fee for access to discounted merchandise. By charging membership fees instead of making a profit on product mark-ups, Rising Star was able to keep prices low enough to be competitive with more traditional discount stores. Not having to build warehouses or buy expensive real estate had allowed him to put money where it counted--in computer systems and a Web site that delivered what was promised.

The concept had taken off beyond his wildest dreams. Customers loved the convenience of at-home shopping when it was safe, reliable and inexpensive, and Rising Star had become profitable early on. The company had gone public when it reached the milestone of more than a million items for sale on its Web site.

But growth had slowed a bit after that, and Jed began acquiring other companies in an effort to offer more products so Rising Star could continue to show increasing earnings. Now he was convinced that to keep Rising Star on the cutting edge, he needed to add brand name merchandise and services to the mix. He wanted Rising Star to expand into a more up-scale market.

RGL, Inc. was the perfect solution. The company owned nationally known rental car, hotel and real estate franchises. Jed believed a merger with RGL would position Rising Star to challenge--and overtake--large, established traditional retailing companies.

The thought had him smiling to himself as he walked into the restaurant. Not that he needed the money another expansion would bring. His stock in Rising Star had made him a millionaire several times over. No, he wasn’t smiling over making more money. He was smiling because his vision of an ever-brighter future for Rising Star was finally turning into reality.

The Problem

He found himself smiling again as he strode into Rising Star’s corporate headquarters two hours later. He and Reilly Lippert had done a bit of verbal fencing, but Jed had come away from the meeting with a sense of accomplishment. Reilly was definitely interested. They’d both decided to approach members of their respective boards. Even though Jed felt the asking price was high, he believed the scale economies and increased market power made it worthwhile. He was ready to make the next move. He’d had the steps planned for weeks.



He was so lost in thought as he entered his office that he nearly jumped when Lauren Conway said, "I'm glad you're back. I need to talk to you."

"About what, Rennie?" Jed settled warily into his chair, his euphoria vanishing. "Accounting stuff?"

She returned his look without a trace of humor. "You might say so. Specifically, about mergers, and how I think Rising Star is letting earnings-report considerations drive its timing."

He'd already heard enough. He said, "Then you really need to talk to Quinn."

"Oh, no," she said firmly. "Quinn and I don't talk, we argue. He's very territorial and extremely defensive."

"He has a right to feel that way." Jed felt obligated to defend Quinn, though he knew she was right. "He helped Rising Star grow from next to nothing to where it is today."

"That may be," Rennie said. "But I'm not entirely comfortable with some of the accounting decisions that have brought us to this point. For example, I think we've been overly generous with our estimates of merger reserves."

Jed frowned at her, remembering what Quinn had told him earlier about Rennie's suspicions. "What exactly are you saying, Rennie? Do you think there's something wrong with the way Quinn's been handling the books?"

Rennie shook her head. "Not at all. Quinn is very good at his job. But, I know accounting, Jed, and the way Rising Star has been buying earnings with these acquisitions bothers me." She held up a hand when he would have interrupted. "Hear me out, please. I understand earnings management. I even admit that many of the companies Rising Star bought in earlier years have been profitable because they bring in more income than it costs to finance the purchase. But I've analyzed the numbers, Jed. Lately our returns on those assets have been slipping. The problem is that every time Rising Star makes another acquisition, we've had to pay a higher premium. The cycle is never-ending. Higher costs lead to lower earnings, which means more acquisitions in order to keep up with expectations. And because all that's left to buy are marginal companies, some of those acquisitions aren't necessarily good business deals. They're just means of increasing earnings to meet analyst's expectations. Which I do admit we've done."

She leaned forward. "I know you're having merger talks with RGL, Jed. But I think we should concentrate on growing our core business to meet expectations. Instead, we're financing our future with earnings that will cost more than the value they bring. Shareholders expect--and I think, deserve--solid earnings growth, not smoke and mirrors. I believe Rising Star should have a financial discipline we can all be proud of."



She stood. "Please think it over before you decide to take the talks with RGL any further."

The Dilemma

As the door swung gently closed behind Rennie, Jed thought about what she'd said. It was true that the cost of purchasing companies had grown. He suspected it might also be true that Rising Star had overpaid for a few of the companies they'd acquired. But he had agreed with Quinn that meeting growth and earnings expectations was important. And he'd always felt he was making good deals.

Comments on "Is it Okay to Buy Earnings?"

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Dan's practice is limited to consulting services, including litigation involving accountant's malpractice issues. His most recent book is Audit Committees: A Guide for Directors, Management, and Consultants (Aspen Law & Business).

"There is nothing inherently wrong in aggressively making mergers and acquisitions (that is, buying earnings via acquisitions)."

Rennie Conway, as a director of Rising Star, Inc., and a member of its audit committee, has a legitimate concern about certain risks and whether they are being properly controlled and managed. There is nothing inherently wrong in aggressively making mergers and acquisitions (that is, buying earnings via acquisitions). However, when companies engage in such activities, there is an increase in business, information systems and financial statement risk. In fact, if such risks are not identified and controlled, the risk associated with earnings management and financial statement manipulation (that is, cooking the books) significantly increases. Therefore, a vigilant audit committee member should ask penetrating and probing questions about whether those risks have been identified, whether appropriate controls have been implemented and if those controls are working effectively. These questions should be presented to and discussed with chief financial officer Quinn Walker, the chief executive officer and other members of the management team, the internal auditors and the external auditors.

A business combination usually requires the establishment of an accounting estimate for restructuring charges (that is, a merger reserve). Merger reserves cover one-time, merger-related costs, such as legal and other professional fees, anticipated losses on asset impairment and disposals, and expenses to integrate, consolidate, relocate and eliminate redundant operations, including provisions for employee termination. In purchase accounting, the debit is usually made to "goodwill" and a credit is made to a balance sheet liability account to establish a merger reserve.



Of course, the merger reserve is a complex accounting estimate and actual costs will probably differ from estimates. In purchase accounting, after one year, any change in the merger reserve should be reflected in the company's income statement. Any material modifications to previously established merger reserves should be disclosed in the financial statement footnotes. In no case should merger reserves be manipulated to enable a company to meet Wall Street earnings projections.

One of Rennie's apparent concerns is that past merger reserves have been high, perhaps even overstated. Therefore, she naturally would want an accurate accounting to write down any excessive reserves, including a restatement of past financial statements if misstatements were made when the merger reserves were established. She would want assurances from management and the auditors that under no circumstances were the excessive charges simply taken into income to bolster income to meet forecasts. Furthermore, she would want to make sure that management has implemented appropriate controls to prevent future mistakes in estimating merger reserves.

Consequently, Rennie has a valid concern that Rising Star should address. The company should analyze the merger reserves created in prior years to determine if they were properly established, used and adjusted. Based on that analysis, new or improved controls should be implemented to minimize the risks that could cause financial statement misstatements due to fraud or error. In the meantime, the board of directors should address her concern about overpaying for acquisitions and use the opportunity to examine the company's acquisition strategy.

As Quinn and Jed Parker mull over Rennie's concerns, they should be mindful of their primary responsibility for the fairness of Rising Star's financial statements. In other words, it is imperative that they believe to the best of their knowledge that the financial statements are fairly presented in accordance with generally accepted accounting principles. This responsibility is evidenced by the fact that both Parker and Quinn will have to sign a management representation letter, which is addressed to the external auditor, as required by generally accepted auditing standards. The management representation letter explicitly states that Parker and Quinn believe the financial statements are fairly presented in accordance with GAAP. Moreover, the letter explicitly states that they believe that significant estimates (for example, merger reserves) have been properly recorded and disclosed in the financial statements.

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Author’s note:

The commentary below represents my own personal views and observations.

This story is fairly typical of the high-tech, Internet market during the end of the 1990s and into 2000. Investors seemed to shower start-up companies with capital to fund the visions of entrepreneurs who were truly pioneering the electronic information era. The voracious appetite for capital at companies such as Rising Star led management to promise investors what they wanted to hear--revenue and earnings growth. For a while it seemed that other fundamentals, such as return on investment and payback period, were no longer interesting or requirements for garnering capital.

Someone once described this period as a type of “Western land grab,” reminiscent of the days where more land--regardless of quality--was considered essential. Doing deals, and “growing” by acquisition, was standard operating procedure. Since the capital was flowing in the front door, those making the deals believed they could pay a premium just to beat the other bidders. These deals were also typically based on multiples of revenue growth, and ignored profitability and cash flow. Once the capital flow stopped, many of these companies found themselves highly leveraged and still burning cash.

Lauren Conway offers sound advice to the chief executive officer. Solid earnings growth is critical to increasing shareholder value. Too many acquisitions in a relatively short time can cause tremendous downward pressure on earnings growth. I believe that the capacity to integrate acquisitions diminishes as the number of acquisitions increases and diminishes exponentially as the span of time condenses.

If companies buy earnings to avoid disappointing analysts, they are not avoiding the disappointment but merely postponing it.

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Jed Parker should proceed, as planned, with negotiations to acquire RGL. He should, however, be establishing acquisition criteria, which should be reviewed with his board. These criteria, which should not be inviolate if an acquisition is a strategic imperative, would establish board-approved financial objectives that an acquisition should meet. They should address questions such as:

- How much earnings-per-share dilution is the company willing to incur, if any, in the first and second year?
- What is the company's leverage target, and what is the maximum leverage that the company is willing to incur? This leverage target should be both balance-sheet and earnings-coverage oriented, and should be designed to protect a minimum debt rating.
- What is the company's minimum goal for return on invested capital on capital projects, including acquisitions? How quickly must this goal be achieved?

In addition, Jed needs to educate his board about how analysts view the company's earnings prospects. For example, what are Wall Street's expectations for organic growth and margins? Do analyst projections include or exclude future unspecified acquisitions? If they include them (a highly unlikely prospect because the timing of acquisitions is unpredictable), Rennie Conway is overreacting that somehow the company is "buying earnings" to meet expectations. If, on the other hand, analyst expectations do not include future acquisitions, Rennie is still probably overreacting because their models will be adjusted once the terms of a merger are announced.

Jed needs to follow up with the company's outside auditors to determine whether they believe his chief financial officer has been overly aggressive in establishing so-called "merger reserves." Further he needs to ask if there has been any inappropriate use of such reserves. He should adopt a strict policy with respect to such items.

Finally, he needs to have a private meeting with Rennie Conway to review all of the above issues. If she has concerns, they should be discussed at a future board meeting.

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Executive Summary

Jed Parker and Quinn Walker are allowing their desire to achieve a set goal--to meet or exceed financial analysts' earnings expectations--to influence the decision on whether continued mergers and acquisitions are in the best interests of the company and its stakeholders. Rennie Conway, a member of the audit committee, attempts to slow down the process by pointing out to Parker, the chief executive officer of Rising Star, Inc., that the company is managing earnings. She worries that the cost to acquire a company is increasing and future earnings are in jeopardy. The result may be to acquire more and more companies just to keep up with analysts' estimates of future earnings.

Parker suggests that Conway should back away from current discussions with RGL on a merger and "should concentrate on growing our core business to meet expectations."

Stakeholders and Interests

The main stakeholders include the shareholders, financial analysts, Jed Parker and Quinn Walker and the company. The shareholders are of primary importance since they provide the funds that enable the company to continue its merger activity. Moreover, the value of their stock investment is at risk because future share prices may decline if the return on acquired assets continues to drop and the cost of taking over other companies continues to rise. The shareholders' best interests are not served by artificially increasing profits through designed merger and acquisition activity that masks true operating results.

Ethical Concerns

Jed Parker and Quinn Walker are in a difficult position. On the one hand, they believe that their responsibilities to the stockholders include meeting or exceeding earnings estimates, thereby satisfying the financial analysts and keeping stock prices high. On the other hand, they are aware of the increasing problem of maintaining efficient internal controls and reliable management information systems while expanding their operations.

Parker seems to be genuinely concerned when Conway says that the best interests of the shareholders are not served by jeopardizing the quality of earnings.

The stockholders' right to receive accurate and reliable financial information that portrays the true operating results of Rising Star is at risk. The company's reliance on mergers to create earnings to meet analysts' forecasts brings into question the predictability of future earnings, since the number of sound acquisition candidates is diminishing. The company appears to be caught up in a spiraling cycle of acquiring other companies to keep earnings levels high even though there may not be a sound business reason for such actions.

The company should honor the audit committee's rights to be involved in the advisory process on mergers and acquisitions. When Conway approaches Parker on her own, she fails to recognize the important financial reporting oversight role of the entire committee.



Alternatives

Parker has a variety of alternative courses of action. He can continue merger discussions with RGL, back away from additional acquisitions until the company's internal systems can be strengthened or bring the issue to the audit committee. As CEO, he has an ethical obligation to the stockholders to exercise due care in carrying out his responsibilities. The stockholders place their trust in top management to make decisions that are in the company's best interests. Conway has exercised due diligence as a member of the audit committee in questioning the company's continued merger activity. The best alternative is to hold off on future acquisitions until the entire audit committee can discuss the effects on current and future earnings and the company can upgrade its internal controls and management information system.