

## A Case Study: Earnings Manipulation And The Role Of The Media by Rick Wayman ([Contact Author](#) | [Biography](#))

This article is a case study on the potential for earnings manipulation under [GAAP](#) and the role of the media in post-Enron Wall Street. We'll focus on the decision of Cardinal Health, Inc. (NYSE:[CAH](#)) to record income from a settlement before its was finalized, and question why this event became such a hot topic in the news.

### Overview

Cardinal Health, Inc. was involved in [antitrust](#) claims against certain vitamin manufacturers for overcharging CAH in prior years. In three earnings quarters between December 2000 and June 2002 (spanning two fiscal years), CAH recognized amounts from the settlement into income before a final settlement was signed. An article in the April 2, 2003, issue of *The Wall Street Journal* implied that CAH recognized these amounts in order to meet [consensus](#) earnings estimates. (To read further on earnings, see [Can Earnings Guidance Accurately Predict The Future?](#) and [Target Prices Vs. Ratings.](#))

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For the Joe Friday investors, here are the facts. The amounts of the settlement were recorded in three quarters as follows:

- December 2000 [10-Q](#): \$10 million (about \$0.015 per share) was recorded but the amount was not disclosed and no other details were provided.
- September 2001 10-Q: \$12 million (about \$0.017 per share) was recorded, and a statement in [Management's Discussion & Analysis](#) noted the "recording of a minimum recovery expected to be received for claims against vitamin manufacturers...", but neither the amount nor other details were disclosed.
- June 2002 [10-K](#): An additional \$13.3 million (about \$0.19 per share) was recorded (to reflect the full award) and previously recorded amounts were detailed.

There are two things to be noted from this set of circumstances:

- First, the actual amount received (\$35.3 million) was much higher than the amounts recognized prior to June 2002 (\$22 million), which could be viewed as evidence of CAH's conservative treatment of the expected gains.
- Second, until June 2002, investors did not have any information to evaluate the accounting decisions or determine the per share impact. According to CAH, the company did not disclose most of the details until the 2002 10-K for two main reasons: first, the company did not want to let the defendants know what they expected to receive, and second, from the company's perspective, the amounts were relatively immaterial.

### The Certainty Test

Whether the legal cases had reached a point where results were certain is possibly the most uncertain

aspect of this case. Generally speaking, conservative accounting requires that potential awards from litigation not be recorded until the deal is finalized and the papers are signed.

However, because the courts had found the defendants guilty and those corporations had the financial capability to pay the expected amounts, CAH's attorneys and accountants felt that these antitrust claims had reached a point where there was a reasonable degree of certainty that funds would be received. Consequently, under GAAP's matching principle, the amounts had to be recorded in the quarter in which it was deemed that the amounts were certain. (It should be noted that CAH's auditor at the time was Arthur Andersen.)

### **The Materiality Test**

[Materiality](#), however, is a concept that has been debated for some time. For a while, it was common practice under GAAP that anything less than a certain percentage (for example below 5%) was considered immaterial and did not have to be disclosed. Companies would otherwise have to discuss everything and the [SEC](#) filings would be extremely long and hard to read. More recently the definition has shifted to anything that can be reasonably expected to move the market, which is difficult to determine because that which moves the market can only be determined after the fact.

To many investors and at least to the Street, a penny or two is material and can be expected to impact a stock's price. From a corporate point of view, the amounts recognized do appear to be relatively immaterial. The total amount recognized (\$35.3 million) amounts to 0.1% of total 2002 [revenues](#), 3.2% of total 2002 [net income](#) and 2.6% of 2002 [earnings per share](#) (EPS).

The *WSJ* article implies that CAH recorded the gains in order to meet earnings expectations but, if earnings manipulation was the intent, a company as large as CAH has many opportunities to fudge a couple cents and still be in compliance with GAAP. As such, this issue may be one of those gray areas in GAAP where a full knowledge of the details is necessary in order to evaluate the accusations.

Even if CAH was aggressive in recognizing the awards, the amounts recognized early fell short of the total amount awarded to the company, which indicates that the company was somewhat conservative in terms of forecasting the expected claim. CAH recognized \$10 million and \$12 million in the quarters ending December 2000 and September 2001, respectively. The actual award was \$13 million more, which was recorded in June 2002.

### **The Verdict**

Any big company has a large amount of discretionary spending that can be used to manipulate earnings. A cynical investor could focus on any one of a number of discretionary items to make an earnings manipulation claim against any large company. To determine whether a company is manipulating earnings, investors must consider the overall corporate ethics. To do this, you need to look at how the company has reacted to ethical issues and the level of detail in corporate filings.

In CAH's case, it is difficult to prove beyond a reasonable doubt that the company's goal was to manipulate EPS. The company's filings indicate that the company has consistently provided a good level of detail as required under GAAP. A full accounting of how the vitamin settlement was recorded was provided in the 2002 10-K.

It is important to note that this issue has arisen in an environment that is quite different from the one in which the decisions were made. In today's post-Enron Wall Street it is easy to second guess and say that the company should not have recorded anything unless it was ready to fully disclose the details. At the time the decisions were made, however, the company acted in accordance with current regulations and on the advice of its lawyers and accountants.

### Why Now?

Regardless of whether you think CAH is guilty, it is curious that this event became such a big news item nearly two years later. There are at least two reasons why this item made the *WSJ*:

- The [shorts](#) were scared. The stock had been in a steep downtrend since November 2002 but started to rally March 14. It is conceivable that the shorts may have been attempting to get bad news into the press in order to salvage their positions (in which case this was unsuccessful because the stock continued to rally).
- The media was in full witch-hunt mode. Just like the market at the time, the media had shifted from [bull](#) to [bear](#). Articles about how orphaned small cap stocks, which are not followed by any analysts, are posting impressive gains do not sell like stories about "another Enron". While these stories are very helpful because they educate investors by focusing on critical issues, their perspective is distorted and sometimes do a disservice to the subject company.

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