THE CONVERSATION

Some answers, more questions over Dick Smith failure

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A report into Dick Smith's failure is damning. AAP/Joel Carrett)

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In their report on the demise of Dick Smith, McGrathNicol liquidators pinpointed dubious accounting methods that are known in the industry as "real activities management".

The practices, involving manipulating sales figures and stock inventories saw Dick Smith purchasing excessive amounts of inventory in order to fill their rapid expansion of stores and bank rebates from suppliers to boost earnings.

The origins lie in Dick Smith's transition from a subsidiary of Woolworths to its listing on the Australian Stock Exchange. This took only a year but the private equity owners of Dick Smith, Anchorage Capital, were able to realise a high price when the firm was listed, making a significant profit from the deal. And this is where the seeds of failure were likely sowed.

Investments by private equity are always undertaken with the aim of rapidly increasing the value of the firm. This is done through selling non-core assets, discontinuing non-profitable business segments and looking to improve efficiency in the remaining business.

These remaining businesses are then sold as profitable - and perhaps most importantly - growing businesses. In the case of Dick Smith, prospective owners were attracted to the IPO with an expectation of a growing business. This ensured that directors placed enormous demands on management and pressure on staff to purchase excessive inventory.

This strategy is likely linked to its float on the ASX last year, providing directors with incentives to pursue aggressive growth that led to increases in floor stock as well as in its warehouse.

There is an extensive accounting research literature that refers to these actions as "earnings management" (EM) and in this particular case a variation of EM known as "real activities management" (RAM).

RAM is a manager's divergence from standard operational behaviour involving the structuring of transactions that will alter financial results in order to potentially mislead the users of financial reports.

It involves activities such as the "myopic" reduction of research and development expenditure, timing of the sale of fixed assets, price discounts to meet short-term earnings targets, and overproduction that generates excess inventory in order to lower the cost of goods sold. Initially, the financial results of RAM are positive, but down the track have a negative impact.

Unfortunately, RAM is difficult to detect or measure as it is easily disguised in normal day-to-day business activities. It is not based on the interpretation of the accounting standards and corporations law, and instead involves the use of "legitimate" transactions. Both traditional EM and RAM lower the overall value of the firm in the longer run.

All EM activities tend to intensify for companies in financial distress. Strategies viewed as previously risky may be contemplated. Companies have greater incentive to therefore manipulate accounting policies to temporarily increase operating income to evade default on debt contracts and to improve results to avoid additional monitoring of shareholders.

Despite it being seen as inherently risky, a 2005 survey study by John Graham, Campbell Harvey and Shiva Rajgopal indicates that RAM is a preferred EM tool for management to attain earnings benchmarks. Their study sites numerous examples of RAM.

Almost 80% of the CFOs surveyed indicated that, in order to meet an earnings target or “smooth” earnings, they would decrease expenditure on R&D, advertising, and maintenance, while 50% said they would postpone a new project, even if such delay caused a small loss in firm value. Plus, the incentives to undertake such activities increase in businesses that are financially distressed.

If one subscribes to the conclusions within accounting research, the Dick Smith strategy was always going to be a dangerous one, with the incentive for management to maintain only likely to increase, as the group’s financial distress intensified.

Dick Smith’s core business of disposable consumer electronics (such as computers, mobile phones, televisions, sound systems) is extremely competitive, has low profit margins, and inventory has notoriously short shelf life.

Subsequently, Dick Smith wound up carrying a lot of inventory that was worth less than they could sell it for. Although their suppliers offered discounts and rebates that were designed both to aid marketing and provide customer discounts, Dick Smith instead used their supplier rebates to over-inflate their sales figures.

However, with wafer slim product margins to start with, they were now making real losses. These “rebated sales” were never going to be enough to supplement the retail cash flows that management needed for a sustainable business and had budgeted on.

The company’s auditors, Deloitte questioned these rebates as far back as September 2015, and by October Dick Smith needed to write down inventory by $60 million because they carried too much in obsolete stock. Their share price was always going to suffer from this, which made it even more likely that Dick Smith would breach their debt covenants with the banks.

In the end, they simply paid too much for inventory that they couldn’t sell profitably and their subsequent cash flow shortage made them insolvent. Ultimately, although employee benefits have been paid in full, it appears to McGrathNicol that there is a likely creditor shortfall of around $260 million.

This raises a number of questions of both management and the auditors. While Deloitte realised that inventory was over-valued, how did they (and Dick Smith directors) justify their decision to value the company as a “going concern”?

When did Deloitte advise the directors of control weaknesses in their management control systems that allowed managers to manipulate sales figures and stock purchases to meet budget expectations rather than manage the business to real market demand? Were the directors trading while Dick Smith was insolvent?

These questions will need answers. The Dick Smith saga is far from over.