Harnischfeger corporation assignment

ASSIGN BUSTER

Harnischfeger Corporation Teaching Note INTRODUCTION The purpose of the " Harnischfeger Corporation" case is to expose students to the managerial motives for making major financial reporting policy changes. Generally accepted accounting principles (GAAP) allow companies wide latitude in the choice of accounting policies. After a firm chooses a set of accounting policies, current accounting rules permit changes from one alternative policy to another at the discretion of the management.

Since reported accounting figures are widely used by a number of external parties, managers of firms have incentives to choose accounting policies in order to influence the behavior of these parties. A variety of managerial motives for accounting policy decisions have been identified in the accounting literature. The Harnischfeger case is designed to encourage students to explore these motives. Harnischfeger Corporation, a large New York Stock Exchange company, faced a financial crisis in 1982. New management was appointed to turn the company around.

As part of its restructuring strategy, the new management team made a number of financial reporting policy changes in fiscal 1984. Together, these changes accounted for most of Harnischfeger's reported 1984 profits. More significantly, these changes represented a substantial switch from the company's earlier conservative reporting philosophy to a more aggressive one. The case describes the company's financial crisis, the turnaround strategy of the new management team, and the accounting policy changes that took place in 1984. This case is a by-product of my field research, which is described in the paper, " The Anatomy of an Accounting Change. This paper is published in Accounting and Management: A Field Study

Perspective, edited by William Bruns and Robert Kaplan (Harvard Business School Press, 1987). This teaching note was prepared by Krishna G. Palepu. Copyright (1987 by the President and Fellows of Harvard College. Harvard Business School teaching note 5-187-152. This case can be used in several different ways. At the Harvard Business School, the case has been used as part of a module dealing with the accounting policy decisions of firms and the stock market's ability to " see through" these decisions.

The sample assignment described below assumes that the case is used by itself in a second-year MBA course on financial statement analysis or a course on financial reporting. QUESTIONS FOR STUDENTS The following set of questions are in the textbook and are designed for use in a class where the instructor prefers to provide a minimum level of structure to the students: 1. Identify all the accounting policy changes and accounting estimates that Harnischfeger made during 1984. Estimate, as accurately as possible, the effect of these changes on the company's 1984 reported profits. 2.

What do you think are the motives of Harnischfeger's management in making the changes in its financial reporting policies? Do you think investors will see through these changes? 3. Assess the company's future prospects given your insights from questions (1) and (2) and the information in the case on the company's turnaround strategy. For instructors who prefer to use a more structured approach to teaching the case, the following questions will guide students through the material: 1. Describe clearly the accounting changes Harnischfeger made in 1984 as stated in Note 2 of its financial statements (pages 212-213 of the text). . What is the effect of the

depreciation accounting method change on the reported income in 1984? How will this change affect profits in future years? 3. What is the effect of the depreciation lives change? How will this change affect future reported profits? 4. The depreciation accounting changes assume that Harnischfeger's plant and machinery will last longer and will lose their value more slowly. Given the business conditions Harnischfeger was facing in its primary industries in 1984, are these economic assumptions justified? 5.

In Note 7 (pages 215-216), Harnischfeger describes the effect of LIFO inventory liquidation on its reported profits in 1984. Describe what is meant by LIFO liquidation, and how liquidation affects a company's income statement and balance sheet. 6. Note 8, page 216, states Harnischfeger's allowance for doubtful accounts. Compute the ratio of the allowance to gross receivables (receivables before the allowance) in 1983 and 1984. What would the allowance have been if the company maintained the ratio at the 1983 level? How much did the pre-tax income increase as a result of the changed ratio in 1984? . Note 9, page 216, states that Harnischfeger decreased its R&D expense in 1984 relative to the previous two years. Do you think this change was motivated by business considerations or accounting considerations? How did this change affect the company's reported profits in 1984? 8. Note 11, pages 216-217, describes a number of changes in Harnischfeger's pension plans in 1984. Describe these changes as clearly as you can. What are the economic consequences of these changes to Harnischfeger and its workers? 9. How did the pension plan changes affect Harnischfeger's financial statements in 1984?

Are these changes likely to affect future profits? 10. Summarize all the accounting changes Harnischfeger made in 1984, and their effects on pre-tax profits and cash flows in 1984. 11. Accounting statements are used by investors, lenders, customers, employees, and governments in dealing with Harnischfeger. Among these groups, who is most likely to " see through" the above accounting changes, and who is least likely to do so? 12. Are the accounting changes likely to help or to hinder Harnischfeger's ability to implement its business plan? Be as specific as possible. 3. Overall, what is your assessment of Harnischfeger's future as of 1984? Handout: (To be handed out at the end of the class.) Krishna Palepu. " The Anatomy of an Accounting Change. " In Accounting and Management: A Field Study Perspective, edited by William Bruns and Robert Kaplan. Boston: Harvard Business School Press, 1987. CASE ANALYSIS AND TEACHING STRATEGY I begin the class by mentioning the following recommendation of a leading Wall Street investment house on Harnischfeger's stock just prior to the release of the company's 1984 Annual Report:

We recommend the stock of Harnischfeger Corporation for purchase in speculative accounts because we expect the company to report a modest profit this year and untaxed earnings of $3. 00 per share in 1985, following ten years of deteriorating financial statements and two years of large losses. Earnings power, assuming a sustained recovery of the company's markets, could be $4. 00-$6. 00 per share in the 1986-87 time period. The Harnischfeger stock is selling at less than three times these peak earnings (were they taxed) and at a slight discount to book value.

I ask how many students would follow the above investment recommendation and invest in Harnischfeger's common stock after seeing the company's 1984 Annual Report, and then I take a vote. This gets the class thinking about the overall effectiveness of the company's strategy and its financial accounting decisions. My experience has been that most of the students are skeptical about the company at this point and therefore would not want to invest in the company's stock. I start the discussion by calling on one of these students and asking him or her to evaluate the company's 1984 profit performance.

The few students who want to invest in the company provide an interesting counterpoint of view and should be called on later in the class. Discussion of Question 1 Harnischfeger's accounting decisions account for a large portion of the company's reported profits in 1984. Students identify a number of these decisions and their profit impact. 1. The depreciation method was changed from accelerated to straight-line, applied retroactively to all assets. The cumulative effect of this change, not including the reduction in the current year's depreciation expense, increased after-tax net income for 1984 by $11. 05 million. The company did not report the reduction in the depreciation expense in 1984 due to this change. (See Exhibit 4, Note 2, in the case.) 2. The company also changed its estimated depreciation lives of certain US plants, machinery, and equipment, and the estimated residual values of certain machinery and equipment effective the beginning of the fiscal year 1984. This change increased the pretax reported profit by $3. 2 million. Since the company paid no domestic federal income taxes in 1984, after-tax income also increased by the same amount. (See Exhibit 4, Note 2,

in the case. 3. During 1984, the company changed its rate of return assumption for determining pension expense. The rate assumed was 9% in 1984 compared to 8% in 1983 and 7. 5% in 1982. During the year, the company also restructured its pension plan and recaptured $39. 3 million in excess plan assets. The effect of the change in the rate of return assumption for the pension plan and the plan restructuring reduced the pension expense by approximately $4. 00 million in 1984. (See Exhibit 4, Note 11, in the case.) 4. The liquidation of LIFO inventories resulted in a net income increase of $2. million. (See Exhibit 4, Note 7, in the case.) 5. The company's provision for doubtful accounts receivables as a percentage of total receivables was 8. 4% in 1984. The corresponding percentage in 1983 was 11. 3%. If the company maintained the same percentage provision in the two years, the bad debt expense in 1984 would have been $1. 5 million more than the reported expense. (See Exhibit 4, Note 8, in the case.) 6. Effective fiscal 1984, the company changed the financial year ending from July 31 to September 30 for certain foreign subsidiaries.

Thus, the 1984 consolidated income statement of Harnischfeger included the results of 15 months of operations of these subsidiaries. This action increased 1984 net sales by $5. 4 million. The profit effect of this change was not reported. (See Exhibit 4, Note 2, in the case.) 7. The company's research and development (R&D) expense in 1984 decreased by $7. 0 million over the previous year. Most of this reduction was a result of the company's agreement with Kobe Steel, Ltd. Under this agreement, Kobe agreed to reimburse Harnischfeger up to $17. 0 million dollars of R&D expense over a period of three years.

However, some students argue that Harnischfeger may be cutting its research budget since the actual reduction in Harnischfeger's 1984 R&D expense is more than one-third of this amount. (See Exhibit 4, Notes 6 and 9, in the case.) 8. Effective 1984, Harnischfeger began to include in its net sales products purchased from Kobe Steel, Ltd. , and sold to third parties by Harnischfeger. Previously only the gross margin on Kobe-originated equipment was included in Harnischfeger's financial statements. This increased Harnischfeger's sales in 1984 by $28. 0 million but had no impact on its profits.

Some students would mistakenly argue that this had an impact on Harnischfeger's net income. (See Exhibit 4, Note 2, in the case.) Although some of the above are pure accounting decisions with no direct cash-flow consequences, the other decisions affect the company's reported profits as well as its cash flow. The instructor should ask the class to identify the latter-type decisions among the above. Discussion of Question 2 The above analysis shows that most, if not all, of the reported profits of Harnischfeger in 1984 are produced by accounting changes.

Therefore, the accounting changes helped the management report a significant profit rather than a modest loss. The instructor should point this out to the class and ask: Why do you think the management of Harnischfeger made these accounting changes? Students point out a number of possible motives for the accounting changes: 1. Boost the company's stock price so that the company could raise new capital, 2. Meet the earnings targets of the company's top management compensation plan, 3. Avoid the violation of debt covenant restrictions, and 4.

Improve the company's image with the customers, dealers, and prospective employees. Some students argue that the analysis in Question (1) shows that it is too complicated for an average investor to " see through" the impact of all the accounting changes. They further point out that, even if many analysts recognize the effect of the company's accounting decisions on the 1984 profits, it is quite unlikely that the analysts would be able to assess the impact of these changes in future years. Other students are likely to argue that the market processes the reported profit numbers efficiently.

They argue that there are some sophisticated analysts who could perform the analysis that was done in the class. The instructor should encourage this discussion. At some point in the discussion, the instructor should intervene and summarize the evidence from the research literature: 1. There is considerable evidence in finance and accounting literature that shows that the capital markets are generally efficient. 2. For stock prices to reflect reality in an unbiased manner, it is not necessary that everyone in the market has to process the information correctly.

As long as there are some sophisticated investors who can " see through" the company's accounting changes, the stock price will reflect this due to the possibility of arbitrage by these investors. 3. The accounting studies that examine the stock market reaction to accounting changes conclude that the market is not fooled by the accounting decisions of firms. However, the evidence presented in these studies is not conclusive. Also, these studies do not examine whether the stock market recognizes the recurring effects of accounting changes. Without additional research, it is difficult to make conclusive statements on this issue. . Even if capital markets see through the

effects of accounting changes, managers may believe otherwise in making accounting decisions. This is likely to happen if there are no significant penalties associated with such behavior. Even if investors fully recognize the impact of Harnischfeger's accounting decisions, there are other reasons for the company's managers to make these decisions. As Exhibit 2 in the case indicates, the top management of the company is awarded significant bonuses based on the company's reported profits. This provides an incentive for the managers to boost profits through accounting changes.

However, if the compensation committee of the company's board of directors recognizes this possibility, the committee could adjust the reported profits before awarding management bonuses. The instructor should challenge the students by asking: If investors can see through these changes from public information, why can't the board do it, especially when it has access to additional information in the firm? The third possible motive that is mentioned by the students is the desire of Harnischfeger's management to avoid the violation of debt covenant restrictions.

Since the company recently experienced the painful consequences of violating these restrictions, it is plausible that the management changed the accounting policies to avoid future violations of the debt restrictions. If debt covenants are specified in terms of accounting numbers, managers have an incentive to choose accounting policies to minimize the violation of the covenants. However, if lenders recognize this possibility, lending agreements would be modified to avoid this possibility as long as the cost of such a modification is not significant.

The fourth possibility is that the accounting decisions are motivated by a desire to convince the company's customers, suppliers, dealers, and employees that Harnischfeger is again back on track and is viable. Given the nature of the company's products, a lack of confidence in the company's viability is likely to impair the company's ability to sell its products. In fact, the company was negotiating long-term contracts in 1984 with the governments of Turkey and China. It is quite possible that the company's return to profitability might have helped the management in this respect.

Similarly, the company's ability to attract and retain talented employees might have been helped by the image that the company was back on track. During my visit to the company, Harnischfeger's management pointed out one additional factor in the company's accounting decisions: the role of internal management considerations. The company used the same set of accounting rules for external reporting and for internal management accounting. The company's product pricing was based on fully allocated product costs, and therefore its accelerated depreciation policies apparently caused its products to be overpriced relative to competition.

In addition, the higher depreciation charges led to increased capital reinvestment demands from its divisions for maintaining and replacing the company's fixed assets. The company's management mentioned three principal reasons for its accounting decisions: (1) a belief that the external users of accounting data did not adjust for Harnischfeger's conservative financial reporting when comparing the company's performance with other companies in the industry, (2) the unpleasant experience with its debt

covenant restrictions, and (3) the interaction between management accounting and external reporting.

These reasons are discussed in greater detail in my paper, “ The Anatomy of an Accounting Change. ” Underlying all the accounting changes was a reporting philosophy outlined by the then chief financial officer and the current president of the company: In accounting there is no such thing as absolute truth. The same underlying reality can be accounted for using a range of assumptions. The earlier philosophy of this company was to choose the conservative alternative whenever there was a choice. Now we have decided to change this. We would like to tell the world that we are alive and well.

We wish to tell the truth but do not want to be overly conservative in doing so. When the outside world compares our financial performance with that of other companies, they may or may not take the time and effort to untangle the effects of the differences in financial policies that various companies follow. My own belief is that people adjust for the obvious things like one-time gains and losses but have difficulty in adjusting for ongoing differences. In any case, these adjustments impose a cost on the user. If people adjust for the differences in accounting policies when they ompare us with other companies, then it should not matter whether we follow conservative or liberal policies. But suppose they do not adjust. Then clearly we are better off following the more liberal policies than conservative policies. I am not sure whether people make the adjustments or not, but either way we wish to present an optimistic version of the picture and let people figure out what to do with the numbers. As a company you have to put the best foot forward if

you want to raise capital, convince customers that you are a viable company, and attract talented people to work for the company.

I feel that the financial reporting should help rather than hinder the implementation of our operating strategy. In my opinion, the changed accounting format highlights the effectiveness of our strategy better than the old policies do. The instructor can sum up the class discussion on question (2) by mentioning the views of the management described above. Discussion of Question 3 After completing the analysis of Harnischfeger's accounting policy changes, the class should be asked to assess the company's future.

At this point, I go back to my original question to the class, namely, " Is it worthwhile to invest in the company's stock in early 1985? " I call on a student who considers the company's stock a good investment and ask him or her to explain why. Harnischfeger's turnaround strategy consists of four elements: (1) changes in top management, (2) cost reductions to lower the company's break-even point, (3) reorientation of the company's business, and (4) restructuring the company's finances to facilitate the implementation of the reorientation strategy.

The changes in the top management seem to be good. The new chief executive officer (CEO) has considerable experience in Harnischfeger's industry. The new CEO demonstrated his credibility with the financial community by successfully negotiating with the company's lenders to restructure the company's debt. The new management has taken several steps in the right direction. The company's cost-reduction programs seem to

be paying off. These programs were helpful in reducing the company's losses in 1984. The financial management of the company also seems to be sound.

The cost-reduction programs and the pension restructuring have improved the company's cash flow. The total cash-flow analysis, shown in Exhibit 1, indicates that the company has been able to generate positive cash flow from its operations in 1984. The company raised substantial new capital through a public offering of debentures and common stock and used the proceeds to pay off all of the company's restructured debt. Finally, the company's business strategy seems to be sound. The management recognized the potential to exploit the company's strength in the material handling equipment business.

Through its Harnischfeger Engineers subsidiary, the company planned to expand in this area and concentrate on the high margin " systems" business. This strategy is likely to help the company to move away from the mining and construction equipment business, which is a low-growth and cyclical industry, to a higher-growth and more stable business. Students who are optimistic about the company's future cite the above factors as the reasons for their support for the company and its management. They argue that these factors indicate that the company's new management has the right ideas and knows how to turn the company around.

These students suggest that the management's accounting decisions were part of its attempt to implement the company's strategy and are therefore constructive. The instructor should wrap up the case discussion by reviewing the company's motives for its accounting decisions. The instructor should

point out that understanding these motives is essential for an analyst who is interested in assessing the company's current performance and its future potential. The instructor may end the class by taking a second vote on the investment potential of the company's stock and sharing with the class the subsequent events described below.

SUBSEQUENT DEVELOPMENTS The following events describe the developments subsequent to the time of the case. As can be seen, Harnischfeger seems to have succeeded in implementing its strategy effectively. Also, the company continued to liberalize its financial reporting policies. 1985 1. The company changed its accounting for duration patterns and tooling. Previously, the cost of the patterns and tooling was expensed in the year of acquisition. Under the new method, these costs are capitalized and amortized over their estimated useful lives. 2.

Harnischfeger reported a net profit of $0. 74 per share for fiscal 1985. The accounting change described above contributed $0. 24 per share to the reported profits. 3. The company raised $147 million by issuing preferred stock. 1986 1. Mr. Goessel was appointed as the chairman and CEO of the company, and Mr. Grade was appointed as the president and chief operating officer (COO). Previously, Mr. Goessel was the president and COO, and Mr. Grade was the CFO. 2. Harnischfeger acquired Beloit Corporation, a producer of papermaking machinery and systems, for $175 million in cash.

Later in the year, stock equivalent to a 20% equity interest in Beloit was sold to Mitsubishi Heavy Industries, Ltd. , for $60 million in cash. 3. The company acquired Syscon Corporation, a firm based in Washington, DC for $92 million

in cash. Syscon developed advanced computer systems for military markets. 4. Harnischfeger announced a plan to sell the company's Construction Equipment Division for approximately $17 million in cash and $55 million in debentures. 5. The company reported that Harnischfeger Engineers received a major order for the design of an automated car assembly plant. . Harnischfeger reported a net loss of $1. 14 per share for fiscal 1986. This consisted of a profit of $2. 15 per share from continuing operations, a loss of $4. 45 per share from discontinued operations (Construction Equipment Division), and a gain of $1. 16 per share from the adoption of the new pension accounting rules. 1987 1. Harnischfeger received a takeover offer from Columbia Ventures, Inc. , for $19 per share in cash. The company considered the offer inadequate and rejected it. Exhibit 1Total Cash-Flow Analysis ($ in thousands) | 1984 | 1982 | 1981 | | | | | | | Working capital from operations | $ 2, 961 | $ 1, 763 | $ (55, 902) | |(Increase)/decrease in accounts receivable |(23, 908) |(5, 327) | 42, 293 | |(Increase)/decrease in inventories | 9, 282 | 56, 904 | 26, 124 | (Increase)/decrease in refundable income taxes and related interest | | | | | | 11, 289 |(2, 584) |(6, 268) | | (Increase)/decrease in other current assets | 259 | 10, 008 |(439) | | Increase/(decrease) in accounts payable | 16, 488 |(1, 757) |(3, 302) | | Increase (decrease) in employee compensation and benefits payable | | | | | | 698 |(15, 564) |(3, 702) | | Increase/(decrease) in accrued plant closing costs |(3, 888) |(14, 148) | 20, 496 | | Increase (decrease) in other current liabilities | (3, 181) | (15, 927) | (3, 030) | | Cash from operating cycle | $ 10, 000 | $ 13, 368 | $ 16, 270 | | Minus plant and equipment additions | (5, 546) | (1, 871) | (10, 819) | | Cash before dividends, investments, and external financing | | | | | |$ 4, 454 |$ 11, 497 |$ 5, 451 | | Minus cash dividends | 0 | 0

| (2, 369) | | Cash before investments and external financing | $ 4, 454 | $ 11, 497 | $ 3, 082 | | Minus advances to unconsolidated companies |(2, 882) | 0 | 0 | | Plus other | 269 | 1, 531 | 848 | | Cash before external financing | $ 1, 841 | $ 13, 128 | $ 3, 930 | | | | | | | External Financing: | | | | | | | | | Proceeds from senior notes and subordinated | | | | | Debentures |$ 120, 530 |$ 0 |$ 0 | | Conversion of export and factored receivable sales to debt | | | | | | 0 | 23, 919 | 0 | | Restructured debt | 0 | 158, 058 | 0 | | Debt replaced, including conversion of receivable sales of 23, 919 | | | | | | 0 |(158, 058) | 0 | | Repayments of debt |(161, 500) |(760) |(9, 409) | | Increase (repayment) of short-term bank notes payable | 2, 107 |(3, 982) |(2, 016) | | Other increases in debt | 1, 474 | 0 | 25, 698 | | Issuance of common stock | 21, 310 | 0 | 449 | | Issuance of common stock warrants | 6, 663 | 0 | 0 | | Salaried pension assets reversion | 39, 307 | 0 | 0 | | Cash from external financing | $ 29, 891 | $ 19, 177 | $ 14, 722 | | Net increase (decrease) in cash and temporary investments | | | | | |$ 31, 732 |$ 32, 205 |$ 18, 652 |