Crazy Eddie, Inc.

Case 1.6
Team Members ….

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Crazy Eddie Facts

- High school drop out at age sixteen. Began his career by peddling TV sets in his Brooklyn neighborhood.
- Famous for his "crazy" sales tactics and advertisements.
- Most distinctive trait was his inability to trust anyone outside his large extended family;
- In the early 1980s, sales of electronics exploded.

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Crazy Eddie Facts

- In 1984, Crazy Eddie went public.
- It took the underwriting firm more than a year to publicly offer the stock as they found the company's financial records to be in disarray

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Crazy Eddie Facts, cont'd

- Once public, Antar strived to convince the world that his firm was financially strong and well managed.
- In 1986, Antar resigned as company president after realizing more than $50 M on the sale of Crazy Eddie stock.
- Shortly after a hostile takeover in November 1987, a physical inventory count revealed a $65 M shortage of inventory that equaled the total profits reported by Crazy Eddie since going public in 1984.

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Crazy Eddie Facts, cont'd

- What were Antar's tactics for accounting irregularities?
  - False entries (sales and inventory that didn't exist)
  - Inventory count sheets for items that did not exist.
- Four different accounting firms audited Crazy Eddie's financial statements over its turbulent history.

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Crazy Eddie Facts, cont'd

- Main Hurdman supposedly "lowballed" to obtain the Crazy Eddie audit.
- During court cases, it was revealed that Antar and his associates engaged in a large-scale plan to deceive the auditors (collusion).
- When finally caught in May 1994, Antar was sentenced to 12 years in prison and ordered to pay restitution of $121 M to former stockholders and creditors.

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Financial Analysis and Red Flags

STUDENT 1

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The font here is too small. If you present information like this split the Information up onto several slides.

Crazy Eddie, Inc.
Common Size Balance Sheet
Consolidated
(000's omitted)

		% of total assets March 1, 1987	% of total assets March 2, 1986	% of total assets March 3, 1985	% of total assets May 31, 1984
Current assets					
Cash	$	3%	10%	34%	4%
Short-term investments		41%	21%	-	-
Receivables		4%	2%	4%	7%
Merchandise inventories		37%	47%	41%	64%
Prepaid expenses		4%	2%	1%	1%
Total current assets	$	89%	82%	80%	76%
Restricted cash		-	3%	11%	-
Due from affiliates		-	-	-	16%
Property, plant and equipment		9%	6%	6%	5%
Construction in process		-	5%	2%	-
Other assets		2%	4%	2%	3%
Total assets	$	100%	100%	100%	100%
Current liabilities					
Accounts payable	$	17%	41%	35%	55%
Notes payable		-	-	-	8%
Short-term debt		17%	2%	1%	0%
Unearned revenue		1%	3%	2%	2%
Accrued expenses		2%	13%	13%	17%
Total current liabilities	$	37%	59%	51%	82%
Long-term debt		3%	6%	12%	0%
Convertible subordinated debentures		27%	-	-	-
Unearned revenue		1%	1%	1%	1%
Stockholder's equity					
Common stock		0%	0%	0%	0%
Additional paid-in capital		20%	14%	19%	2%
Retained earnings		12%	19%	17%	15%
Total stockholder's equity	$	32%	34%	36%	17%
Total liabilities and stockholder's equity	$	100%	100%	100%	100%

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Crazy Eddie, Inc.
Common Size Income Statement
Consolidated
(000's omitted)

		% of net sales March 1, 1987	% of net sales March 2, 1986	% of net sales March 3 1985	% of net sales May 31, 1984
Net sales	$	100.0%	100.0%	100.0%	100.0%
Cost of goods sold		(77.2%)	(74.1%)	(75.9%)	(77.9%)
Gross profit	$	22.8%	25.9%	24.1%	22.1%
Selling, general and administrative expense		(17.4%)	(16.4%)	(15.0%)	(16.4%)
Interest and other income		2.1%	1.2%	0.9%	0.5%
Interest expense		(1.5%)	(.3%)	(0.3%)	(0.4%)
Income before taxes		6.0%	10.4%	9.7%	5.8%
Pension contribution		(.1%)	(.3%)	(0.4%)	-
Income taxes		(2.8%)	(5.1%)	4.9%	(3.1%)
Net income	$	3.0%	5.0%	4.3%	2.7%

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Crazy Eddie, Inc.

Analytical Review: Income Statement
Year Ended March 2, 1986
(000's omitted)

		March 2, 1986	March 3, 1985	$ Change	% Change
Net sales	$	262,268	136,319	125,949	92.4%
Cost of goods sold		(194,371)	(103,421)	(90,950)	87.9%
Gross profit	$	67,897	32,898	34,999	106.4%
Selling, general and administrative expense		(42,975)	(20,508)	(22,467)	109.6%
Interest and other income		3,210	1,211	1,999	165.1%
Interest expense		(820)	(438)	(382)	87.2%
Income before taxes		27,312	13,163	14,149	107.5%
Pension contribution		(800)	(600)	(200)	33.3%
Income taxes		(13,268)	(6,734)	(6,534)	97.0%
Net income	$	13,244	5,829	7,415	127.2%

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Red Flags: Financial

- Current Ratio is going up. Inventory represents half of total assets and since inventory is volatile, then that ratio should be questioned further.
- Inventory Turnover is getting slower. Since sales are going up, you'd assume inventory would be turning over faster.
- Consider the electronics industry: you would assume that the goods would turnover more often than 4 months (113 days).
- Accounts Receivable Turnover: every 7 days? Seems odd…
- Gross margin and Profit margin going down, but sales going up… something is fishy.
- Sales went from -7% to +92% to +34%. Very volatile.

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Red Flags: Nonfinancial

- As noted in the introduction the integrity of Antar was in question.
- Related Parties: large number of the company's officers were family members
- Switched auditors four times
- Crazy Eddie's accountants were former employees of their auditing firm (Main Hurdman)

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Irregularities

STUDENT 2

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Irregularities

- Falsification of inventory count sheets
  - Analytical procedures
    - Inventory turnover ratio [113 days - '87 v. 162 in '86]
    - Age of Inventory [112 days - '87 v. 80 in '86]
    - Compare actual v. budget
    - Compare client to industry
    - Review nonfinancial and outside information
    - Trace to supporting documentation

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Discussion of Audit Planning Professional Guidance

- Moreover, the audit planning varies with the size and complexity of the entity, experience with the entity, and ***knowledge of the entity's business*.**
  - The auditor should obtain a *level of knowledge* of the entity's business that will enable him to *plan and perform his audit in accordance with GAAS*. That level of knowledge should enable him to obtain an *understanding of the events, transactions, and practices that may have a significant effect on the financial statements*. The knowledge helps the auditor identify areas that need special consideration; assess conditions under which accounting data are produced, processed, reviewed, and accumulated; evaluate the reasonableness of estimates; and make judgments about the appropriateness of accounting principles.

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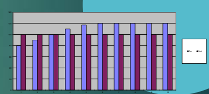
Lowballing and Its Effects on Audits

- *Lowballing (quasi rents)* is a practice utilized by auditors, whereby the auditing firm bids for an audit at a price below its cost.
- In other words, the firm is charging a fee below the marginal cost of the audit.
- The primary reason that auditors employ this practice is to ensure that receive and retain a client base.
- **Graphic is BAD, no labels, titles…**



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Independence

- Question # 6 What are the pros and cons of hiring individuals who have formerly served as a company's independent auditor?
- Cons
  - Independence becomes questionable
  - Ability to objectively audit the company becomes questionable
  - Critics say "A company that hires one of its former auditor can more easily conceal fraudulent activities during the course of audits"
  - AU Section 220 Independence
  - ET Section 102 Integrity and Objectivity

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Independence, cont'd

- Pros
  - Big accounting firms encourage their personnel to work for clients in the apparent belief that it helps cement the accountant-client relationship
  - The former independent auditor would have a greater understanding and greater knowledge of the business and how it functions
  - AU Section 8310 Knowledge of the Business

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Related Standards or
current events

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Additional
comments/Information

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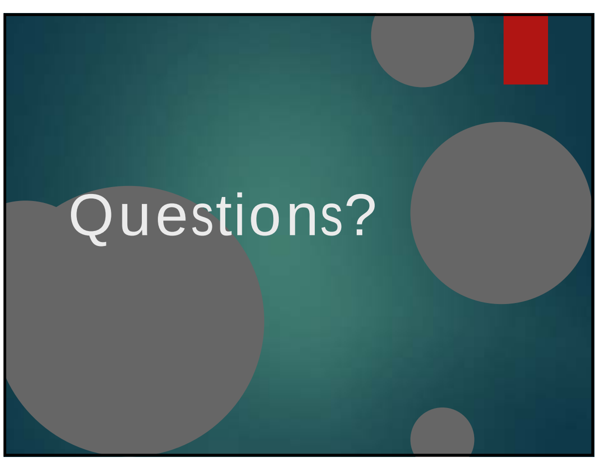
Questions?

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