CAPSIM Core

Finance

Why the rules are the rules

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According to the Organic Trade Association, sales of organic food steadily growing since 2012. Americans spent $43.3 billion on organic products in 2015.

One company riding that wave is Hains Celestial Group which sells organic food and personal care products through distributors to thousands of retailers. For the first half of 2016, Hains Celestial saw its share price increase 32%. Then, in August, it lost $1.3 billion from its market value overnight, after announcing profit targets would not be met for the fiscal year to June 30th and year-end results would be delayed. All because of accounting.

Is it the market, or the reporting?

Some commentators speculated Hains' problems may flag a softening in the market for consumer organics. Others said the loss of value was a temporary setback, making it a good time to buy Hains Celestial shares. Whatever the final fallout, a company growing strongly and selling some of the hottest products in the food industry hit a roadblock because of accounting anomalies -- and it is far from the first.

The problem stemmed from the timing of Hains' revenue reporting. When the company ships product to a distributor, it books the revenue. Distributors receive concessions that Hains applies according to a formula, rewarding them for high volumes sold in shorter periods. "Since Hain recognizes revenue before the goods are sold, it needs to make an estimate of how big those concessions will be," said Fortune Magazine. According to the Wall St Journal: "It is reviewing whether revenue associated with the concessions should continue to be reported when products are shipped to distributors or recorded when the distributors sell them to retailers." Perhaps more worrying is the company's admission that it needs "to assess its internal controls over financial reporting."

Some scope for flexibility

Forbes pointed to another organic food company, Annie's, that faced similar problems due to accounting irregularities in 2014 but recovered quickly, and was bought by General Mills soon after.

While there is some scope for individual companies and industries to incorporate unique aspects of their businesses in their financial reporting, the rules of accounting – laid out in the Generally Accepted Accounting Principles (GAAP) – are very strict. Clear rules means that stakeholders – including shareholders, potential buyers and even governments – can make consistent evaluations over time and between different companies.

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to restore confidence in the markets, investors also want companies to respect the spirit of the standards."

Investors require valid information

"Investors do not like to be misled by fraudulent or dishonest managers who are economical with the truth or bend it to their advantage," warns Jenny Rayner, in Managing Reputational Risk: Curbing Threats, Leveraging Opportunities (Wiley, September 11, 2003). "It is no longer sufficient merely to comply with accounting rules so that there is no technical breach; to restore confidence in the markets, investors also want companies to respect the spirit of the standards."

After the accounting and audit scandals that bankrupted Enron and WorldCom in the early 2000's, new legislation in the U.S., the Sarbanes-Oxley Act, increased penalties for destroying, altering, or fabricating records in federal investigations or for attempting to defraud shareholders. The act also increased the accountability of auditing firms to remain unbiased and independent of their clients. That makes it more difficult for fraud to go unpunished, but as Hains Celestial discovered (to its detriment) any accounting irregularities can have serious implications in the marketplace.