Chapter 13

**Sustainable Income**

Sustainable income is the most likely level of income to be obtained in the future. The desire to establish sustainable income is why we have a multi-step income statement. The most likely sustainable income is Income From Operations (income before other gains and losses). Your book contends that all income before Irregular items constitutes sustainable income.

**Irregular Items**

Net Income before Irregular Items appears after income tax expense. After this net income figure Irregular Items are reported net of income tax (with the income tax taken out). They are made up of three items that begin with DEC:

- Discontinued Operations;
- Extraordinary Items; and
- Cumulative Effect of Change in Accounting Principles

**Discontinued Operations**

When a company has decided to sell a line of business, the income from the operation of that business shifts from Income From Operations to Discontinued Operations. The gain or loss on the sale is also reported in this section. The income/gain is reported net of tax.

**Extraordinary Items**

Extraordinary Items are supposed to be very rare. Extraordinary items must meet two tests:

- unusual in nature; and
- infrequent in occurrence

Both tests must be met. A labor strike may be infrequent, but it is not unusual. Mount St. Helens is unusual and infrequent and the loss from the eruption is extraordinary. Expropriation of asset by foreign government (e.g., Cuba seizing American assets) is extraordinary items. Loss from an earthquake in California is probably not extraordinary. Extraordinary losses are shown net of tax.

If only one of the two tests are met, then the item will probably be reported as Other Revenue and Gains.
Cumulative Effect of Change in Accounting Principle

When a company makes a change in its accounting method (e.g., switching depreciation from declining balance to straight-line), the change appears in two places:

- The new method is used in the calculation of net income in the body of the income statement; and
- The cumulative difference in net income that the company would have experienced had it been using the new method in the prior years is reported as an Irregular Item.

The cumulative effect of change in accounting principle is shown net of tax.

Comprehensive Income

Some gains (or losses) are not reported on the income statement. These gains and losses are shown as increases (or decreases) to shareholder equity without appearing in the income statement. FASB now requires that the company add (or subtract) these items from net income and report the figure as comprehensive income.

An example of these gains (or losses) are unrealized gains (or unrealized losses) from marketable securities. When you hold marketable securities, you are supposed to adjust your portfolio up (or down) to its fair market value. If you actively trade marketable securities, the increase (or decrease) in your portfolio is shown on the income statement even though the gain (or loss) is unrealized (you haven’t sold it yet). If you hold marketable securities with the intention to sell it when the time is right it is considered to be “Available For Sale.” Unrealized gains (or losses) from these marketable securities are not reported on the income statement, but they are reported on the balance sheet with an adjustment to the asset on the left side of the balance sheet, and an adjustment to equity on the right side of the balance sheet.

Financial Statement Analysis

Financial statement analysis is rooted in financial statements. We are using financial statements as the basis to make judgments about the company. (e.g., is the company solvent or is it a good investment) While our decision is directed towards the future, we are looking at the financial records of past performance in making those decisions. You have to look beyond the financial statements. You have to consider such things as how is the business environment changing for the company in question. This involves looking at economy wide factors, industry factors as well as individual company factors.
Often we compare key figures from financial statements. Such a comparison can be made:

- Within A Company.
- Between Companies Within the Same Industry.
- With Industry Averages for those figures.

It is important that you make meaningful comparisons when you compare different companies. Companies have to be in the same industry in order for the comparison to make any sense. Ratios vary widely between industries. For example, below you will find key ratios for a number of different industries in 1987.

**RATIOS FOR SELECTED INDUSTRIES. 1987**

<table>
<thead>
<tr>
<th>Industry</th>
<th>Rtn On Equity</th>
<th>Rtn On Sales</th>
<th>P/E Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aerospace</td>
<td>14.0%</td>
<td>3.2%</td>
<td>9</td>
</tr>
<tr>
<td>Airlines</td>
<td>-0.5%</td>
<td>0.1%</td>
<td>NM</td>
</tr>
<tr>
<td>Appliances</td>
<td>16.9%</td>
<td>4.8%</td>
<td>11</td>
</tr>
<tr>
<td>Automotive</td>
<td>16.4%</td>
<td>4.7%</td>
<td>6</td>
</tr>
<tr>
<td>Banks &amp; Bank Holding Cos.</td>
<td>-7.7%</td>
<td>-2.8%</td>
<td>NM</td>
</tr>
<tr>
<td>Beverages</td>
<td>19.9%</td>
<td>7.2%</td>
<td>16</td>
</tr>
<tr>
<td>Building Materials</td>
<td>21.5%</td>
<td>7.1%</td>
<td>9</td>
</tr>
<tr>
<td>Chemicals</td>
<td>15.7%</td>
<td>7.0%</td>
<td>12</td>
</tr>
<tr>
<td>Conglomerates</td>
<td>17.1%</td>
<td>4.7%</td>
<td>10</td>
</tr>
<tr>
<td>Containers</td>
<td>15.3%</td>
<td>4.4%</td>
<td>12</td>
</tr>
<tr>
<td>Drugs</td>
<td>23.5%</td>
<td>12.3%</td>
<td>18</td>
</tr>
<tr>
<td>Electrical and electronics</td>
<td>13.4%</td>
<td>5.0%</td>
<td>17</td>
</tr>
<tr>
<td>Food processing</td>
<td>20.7%</td>
<td>4.1%</td>
<td>15</td>
</tr>
<tr>
<td>Food and lodging</td>
<td>20.5%</td>
<td>5.9%</td>
<td>15</td>
</tr>
<tr>
<td>General machinery</td>
<td>3.5%</td>
<td>1.6%</td>
<td>41</td>
</tr>
<tr>
<td>Leisure time industries</td>
<td>13.6%</td>
<td>5.9%</td>
<td>18</td>
</tr>
<tr>
<td>Metals and metals mining</td>
<td>7.7%</td>
<td>4.8%</td>
<td>14</td>
</tr>
<tr>
<td>Office equipment and computers</td>
<td>14.3%</td>
<td>8.2%</td>
<td>14</td>
</tr>
<tr>
<td>Oil and coal</td>
<td>4.8%</td>
<td>1.9%</td>
<td>30</td>
</tr>
<tr>
<td>Paper and forest products</td>
<td>14.2%</td>
<td>6.2%</td>
<td>12</td>
</tr>
<tr>
<td>Personal care products</td>
<td>13.5%</td>
<td>4.1%</td>
<td>21</td>
</tr>
<tr>
<td>Publishing, radio and television</td>
<td>16.8%</td>
<td>7.4%</td>
<td>21</td>
</tr>
<tr>
<td>Railroads</td>
<td>7.9%</td>
<td>6.2%</td>
<td>13</td>
</tr>
<tr>
<td>Retailing--food</td>
<td>16.7%</td>
<td>1.4%</td>
<td>17</td>
</tr>
<tr>
<td>Retailing—nonfood</td>
<td>13.7%</td>
<td>3.0%</td>
<td>15</td>
</tr>
<tr>
<td>Service Industries</td>
<td>11.8%</td>
<td>2.7%</td>
<td>19</td>
</tr>
<tr>
<td>Steel</td>
<td>6.9%</td>
<td>2.5%</td>
<td>23</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>13.3%</td>
<td>8.0%</td>
<td>13</td>
</tr>
<tr>
<td>Textiles and apparel</td>
<td>14.4%</td>
<td>4.3%</td>
<td>12</td>
</tr>
<tr>
<td>Tire and rubber</td>
<td>20.1%</td>
<td>3.9%</td>
<td>10</td>
</tr>
</tbody>
</table>
Tobacco  22.4%  6.6%  12
Trucking  9.1%  2.4%  18
Utilities  11.6%  10.6%  10

NM – "Not meaningful"

When making the comparisons, financial analysts engage in:

- Horizontal Analysis;
- Vertical Analysis; and
- Ratio Analysis

**Horizontal Analysis**

One method of analyzing financial statements is horizontal analysis. Imagine a comparative financial statement with results for different years presented in separate columns. The term, horizontal, means that you make your comparison horizontally over the different years. (e.g., changes in revenues from year to year).

You can compare horizontal trends: (i) over a number of years for one company, (ii) between different companies, or (iii) with industry averages. For example, you could note that our sales revenue has grown 10% in each year for the past three years. You could also note that our sales revenue has grown 10% a year for that period while our competitors have grown 12% a year over the same period. You could also note that our sales revenue growth has been 10% a year while the industry average was 9% a year over the same period.

**Vertical Analysis**

Another method of analyzing financial statements is vertical analysis. The term, vertical, means that you make your comparison vertically down and up the financial statement. With vertical analysis, you convert financial statements to common-size financial statements. Common-size financial statements are statements that are adjusted for size. Balance sheet figures are divided by Total Assets, and income statement figures are divided by Gross Revenues.

The vertical analysis can involve:

- one company,
- different companies, or
- industry averages.

For example, you could note that our research and development expenses are 5% of our net sales. You could also note that our research and development expenses are 5% of our net sales while our competitors only spend 4% of its net
sales. You could also note that we spend 5% of our net sales on research and development expenses while the industry average is 7%.

Vertical Analysis is important when making comparisons between different companies and industry averages because company size is eliminated from the analysis.

Common-size figures can be compared over time thereby combining vertical analysis with horizontal analysis.

**Example**

The Percentage of Sales Column (Column D) is an example of Vertical Analysis. The Difference Between 2002 and 2003 Columns (Columns H & I) are examples of Horizontal Analysis.

**Ratio Analysis**

With ratio analysis you examine key financial ratios of companies.

**Liquidity Ratios**

Liquidity refers to the company's ability to meet its current obligations. Thus, liquidity tests often focus on the size of, and relationships between, current liabilities and current assets. (Current assets presumably will be converted into cash in order to pay the current liabilities.)
In order to examine the relationship between current assets and current liabilities, you could look at the current ratio, the quick ratio (also called the acid-test ratio), and the doomsday ratio (also called the cash ratio):

- **Current Ratio** = \( \frac{\text{Current Assets}}{\text{Current Liabilities}} \)

- **Quick Ratio** = \( \frac{\text{Current Assets} - \text{Prepaid Expense} - \text{Inventory}}{\text{Current Liabilities}} \)

- **Doomsday or Cash Ratio** = \( \frac{\text{Cash + Cash Equivalents}}{\text{Current Liabilities}} \)

A variation of the Doomsday Ratio is the Current Cash Coverage Ratio:

- **Current Cash Coverage Ratio** = \( \frac{\text{Cash From Operations}}{\text{Average Current Liabilities}} \)

In making an examination of liquidity, you should also examine the quality of the short-term assets. If these assets are of poor quality, they may not be very liquid.

For example, you should examine the quality of a company’s inventory. If it has too much inventory, then it will take a long time to convert it into cash. A long period could also expose the inventory to an increased possibility of becoming obsolete, which would make it more difficult to convert into cash:

- **Inventory Turnover** = \( \frac{\text{COGS}}{\text{Average Inventory}} \)

- **Number of Days Sales in Inventory** = \( \frac{\text{Average Inventory}}{\text{COGS/365}} \)

An examination of liquidity should also include an examination of the quality of a company’s accounts receivable. If a company takes a long time to collect its accounts receivable, it obviously takes a long time to convert them to cash. Moreover, it may indicate that the company may have a difficult time ever collecting the accounts receivable.

- **Receivable Turnover** = \( \frac{\text{Net Credit Sales}}{\text{Average Accounts Receivable}} \)

- **Number of Days Sales in Receivables** = \( \frac{\text{Average Accounts Receivable}}{\text{Net Sales/365}} \)
Cash Conversion Cycle (Not In Book)

The Cash Conversion Cycle is an indication of liquidity. It gives you an approximation of how long it takes a company to convert its investment in inventory into cash receipts from the sale of that inventory. The Cash Conversion Cycle is calculated as follows:

<table>
<thead>
<tr>
<th>Days</th>
<th>Time It Takes to Collect Accounts Receivable</th>
<th>Number of Days Sales in Receivables:</th>
<th>18</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Plus: Time It Takes To Sell Inventory</td>
<td>Number of Days Sales in Inventory</td>
<td>65</td>
</tr>
<tr>
<td></td>
<td>Operating Cycle</td>
<td></td>
<td>83</td>
</tr>
<tr>
<td></td>
<td>Less: Time Company Can Delay Payment of Its Own Accounts Payable</td>
<td></td>
<td>-47</td>
</tr>
<tr>
<td></td>
<td>Cash Conversion Cycle</td>
<td></td>
<td>36</td>
</tr>
</tbody>
</table>

In this example, it takes the company 83 days to recoup the investment in its inventory. Thus it needs to cover its expenses for that 83 day period from other sources. For part of that 83 day period, it can cover its expenses by not paying them. It can only do this for 47 days. This means that it has to find financing for its expenses for 36 days.

The time that the company can delay the payment of its own accounts payables can be approximated as follows:

\[
\text{Days' payables} = \left( \frac{\text{Operating Payables}}{\text{Pre-tax cash expenses}} \right) / 365
\]

Pretax cash expenses can be approximated by adding all expenses except taxes and then subtracting noncash expenses such as depreciation. Operating payables include accounts payable, accrued wages and payroll taxes, and other items that represent deferred payments for operating expenses. A note payable would be included if its proceeds financed accounts receivable or inventories; otherwise, short-term debt is excluded.

Solvency Ratios

Solvency pertains to the company's ability to meet the interest costs and repayment schedules associated with its long-term obligations. Analysts look at the size of the Long-Term Debt in comparison with other items on the balance sheet. This gives a sense of the amount that the corporation can still borrow or whether it has maxed out its long-term borrowing ability:

\[
\text{Debt To Total Assets Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}
\]
Ratio of Fixed Assets to Long-Term Debt = \( \frac{\text{Net Fixed Assets}}{\text{Long-Term Liabilities}} \)

Debt to Equity Ratio = \( \frac{\text{Total Liabilities}}{\text{Stockholders’ Equity}} \)

Cash Debt Coverage Ratio = \( \frac{\text{Cash Flow From Operations}}{\text{Average Total Liabilities}} \)

You also can look at the ability of a company to pay the interest expense associated with its Long-Term Debt:

Times Interest Earned Ratio = \( \frac{\text{Net Income} + \text{Tax Expense} + \text{Interest Expense}}{\text{Interest Expense}} \)

Your book also notes that you can look at a company’s free cash flow. Free Cash Flow is the amount of annual cash flow generated by the company that is not needed for capital expenditures and dividends is available to repay Long-Term Debt:

Free Cash Flow = \( \text{Cash From Operations} - \text{Capital Expenditures} - \text{Dividends} \)

**Profitability Ratios**

In evaluating a firm’s profitability, there are a number of returns you could consider.

Earnings per share (EPS) are used by Investors to judge a company's profitability, to estimate its future earnings, and to compare it with other companies. A company that has issued no securities that are convertible into common stock has a simple capital structure. In this case, a company's EPS is calculated as follows:

\[
\text{EPS} = \frac{\text{Net Income} - \text{One Year's Dividends on Preferred Stock}}{\text{Weighted Average Number of Shares of Common Stock Outstanding}}
\]

EPS is reported on the Income Statement. EPS figures should be given for the following income items:

- Income Before Irregular Items,
- Irregular Items, and
- Net Income.

A company that has issued securities that may be converted into common stock has a complex capital structure. For example, common stock equivalents such as stock options and certain convertible securities might exist, producing a potential
dilution (decrease) in EPS. In this case, presentation of both primary EPS and fully diluted EPS is required.

Price/Earnings Ratios (P/E Ratios) are the broadest and most widely used overall measure of performance:

\[
P/E \text{ Ratio} = \frac{\text{Market price per share}}{\text{Net income per share}}
\]

If you consider a stock’s price as a capitalization of future expected earnings, then a relatively high P/E ratio indicates that the financial market thinks that the company’s earnings will increase. Similarly, a relatively low P/E ratio indicates that the financial market thinks that the company’s earnings will decrease.

This measure involves an amount not directly controlled by the company: the market price of its common stock. Thus, the P/E ratio is a good indicator of how investors judge the firm's performance. Management, of course, is interested in this market appraisal, and a decline in the company’s P/E ratio not explainable by a general decline in stock market prices is cause for concern. Also, management compares its P/E ratio with those of similar companies to determine the marketplace’s relative rankings of the firms.

Basically, the P/E ratio reflects investors’ expectations about the company's performance. P/E ratios for industries vary, reflecting differing expectations about the relative rate of growth in earnings in those industries. At times, the P/E ratios for virtually all companies decline because predictions of general economic conditions suggest that corporate profits will decrease.

Gross Profit Ratio (Gross Margin Ratio) indicates of the competitiveness of the company’s market. If there is a very competitive market for the company’s products, the company will not be able to charge much above the cost of the goods that it sells. Smaller gross margins indicate the company’s competitors have reduced their prices and the company must meet their price or lose business. The PC industry in the 1980’s was not very competitive and the PC manufacturers had large gross margins. These margins shrank as the PC market became more competitive.

\[
\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}}
\]

Profit Margins are a measure of the overall profitability of a firm:

\[
\text{Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}}
\]
Top management needs to examine a number of factors if the profit margin is unsatisfactory. Perhaps dollar sales volume has declined, either because fewer items are being sold or because they are being sold at lower prices, or both. Perhaps the gross margin is being squeezed because cost of sales increases cannot be passed along to customers in the form of higher prices. In a manufacturing firm, cost of sales may be up because of production inefficiencies. Perhaps other expenses have gotten out of control: maybe management has gotten lax about administrative expenses or is spending more for marketing costs than the sales results would seem to justify.

Return On Assets (ROA) reflects how much the firm has earned on the investment of all the financial resources committed to the firm.

\[
\text{Return on Assets} = \frac{\text{Net income} + \text{Interest} (1 - \text{Tax rate})}{\text{Total Assets}}
\]

Your book indicates that the numerator in the ROA calculation is Net Income. This is incorrect. This can be shown with two examples. Assume that you buy property for $100,000 and sell it a year later for $110,000. You made 10% on the asset. Now assume that you bought the same property through financing with a $10,000 down payment and a mortgage of $90,000 and you had to pay interest of 5% or $4,500 for the year that you owned the property. Now, you made $5,500. This is the same property in both examples. The return on the asset is 10%. You should not consider the interest expense when making that determination.

Interest should be considered in determining return on equity. In the first example you had equity of $100,000 and the return was 10%. In the second example, you had equity of $10,000 and made $5,500. This is a return of 55%. Interest is important with return on equity because the size of the equity affects the interest expense.

The ROA is showing you the profitability of the assets of a firm. That profitability should not be affected by management’s decision to issue debt (interest has to be paid) rather than equity (no interest has to be paid).

ROA is a useful measure if one wants to evaluate how well an enterprise has used its funds, without regard to the relative magnitudes of the sources of those funds (short-term creditors, long-term creditors, bondholders, and shareholders).

The ROA ratio often is used by top management to evaluate individual business units within a multidivisional firm (e.g., the laundry equipment division of a household appliance firm). The division manager has significant influence over the assets used in the division but has little control over how those assets are financed, because the division does not arrange its own loans, issue its own bonds or capital stock, or in many cases pay its own bills (current liabilities).
Return on Common Equity (ROE) reflects how much the firm has earned on the funds invested by the common shareholders (either directly or through retained earnings).

\[
\text{ROE} = \frac{\text{Net Income} - \text{1 year's Preferred Dividends}}{\text{Average Common Shareholders' Equity}}
\]

The ROE is obviously of interest to present or prospective shareholders, and is also of concern to management, which is responsible for operating the business in the owners’ best interests. The ratio is not generally of interest to division managers, however, because they are primarily concerned with the efficient use of assets rather than with the relative roles of creditors and shareholders in financing those assets.

Financial Leverage is the ability to increase the return on your investment by borrowing funds at a rate that is below rate of return on the assets of the company. For example, you can benefit by borrowing at 8% and investing the money at 10%.

Your book quantifies this by subtracting the return on the assets of the company from the return on the common equity of the company:

\[
\text{Financial Leverage} = \text{Return on Common Equity} - \text{Return on Assets}
\]

Asset Turnover Ratio is indicates the company’s utilization (productivity) of its assets:

\[
\text{Asset Turnover Ratio} = \frac{\text{Net Sales}}{\text{Average Total Assets}}
\]

The relationship between Return on Assets, Profit Margin, and Asset Turnover Ratio:

\[
\text{ROA} \approx \text{Profit Margin} \times \text{Asset Turnover Ratio}
\]

\[
\frac{\text{Net income + Interest (1 - Tax rate)}}{\text{Average Total Assets}} \approx \frac{\text{Net Income}}{\text{Net Sales}} \times \frac{\text{Net Sales}}{\text{Average Total Assets}}
\]

These relationships suggest the two fundamental ways that the ROA can be improved. First, it can be improved by increasing the profit margin— that is, by earning more profit per dollar of sales. Second, it can be improved by increasing the asset turnover. The asset turnover can be increased in either of two ways: (i) by generating more sales volume with the same amount of assets or (ii) by reducing the amount of assets required for a given level of sales volume.
**Dividend Policy.**

Two other ratios are not, strictly speaking, tests of financial condition. They are related to another aspect of financial management: dividend policy. These ratios are the dividend payout and dividend yield:

\[
\text{Dividend payout} = \frac{\text{Dividends}}{\text{Net income}}
\]

\[
\text{Dividend yield} = \frac{\text{Dividends per share}}{\text{Market price per share}}
\]

The dividend yield on stocks is often compared with the yield (interest) on bonds, but such a comparison is not valid. The earnings of bondholders consist entirely of their interest (adjusted for amortization of discount or premium), whereas the earnings of shareholders consist not only of their dividends but also of retained earnings. Although shareholders do not receive retained earnings, the fact that part of the net income has been retained in the business (and presumably invested in income-producing assets) should enhance future earnings per share. This, in turn, should increase the market value of the shareholders' investment.

**Quality of Earnings**

A company that has high quality earnings provides full and transparent information that will not confuse or mislead users of the financial statements. The lack of quality in earnings is why finance people use tools that employ cash (e.g., Internal Rate of Return, Net Present Values, and Cash Pay-Back Periods) rather than net income when evaluating investments. Some of the factors contributing to a reduction in the quality of earnings include:

- **Alternative Accounting Methods** can reduce the quality of earnings. Companies have a great deal of discretion in calculating net income. They have choices on the method in which the cost of inventory is calculated, the depreciation methods used, the useful life of depreciable assets, and various estimates used in the calculation of income. It is difficult to compare the performance of different companies because of their different accounting methods that they employ.

- **Pro Forma Income** is the recent practice of issuing a pro forma income figure which supposedly eliminates unusual and non-recurring items from net income. These pro forma income figures are not governed by GAAP rules and conventions. The absolute discretion that companies have in presenting pro forma income could be used to mislead investors. It is similar to the situation before the 1929 stock market crash, which brought in the SEC and the era of GAAP in the first place.
Improper Recognition of Income is a major problem in the quality of earnings. Companies and their auditors are straining their interpretation of GAAP in order to present a favorable net income. For example, Enron failed to report liabilities that it should have reported under GAAP rules. This had the effect of misrepresenting its solvency. WorldCom capitalized operating expenses ("line costs") as assets ("prepaid capacity"), and thereby increased its profitability.

Ex-WorldCom Accountant Describes Fraud

NEW YORK—His voice quavering, a former WorldCom Inc. accountant described for jurors Thursday how his bewilderment turned to defiance when he was repeatedly asked to book bizarre, baseless accounting entries.

Mark Abide, testifying for the prosecution at the fraud trial of former CEO Bernard Ebbers appeared close to tears as he recounted being instructed to chalk up billions of dollar in assets he had never heard of.

Abide never implicated Ebbers in his testimony, and said under cross-examination that he believed the strange entries were being ordered by Scott Sullivan, who was chief financial officer at WorldCom.

Abide said he was asked repeatedly in 2001 to update WorldCom asset sheets to include unsubstantiated entries—sometimes more than $700 million per quarter.

"I was shocked," Abide testified. He added later: "It wasn't a tangible piece of equipment. He said he confronted an accountant who was ordering the entries, but that accountant said he did not know either.

As it turned out, the entries were part of a scheme to move WorldCom's capitalizing expenses for so-called line cost fees off the income statement and list them as assets on the balance sheet.

Prosecutors say that improper procedure made up a huge chunk of what was later determined to be an $11 billion accounting fraud at WorldCom, which collapsed in bankruptcy in 2002 and has since re-emerged as MCI Inc.

By early 2002, Abide said, he had made up his mind not to take part anymore in the questionable entries. He said he conveyed his decision to three accounting officials who called him to ask him to book more "prepaid capacity."