**GREEN MOUNTAIN COFFEE: A BAD CUP OF JAVA**

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With lawsuits recently filed against it for [securities violations](http://classactionlawsuitsinthenews.com/class-action-lawsuits/green-mountain-coffee-roasters-securities-fraud-class-action-lawsuit-complaint/), we can no longer ignore the financial reporting indiscretions of Green Mountain Coffee Roasters (GMCR). This is not just a case about bad financial reporting, and likely financial reporting fraud. GMCR offers absolute proof that compliance with generally accepted accounting standards does not necessarily yield transparency in financial reporting. Additionally, the Company’s [soaring stock price](http://www.nasdaq.com/aspx/company-news-story.aspx?storyid=201105040952rttraderusequity_0991) shows how a caffeine addiction can cripple investor decision-making.

Much has been written about the Company’s [accounting errors](http://www.thestreet.com/story/10928191/green-mountain-shares-swing-wildly-after-accounting-errors-revealed.html), SEC investigation, and resulting financial restatements described in its 10K for FYE September 25, 2010. However, all of this has been obvious and building for nearly a decade. In fact, the [Beneish Earnings Manipulation model](http://www.investopedia.com/terms/b/beneishmodel.asp) reveals manipulation probabilities of 19.59% and 18.27% as far back as 2002 and 2006, and 22.99% for 2010, the year with all of the “minor” restatements.

Why are we not surprised? Numerous performance pressures make it impossible for the Company NOT to “cook the books.” Managers are significantly motivated by stock-based compensation. Stock option expense accounted for over 15% of earnings in 2008, over 7% in 2009, and 5% in 2010. Additionally, by its own admission in its 10K MD&A, GMCR cites its growth strategy and need for related capital (p.5 and 13), a highly competitive market (p. 6), and debt covenants (p. F-38), all of which create huge pressures for managers to perform. And unfortunately, they haven’t been.

Return on common equity (ROCE) has consistently declined the past three years from 18.7% in 2008 to 12.3% in 2010, primarily due to asset turnover decreases for both accounts receivable and inventory. In fact, inventory turnover has dropped by half from a high of 9 times per year in 2003 and 2004 to an all time low of 4.4 in 2010. Equally troubling is the Company’s inability to convert reported net earnings into operating cash flows in 2010. Despite a 46% increase in net income in 2010, operating cash flows declined from the previous two years, and actually turned negative—an event that usually means the books have been cooked.

Operating performance is so poor that the Company resorts to pro-forma reporting, but instead of using SEC terminology (i.e., adjusted EBITDA), it has created the “non-GAAP measures” metric to “provide investors with transparency.” However, if GMCR cared so much about transparency why did the Company define and describe the “non-GAAP measures” six full pages before they provided the actual numbers (page 29 vis-à-vis pages 35 and 36) without any description of the pro-forma metrics. And the Company’s acquisition-focused growth strategy is ideal for weakening financial reporting controls.

GMCR’s balance sheet clearly indicates why the Company isn’t performing. Over 44% of the Company’s assets are imaginary ($606.4 million in intangibles and goodwill), and almost equal total stockholders’ equity. Most of the non-goodwill intangibles originated in 2010 and relate to customer relationships and product names. Not surprisingly, the Company is aggressively spreading out the expensing of these assets over periods of 10 to 15 years, when a much shorter period is likely warranted. This just might be another Golf Galaxy in the making with a major impairment charge lurking in the near term.

Accounts receivable, inventories, and property and equipment all doubled in 2010. Despite the significant receivable increase, the Company only slightly increased its bad debt expense, and the amount remains below that reported in 2008.

So, what’s the verdict likely to be in the forthcoming litigation? No question about it: GUILTY! Investors are guilty for overlooking the clear danger signs lurking in both the past and current financial statements. GMCR’s managers are guilty of financial reporting fraud for issuing clearly misleading financial statements to cover poor operating performance. And the auditors are guilty for issuing an unqualified, “clean opinion,” on a restated set of financial statements for a Company with acknowledged material weaknesses associated with an ongoing SEC investigation.

*Additional insights regarding Green Mountain Coffee Roasters’ reporting can be found at:*

Market Watch - <http://www.marketwatch.com/story/green-mountains-accounting-creates-a-stir-2010-10-01>

Seeking Alpha - <http://seekingalpha.com/article/274918-is-green-mountain-coffee-roasters-fudging-its-reserve-numbers>

White Collar Fraud - <http://whitecollarfraud.blogspot.com/2011/05/green-mountain-roasters-more-murky.html>

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*