**a Misclassified Cash Flow: Does It Matter?**

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*This critical incident was prepared by the authors and is intended either for a written assignment or as a basis for class discussion. The views presented here are those of the authors based on their professional judgment and do not necessarily reflect the views of the Society for Case Research. The names of the company and the CPA firm were not given in this case, but are disclosed in the Teaching Note. Copyright © 2014 by the Society for Case Research and the authors. No part of this work may be reproduced or used in any form or by any means without the written permission of the Society for Case Research.*

Helen had an uneasy feeling as she was sitting in her office. She was happy in her position as Manager – Accounting Deal Structure, which she considered as her “dream job” (Sharkey, 2013). Last year, the company’s two top executive tax managers, Gene and Jamie, along with Helen, met with their international accounting firm. The accounting firm proposed a plan that would save the company tens of millions of dollars in taxes and more importantly, increase cash flow from operations. Though she was confident the plan was legal, Helen was having second thoughts about the project (Steffy, 2013).

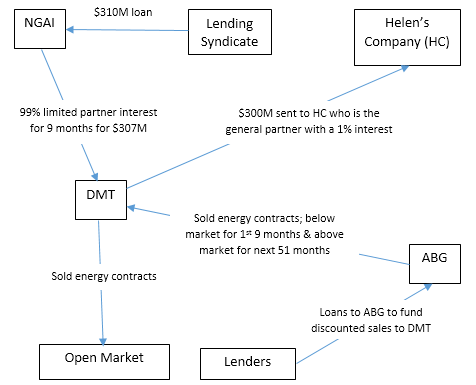
When the idea was presented, Helen, Gene, and Jamie were excited to hear about the plan proposed by their Certified Public Accounting (CPA) firm. Helen’s company had come under close scrutiny by financial analysts because of a widening gap between its net income and cash flow from operating activities. Much of the gap was caused by the company adopting “mark-to-market” accounting. Helen’s company was heavily involved with energy trading. “Mark-to-market” accounting was required for these types of contracts. Under this accounting method, the contracts were presented on the company’s balance sheet at market value. If the contract increased (decreased) in value, an unrealized gain (loss) would be recorded even though there was no corresponding cash flow. These unrealized gains (losses) appeared on the income statement, thus increasing (decreasing) net income. Most of the contracts had increased in value, which resulted in unrealized gains, and thus increased net income without a corresponding increase in cash flow (SEC, 2002).

Their CPA firm had assured Helen, Gene, and Jamie about the legitimacy of the transactions. In fact, one of the accounting firm’s clients was already using the method. The client was a prestigious company, one of the largest in the United States (Sharkey, 2013). The plan was structured in a way that significantly increased cash flows and reduced income taxes. The CPA firm established guidelines that should be followed, such as avoiding certain hedging transactions, in order for the project to be in accordance with generally accepted accounting principles (GAAP). This proposal, which was named “Project Alpha,” appeared to be just what the company needed to appease financial analysts (SEC, 2003).

As time went on, however, Helen became more anxious about the project. She was a team player and loyal to the company. She began working for the company right out of college and had continually risen through its ranks. The company had done much for Helen, and she wanted the company to be successful. The plan appeared to be legal, was used by one of the nation’s fastest growing and largest firms, and was created by one of the most well-known CPA firms in the world (Sharkey, 2013). In addition, Gene and Jamie were older and more experienced than Helen, and they thought the plan was good for the company.

“Project Alpha” was complex and involved some of company’s affiliates and outside lenders. The fees paid for the project were substantial, 35.8 million dollars. Figure 1 graphically shows these intercompany transactions. An affiliate called NGAI borrowed $310 million from a syndicate of lenders. NGAI used these funds to purchase another affiliate named DMT for $307 million. In exchange for this purchase, NGAI had a nine-month, 99 percent limited partnership interest in DMT. Helen’s company held the other 1 percent as a general partner. Of the funds received, DMT sent $300 million to Helen’s company, payable back to DMT on demand. At the same time, another affiliate, ABG, entered into a five-year agreement with DMT to sell energy contracts (SEC, 2002).

**Figure 1: Project Alpha**



During the first nine-months, ABG sold the contracts to DMT at a discount. DMT then sold the contracts on the open market at a profit. From these gains, DMT gave NGAI approximately $300 million to enable NGAI to pay back the loans to the syndicate of lenders. During the remaining term of the five-year agreement, DMT agreed to purchase energy contracts from ABG at above market prices to enable ABG to recoup the losses incurred during the first nine months (SEC, 2002).

ABG borrowed from various lenders to fund their losses for the discounted sales to DMT. After the initial nine-month period, DMT along with its $307 million tax basis, became a wholly owned subsidiary of Helen’s company. DMT would incur heavy losses during the last 51 months of its five-year agreement with ABG. These losses resulted in a tax savings to Helen’s company of $79 million. The main concern, however, was to reduce the gap between net income and cash flows from operations. To address this concern, the $300 million payment from DMT to its general partner (Helen’s company) was classified as a cash flow from operating activities, which increased cash flows from operations by 27 percent. Since the $300 million did not affect net income, the gap between net income and cash flows from operating activities was narrowed (SEC, 2002).

As noted previously, Project Alpha seemed to ease the financial analyst concerns, but Helen was not at ease. She thought what she was doing may possibly be wrong, but she was just following orders. She wanted to be a team player and show her loyalty. Helen was the lowest ranking and least experienced member involved in “Project Alpha.” After all, Helen reasoned, she was certain that she was not doing anything illegal (Sharkey, 2013).

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**TEACHING NOTE**

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**Critical Incident Overview**

This critical incident describes the difficult situation that a young (approximately 29 years old) successful accountant finds herself in after agreeing to go along with a questionable accounting scheme. The accounting project was designed by an international CPA firm and was already being used by one of the largest and fastest growing companies in the United States, which lent credibility to the arrangement. While net income, earnings per share, assets, liabilities, etc. may be correctly stated, this case demonstrates the possible ramifications of an item that is improperly classified.

This incident is appropriate for use in an upper level or graduate financial accounting class (e.g., Intermediate or Advanced Accounting or Accounting Theory) and in an auditing class.

**Research Methods**

This critical incident was developed from secondary sources – primarily releases from the Securities and Exchange Commission and newspaper articles. The name of Helen’s company and the CPA firm were disguised in the paper, but are revealed in the epilogue at the end of this teaching note. The authors felt that giving the names of the company and particularly the CPA firm would prejudice responses by students who have heard of these firms.

**Learning Objectives**

Students completing the Critical Incident should be expected to achieve the following:

*Accounting Mastery*

1. Illustrate with an example the importance of proper classification in accounting even though net income, total cash flows, and other totals are correctly stated. (Questions 1, 2, and 6)
2. Analyze and explain how “mark to market” accounting affects financial statements. (Question 3)
3. Explain the implications of “disguised loans” masquerading as revenues. (Questions 4 and 5)

*Critical Thinking*

1. Recognize the seriousness of a misclassified amount in financial reporting. (Question 6)
2. Know, understand, and be able to apply the appropriate professional standards to guide professional conduct when confronted with a workplace conflict involving an accounting issue. (Question 7)

**Questions**

1. Explain why it matters how items are classified on the financial statements. For example, in this case, does it make a difference on where the $300 million cash flow is reported, as long as the total cash flow is correct?
2. What classification of the $300 million more clearly represents the true financial condition of the firm? Justify your answer.
3. When “mark-to-market” accounting rules are used, how do the unrealized gains and losses affect net income?
4. Evaluate the benefits and possible hazards of the accounting firm’s plan to save on taxes.
5. ABG and DMT reported the contract sales as a sales transaction. What impact does this have on the statement of income? Is this justifiable? Defend your answer.
6. What are the potential consequences of misclassifying the $300 million cash flow?
   1. Describe the effect of this misclassification on the balance sheet, income statement, and key financial measures (such as the current and debt ratios and return on sales).
   2. Evaluate how Sarbanes-Oxley Act (SOX) Act may have had an impact on the decision to proceed with “Project Alpha.”
7. Gene and Jamie had considerably more experience and a higher position with the company. They were in favor of the project. In accordance with the principles of professional practice, what should Helen have done at the point where she experienced reservations about the integrity of the plan?

**Answers to Questions**

1. Explain why it matters how items are classified on the financial statements. For example, in this case, does it make a difference on where the $300 million cash flow is reported, as long as the total cash flow is correct?

*This misclassification was extremely significant. The statement of cash flows has often been viewed as the most reliable of the statements – i.e., less susceptible to manipulation than the balance sheet and income statement. In fact, the SEC stated that the misclassification of the cash flow “was especially significant because the Statement of Cash Flows has historically been considered immune from cosmetic tampering” (SEC, 2002b). Auditors should be able to audit cash, a tangible item. The income statement and balance sheet require many estimates, even more so as the FASB moves toward “mark-to-market” or fair value accounting. Revenues are recorded as earned, and expenses are recorded as incurred, both of which may involve some judgment.*

*In addition, the operating activities section of the statement of cash flows often reflects the health of a company. The main source of cash for a healthy company should come from operations as opposed to investing or financing activities.*

1. What classification of the $300 million more clearly represents the true financial condition of the firm? Justify your answer.

*The $300 million should not have been classified as cash flows from operating activities. Cash flows presented in this section are from the firm’s major revenue generating type of activities. Gene, Jamie, and Helen wanted to classify this amount as an operating activity to close the gap between net income and cash flows from operations. The nature of the payment, however, was clearly a loan. The $300 million cash inflow should have been reported as a cash flow from financing activities. [Note to instructor: The CPA firm instructed the company that if they stayed away from certain hedging contracts that the $300 million should be classified as an operating activity. The company entered into hedging contracts anyway and hid this fact from their CPA firm. Regardless of whether hedging contracts were used, the essence of the $300 payment was a loan, and as such, should have been classified as a financing activity].*

1. When “mark-to-market” accounting rules are used, how do the unrealized gains and losses affect net income?

*“Mark-to-market” accounting refers to recording assets and liabilities of a company at market or fair value. Both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are moving in the direction of placing more items on the financial statements at fair value. When an asset or liability is increased or decreased to fair value, the offsetting debit or credit is to an unrealized gain or loss. These unrealized gains and losses appear on the income statement, thus affecting net income but not cash flow.*

1. Evaluate the benefits and possible hazards of the accounting firm’s plan to save on taxes.

*One of the intentions of the accounting firm’s plan was to reduce taxes. The company thought that they saved $79 million in taxes and also increased net income by that amount. There should be, however, an economic or business purpose behind the tax saving plan. In this case, it appears that there was no separate economic or business purpose. The whole idea of the scheme was to save taxes and increase cash flows from operating activities. The IRS may disapprove and impose penalties for transactions that do not have a business purpose and are solely designed to avoid taxes. [Note: The IRS did not consider this a viable plan and disallowed the tax savings.]*

1. ABG and DMT reported the contract sales as a sales transaction. What impact does this have on the statement of income? Is this justifiable? Defend your answer.

*The agreement between ABG and DMT should not be treated as a sales contract. The essence of the five-year agreement is a loan. Such “sales” are called round trip or wash sales, and unfortunately, are not uncommon and often treated as a sale. If such transactions are treated as a sale, revenues are inflated. Likewise, expenses are also inflated by the same amount. By the time the contract is completed, net income is not affected. In the first nine months of the agreement, DMT showed profits and ABG incurred losses. In the last 51 months of the contract, however, DMT had losses and ABG showed profits. One reason that the SEC is concerned with round trip or wash sales is that revenues often drive stock prices. Thus, investors are misled by inflated revenues.*

1. What are the potential consequences of misclassifying the $300 million cash flow?

*Following generally accepted accounting principles (GAAP) is mandatory for CPAs. All three could (and did) face both civil and criminal liability for their part in Project Alpha. All three probably lost their CPA license.*

1. Describe the effect of this misclassification on the balance sheet, income statement, and key financial measures (such as the current and debt ratios and return on sales).

*All balance sheet and income statement items would be correctly stated even though the $300 million cash flow was misclassified. In addition, nearly all key ratios (including liquidity, activity, and profitability measures) would not be affected. Even cash and total cash flow for the year were correct. [Note to instructor: Accounting students often have difficulty understanding the interrelationship among the financial statements.]*

1. Evaluate how Sarbanes-Oxley Act (SOX) may have had an impact on the decision to proceed with “Project Alpha.” [Note: Use at least Sections 302, 401, and 1106 in your analysis. To address this question, the SOX Act may be found using the following link: <http://www.sec.gov/about/laws/soa2002.pdf>.]

*The Sarbanes-Oxley Act (SOX) introduced some major changes to the governance of financial reporting. When President Bush signed SOX, he referred to the legislation as "the most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt" (SEC, 2014). It is difficult to say how SOX would have affected the plan. “Project Alpha” was initiated before SOX was passed. SOX did require a renewed emphasis on the importance of internal control and corporate governance. These reforms may have alerted top management to the potential problems of the “Alpha Project,” but it is difficult to say what would have happened.*

*Section 302 requires that the principal financial officer sign the report, certifying that the report does not contain any material misstatement. The chief financial officer (CFO) of the company that Helen worked for was not charged with any wrongdoing. It is uncertain how much that the CFO knew about the project. Helen, Jamie, and Gene were secretive about Project Alpha, hiding information from their own company and the company’s CPA firm (SEC, 2003). Section 302 also notes that the financial statements should not be misleading.*

*Section 401 requires that the financial statements be presented in accordance with generally accepted accounting principles (GAAP). The misclassified cash flow was a significant misstatement. It increased their cash flow from operations by 27 percent. It would appear that Helen’s assertion, that nothing illegal was done, would not be an accurate statement (SEC, 2002b).*

*Section 1106 increased the penalties for violations of the securities acts. Before SOX, accountants were subject to criminal and civil penalties. SOX, however, increased potential penalties from $1,000,000 to $5,000,000 and imprisonment from “not more than 10 years” to “not more than 20 years” (U.S. House, 2002).*

1. Gene and Jamie had considerably more experience and a higher position with the company. They were in favor of the project. In accordance with the principles of professional practice, what should Helen have done at the point when she experienced reservations about the integrity of the plan?

*This situation would be difficult particularly if either Gene or Jamie was also Helen’s boss. If she felt comfortable, she should first express her concerns to Gene and Jamie. The Institute of Management Accountants (IMA) has perhaps one of the most well thought out process to resolve ethical conflicts. The following is from the “IMA Statement of Ethical Practice” (Institute, 2013).*

*In applying the Standards of Ethical Professional Practice, you may encounter problems identifying unethical behavior or resolving an ethical conflict. When faced with ethical issues, you should follow your organization’s established policies on the resolution of such conflict. If these policies do not resolve the ethical conflict, you should consider the following courses of action:*

1. *Discuss the issue with your immediate supervisor except when it appears that the supervisor is involved. In that case, present the issue to the next level. If you cannot achieve a satisfactory resolution, submit the issue to the next management level. If your immediate superior is the chief executive officer or equivalent, the acceptable reviewing authority may be a group such as the audit committee, executive committee, board of directors, board of trustees, or owners. Contact with levels above the immediate superior should be initiated only with your superior’s knowledge, assuming he or she is not involved. Communication of such problems to authorities or individuals not employed or engaged by the organization is not considered appropriate, unless you believe there is a clear violation of the law.*
2. *Clarify relevant ethical issues by initiating a confidential discussion with an IMA Ethics Counselor or other impartial advisor to obtain a better understanding of possible courses of action.*
3. *Consult your own attorney as to legal obligations and rights concerning the ethical conflict.*

**Epilogue**

The name of Helen’s company was Dynegy. The Securities and Exchange Commission (SEC) filed an enforcement action against the company, which was named as plaintiff in a civil action suit in 2002. Dynegy paid $3 million to the SEC. The enforcement action was brought due to misclassifying the $300 million cash flow as an operating activity and inflating revenues by the prearranged trades between the two affiliates, DMT and ABG. Such “sales” are called round trip or wash sales. The misclassification of cash flows increased the company’s operating cash flows by 27 percent (SEC, 2002a).

The SEC also brought criminal charges against Helen, Gene, and Jamie (SEC, 2003). Helen and Gene initially entered a not guilty plea. Later, however, when faced with a potentially long prison sentences (up to 24 years), they both pleaded guilty and cooperated with the government. Helen, a mother of two young twin sons, received a jail term of 30 days, a fine of $10,000, and home confinement for six months. Gene was sentenced to 15 months in prison, three months’ probation, and fined $1,000 (Two, 2006). Jamie maintained his innocence and stood trial. He was found guilty and originally received a 24-year prison sentence. Three years after being convicted, his prison sentence was reduced to 6 years (Ex-Dynegy, 2006).

Helen (Sharkey, 2013) now speaks to university students, CPAs, fraud examiners, and others about the importance of doing what is right. In answering the last question in the case above, Helen chose to ride it out and not to say anything. She admits that she did not make the right decision at that time. As she adeptly says, “Would you rather be labeled a whistleblower and temporarily unemployed or labeled a felon and permanently branded?”

The international accounting firm was Arthur Andersen, which no longer exists as an accounting firm. The large company mentioned in the case was Enron. Before the Enron scandal became public, Enron was praised by many in the press. For example, in the January 10, 2000, edition of *BusinessWeek*, Enron CEO, Kenneth Lay, was named as one of the top 25 managers in the country. The article was entitled, *The Dynamo at Enron.* At the time, Enron was a respected company and a highly prized client of Arthur Andersen (Dynamo, 2000).

Dynegy began operations in 1984. The company’s “primary business is the production and sale of electric energy, capacity and ancillary services from … twelve operating power plants in six states” [Dynegy, 2013]. As of December 31, 2012, the company had more than $4.5 billion in assets and employed approximately 1,100 individuals. Sales revenue for 2012 was nearly $1.3 billion. On November 7, 2011, the company filed for Chapter 11 bankruptcy. It emerged from bankruptcy on October 2, 2012.

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