

**FULLY REVISED AND  
UPDATED TH<sub>1</sub>RD EDITION**

# FINANC<sub>1</sub>IAL SH<sub>€</sub>NANIGAN<sub>\$</sub>

**HOW TO DETECT ACCOUNTING  
GIMMICKS & FRAUD IN  
FINANCIAL REPORTS**

**Howard M. Schilit**  
**Jeremy Perler**

# FINANCIAL SHENANIGANS

**THIRD EDITION**

**Howard M. Schilit**  
**Jeremy Perler**



New York    Chicago    San Francisco    Lisbon    London  
Madrid    Mexico City    Milan    New Delhi    San Juan    Seoul  
Singapore    Sydney    Toronto

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ISBN: 978-0-07-170308-6

MHID: 0-07-170308-X

The material in this eBook also appears in the print version of this title: ISBN: 978-0-07-170307-9, MHID: 0-07-170307-1.

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To Diane and Andrea

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## PREFACE

*What has been will be again, what has been done will be done again;  
There is nothing new under the sun.*  
—ECCLESIASTES 1:9

Senior management at publicly traded companies, no doubt, yearn to report positive news and impressive financial results that will please investors and drive the share price higher. While most companies act ethically and follow prescribed accounting rules when reporting their financial performance, some take advantage of gray areas in the rules (or worse, ignore the rules altogether) in order to portray their financial results in a misleadingly positive way.

Management's desire to put a positive spin on financial results has been around as long as corporations and investors themselves. Dishonest companies have long used these tricks to prey on unsuspecting investors, and it is unlikely that they will ever cease to do so. As King Solomon observed in the book of Ecclesiastes, "What has been will be again, what has been done will be done again." With the never-ending need to please investors, the temptation for management to exaggerate the positive through the use of financial shenanigans will always exist. The lure of accounting gimmickry is particularly strong at companies that are struggling to keep up with their investors' expectations or their competitors' performance. And while investors have become more savvy to these gimmicks over the years, dishonest companies continue to find new tricks (and recycle old favorites) to fool investors.

The original 1993 edition of *Financial Shenanigans* introduced readers to the world of corporate chicanery in the form of the seven



Earnings Manipulation Shenanigans. The 2002 edition built on the original framework by identifying new techniques and presenting the worst offenders of the 1990s. With the wave of accounting frauds, restatements, and other financial reporting improprieties over the last decade, this third edition identifies many new techniques companies use to mislead investors. This book expands the discussion of Earnings Manipulation Shenanigans, introduces entirely *new categories* of shenanigans (Cash Flow Shenanigans and Key Metrics Shenanigans), and investigates *new industries* (banks and insurance companies) and *new regions* of the world (Europe and Asia) that have been hit with financial frauds.

## Structure of the New Edition

This edition goes far deeper into the corporate bag of tricks than the earlier ones did, to give readers a comprehensive look at the various kinds of scams that are prevalent today. We have grouped these financial reporting shenanigans into three categories:

- *Earnings Manipulation Shenanigans* reveals how companies manipulate the Statement of Income to report higher revenue, inflated profits, or improperly smoothed income.
- *Cash Flow Shenanigans* discusses tricks used by companies to report misleadingly high cash flow measures, including cash flow from operations and free cash flow.
- *Key Metrics Shenanigans* exposes how companies fool investors by showcasing misleading metrics that are being billed as key measures of business performance or economic health.

## Postmortem: Lessons Learned from Financial Reporting Failures

We believe that the best training for professionals who are involved in preparing, auditing, or evaluating financial reports is an immersion in case studies to learn lessons from real-world financial reporting failures. Robert J. Sack, former chief accountant of the Division of Enforcement at the U.S. Securities and Exchange Commission (SEC), underscored this point by suggesting that accountants be trained more like medical students, who study cadavers to learn from history, stating:

The objective of a medical autopsy is simply to learn what went wrong, and to make a judgment as to what might have been done differently. The medical profession tries to learn from those failures to expand the list of answers. Unfortunately, the financial reporting process sometimes fails too . . . we must find a way for accountants to use those financial reporting failures in the expansion of our knowledge base.

This book uses such an approach, shining a light on the most shocking frauds in recent times and on other companies that tricked investors by reporting false or misleading financial results. Using illustrations culled from SEC enforcement actions, securities class-action litigation, and forensic accounting research by the Center for Financial Research and Analysis (now a part of RiskMetrics Group), we present the most relevant and instructive anecdotes of companies that have employed financial shenanigans to hide business deterioration. These vignettes offer valuable lessons that teach investors how to identify when a company's reported results fail to represent economic reality.

## **Who Will Benefit from Reading This Book**

While we regularly refer to investors in addressing readers throughout this book, we believe that many other parties will also benefit from a rigorous lesson in how to study financial reports to find misleading reporting practices. For example, any party with an economic interest (e.g., commercial bankers, bondholders, insurance underwriters, and other credit providers) needs accurate financial reports that portray the underlying economic reality in order to make informed decisions about an organization. In addition, independent auditors must understand the accounting tricks used by management in order to provide a reasonable opinion on the fairness of financial reports. Boards of directors cannot serve as effective fiduciaries for investors without carefully searching for signs of financial shenanigans. Government regulators must understand accounting gimmickry in order to properly enforce their rules. Influential credit rating organizations will fail to protect bondholders and others if their evaluation of an issuer's financial reports lacks rigor. And corporate executives themselves, who need to monitor both their own performance and that of the competition, would benefit from the lessons in this book.

## **Universal Message about Financial Shenanigans**

While most companies report their results honestly to investors, a significant number use accounting or financial reporting tricks to hide the truth. Since they are likely to be unaware of management's integrity level, smart investors would do well to maintain a healthy skepticism and perform rigorous due diligence with regard to financial reports. Additionally, financial shenanigans occur in every industry and know no geographic borders. Thus, investors following companies headquartered in China, for example, will benefit as much as those interested in companies based in the United States, Brazil, or any other country. Our universal message is that investors should assume that the urge to exaggerate the positive and hide the negative will never disappear. And where temptation exists, shenanigans often follow.

# ACKNOWLEDGMENTS

## From Howard

Many wonderful and generous people have been invaluable in nurturing and shaping my career dedicated to studying and teaching others about ethics in financial reporting.

First thank you to my parents, Irving and Ethel Schilit, for giving me the confidence to believe anything was possible with hard work.

To my siblings, Audrey, Keith, and Rob, for your lifelong friendship and support in all my endeavors.

To my wife, Diane, for accompanying me on a very interesting journey, from life as a professor and author to one as a globe-trotting businessman.

To my children, Jonathan, Suzanne, and Amy, for laughing at my corny jokes and *not* always laughing at my nerdy accountinglike appearance.

To my inspirational teachers at Queens College, Binghamton University, and the University of Maryland for providing me both the direction and tools to pursue my dreams.

To my students and colleagues at American University, who challenged me intellectually as I first researched and taught about financial shenanigans.

To my former colleagues and friends at the Center for Financial Research and Analysis (CFRA) (particularly, Jeremy Perler, Marc Siegel, Jay Huck, Debbie Meritz, and Yoni Engelhart) for helping me build a very special place.

To my clients, who became my most challenging “students.”

And finally, to the dedicated team at McGraw-Hill (notably Leah Spiro, Joe Berkowitz, Janice Race, and Jennifer Ashkenazy) for their tireless effort to shape and polish the book.

## From Jeremy

There are many people to whom I owe gratitude and appreciation:

To Howard Schilit, who inspired me to pursue my passion for financial sleuthing, taught me the art of forensic accounting research, and graciously welcomed me into his house, both figuratively and literally.

To the incredibly talented team of accounting detectives at RiskMetrics Group (and CFRA before it), whose unique blend of curiosity, acumen, ingenuity, and passion helps me grow every day. *Financial Shenanigans* benefited immensely from their bodies of knowledge and work; indeed, it is they who unearthed many of the vignettes featured in this book, in particular, Dan Mahoney (my co-director of research), Enitan Adebajo, David Bassett, Alisa Guyer Galperin, Jill Lehman, and Matt Schechter. Many other colleagues (past and present) were instrumental to this book as well, sharing enlightening stories and shouldering an extra workload.

To the leadership team at RiskMetrics, especially Ethan Berman and Garvis Toler, whose professional support and personal devotion are both endearing and enduring.

To Marc Siegel, a mentor, colleague, and friend, who led me to the crossroads of accounting and the financial markets and showed me how to direct traffic.

To the accounting faculty at the University of Michigan's Ross School of Business, who cultivated my curiosity for navigating a financial *maize* and *blue* the wind that lifted my accounting sails.

To my parents, Vicki and Arthur, who stocked my tool bench and taught me how to build; and to my brothers, Ari, Elie, and Jacob, who filled my foundation.

And most of all, to my wife, Andrea, who strengthens and inspires me every day with her brilliance, benevolence, and endless love. And to our two beautiful girls, Shira and Orli, whose loving eyes and contagious smiles provide me with eternal harmony.

PART ONE  
ESTABLISHING THE  
FOUNDATION

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# 1

## AS BAD AS IT GETS

Like millions of other movie lovers, our families look forward to the late-winter evening each year when Hollywood stages its most prestigious night: the Academy Awards ceremony. The Oscars rank the year's best films, certifying their place in cinematic history. Like the title of a particularly Academy-honored film from 1997, the competitors for the Best Picture Oscar are *As Good as It Gets*.

If we were going to hand out awards for financial shenanigans, however, the competitors would be vying for the title of *As Bad as It Gets*.

### Awards for Most Outrageous Financial Shenanigans

In reviewing the most colossal financial reporting scandals of the last decade, we added our own Creative Accounting Award category, *As Bad as It Gets*, to highlight those in management who possessed the talent, vision, and chutzpah to mislead investors with financial shenanigans.

And the winners are . . .

#### "As Bad as It Gets" Awards in Financial Shenanigans

Category	Company
Most Imaginative Fabrication of Revenue	Enron
Most Brazen Creation of Fictitious Profit and Cash Flow	WorldCom
Most Shameless Heist by Senior Management	Tyco
Most Ardent and Prolific Use of Numerous Shenanigans	Symbol Technologies



**Enron: Most Imaginative Fabrication of Revenue**

Houston-based Enron Corp. quickly became synonymous with the term *massive accounting fraud* in the fall of 2001 with its sudden collapse and bankruptcy. Many people have described the utility company’s ruse as a cleverly designed fraud involving the use of thousands of off-balance-sheet partnerships to hide massive losses and unimaginable debts from investors. While that story line is essentially correct, detection of red flags required no special accounting skills or even advanced training in reading financial statements. It simply required the curiosity to notice and question a stupendous five-year jump in Enron’s sales revenue from 1995 to 2000.

**Warning for Enron Investors—Revenue Growth Defied Reality**

Enron ranked number seven in *Fortune* magazine’s list of the 500 largest companies in 2000 (ranked by total revenue), surpassing such giants as AT&T and IBM. In just five short years, Enron’s revenue had miraculously increased by an astounding factor of 10 (rising from \$9.2 billion in 1995 to \$100.8 billion in 2000). Curious investors might have questioned how frequently companies tend to grow their revenue from under \$10 billion to over \$100 billion in five years. The answer: *never*. Enron’s staggering increase in revenue was unprecedented, and the company achieved this growth without any large acquisitions along the way. Impossible!

As Table 1-1 shows, in 2000, only seven companies produced revenue of \$100 billion or more. Except for Citigroup (with its 1998

Table 1-1. Fortune 500 Largest Companies Ranked by Sales (as of 2000)

(\$ millions)	2000	1999	1998	1997	1996	1995
ExxonMobil	210,392	163,881	100,697	122,379	119,434	110,009
Wal-Mart	193,295	166,809	139,208	119,299	106,147	93,627
General Motors	184,632	189,058	161,315	178,174	168,369	168,829
Ford	180,598	162,558	144,416	153,627	146,991	137,137
General Electric	129,853	111,630	100,469	90,840	79,179	70,028
Citigroup	111,826	82,005	76,431	Predecessor	Predecessor	Predecessor
Enron	100,789	40,112	31,260	20,273	13,289	9,189

Table 1-2. 2000 Sales Growth at Largest Fortune 500 Companies

(\$ millions)	2000	1999	% Change
ExxonMobil	210,392	163,881	28%
Wal-Mart	193,295	166,809	16%
General Motors	184,632	189,058	(2%)
Ford	180,598	162,558	11%
General Electric	129,853	111,630	16%
Citigroup	111,826	82,005	36%
<b>Enron</b>	<b>100,789</b>	<b>40,112</b>	<b>151%</b>

merger of Citicorp and Travelers), these large companies' growth essentially came organically, not through acquisitions.

Notice in Table 1-2 that in 2000, Enron's sales grew a staggering 151 percent, from \$40.1 billion to \$100.8 billion.

Curiously, even though Enron made the list with the big boys, its reported profits, totaling less than \$1 billion (or 1 percent of sales), paled in comparison to the others. Moreover, profits never grew proportionally with sales, a pretty unusual occurrence and a definite warning sign of accounting tricks. If sales grow by 10 percent, for example, investors generally would expect expenses and profits to rise by a similar amount at a business with steady margins. At Enron, no logical pattern existed except that sales shot to the moon and profits barely moved at all. In 2000, sales grew by more than 150 percent, yet profits increased by less than 10 percent, as shown in Table 1-3. How was that possible?

Table 1-3. Net Income of Largest Fortune 500 Companies, Ranked by 2000 Sales Level

(\$ millions)	2000 Net Income
ExxonMobil	17,720
Wal-Mart	6,295
General Motors	4,452
Ford	3,467
General Electric	12,735
Citigroup	13,519
<b>Enron</b>	<b>979</b>

Table 1-4. Enron's Sales, Profit, and Fortune 500 Ranking  
(Based on Annual Sales)

(\$ millions)	2000	1999	1998	1997	1996	1995
Sales	100,789	40,112	31,260	20,273	13,289	9,189
Profit	979	893	703	105	584	520
<b>Fortune 500 ranking</b>	<b>7</b>	<b>18</b>	<b>27</b>	<b>57</b>	<b>94</b>	<b>141</b>

Let's go back a few years further and track Enron's meteoric revenue rise and its race up the Fortune 500 list of largest companies from a middling rank of 141 in 1995 to its lofty top 10 position in the 2000 results (see Table 1-4).

Few companies ever reach \$100 billion in revenue, as Enron did in 2000, and the climb from \$10 to \$100 billion generally takes decades. As Table 1-5 shows, ExxonMobil first reached \$10 billion in revenue in 1963, and not until 1980 did it join the \$100 billion club. General Motors first reached \$10 billion in 1955, yet it took the company 31 more years to join the more exclusive club. Yet, nimble Enron, which hit \$10 billion in 1996, raced to the \$100 billion mark in only 4 years. Such a rapid ascent had never taken place before. In fact, the previous record was set by Wal-Mart, which did it in 10 years. It might have seemed implausible, to an observer, that Enron could have found a legitimate formula to achieve business success immortality. Sure enough, as we will explore throughout this book, this immortality came through perpetrating a gigantic fraud.

Table 1-5. The \$100 Billion Club

	First \$100 B Year	Revenue (\$ millions)	First \$10 B Year	Revenue (\$ millions)	Years from \$10 B to \$100 B
ExxonMobil	1980	103,143	1963	10,264	17
Wal-Mart	1996	106,147	1986	11,909	10
General Motors	1986	102,813	1955	12,443	31
Ford	1992	100,786	1965	11,537	27
General Electric	1998	100,469	1972	10,240	26
<b>Enron</b>	<b>2000</b>	<b>100,789</b>	<b>1996</b>	<b>13,289</b>	<b>4</b>

Source: *Fortune* magazine.

## The Enron Fraud Revealed

The first signs of a massive fraud were revealed when an Enron committee and the firm's auditor, Arthur Andersen, reviewed the accounting for several unconsolidated ("off-balance-sheet") partnerships in October 2001 and concluded that Enron should have consolidated some of these partnerships and included them as a part of the company's financial results. Things went from bad to worse the following month when Enron disclosed a \$586 million reduction in previously reported net income and took a \$1.2 billion reduction in its stockholders' equity. Investors began to flee, and Enron's stock price sank like a boulder. Before Enron's final descent, credit rating agencies cut its rating and virtually all borrowing froze. In early December 2001, Enron filed for bankruptcy with assets of about \$65 billion. It was the largest corporate bankruptcy in U.S. history—until WorldCom declared bankruptcy seven months later (WorldCom was subsequently surpassed by Lehman Brothers in 2008).

In the end, most shareholders suffered staggering losses as Enron's stock price in 2000 plunged from over \$80 per share (with a market capitalization exceeding \$60 billion) to \$0.25 nine short but painful months later. Some insiders, however, sold large parts of their holdings *before* the collapse. Enron's chairman and former CEO, Ken Lay, and other top officials sold hundreds of millions of dollars worth of stock in the months leading up to the crisis.

## Legal Justice for Enron Executives—a Minor Consolation for Shareholders

On May 25, 2006, a jury returned guilty verdicts against Enron's chairman, Ken Lay, and CEO, Jeffrey Skilling. Skilling was convicted on 19 of 28 counts of securities and wire fraud and sentenced to over 24 years in prison. Lay was tried and convicted on 6 counts of securities and wire fraud, but he died two months later while awaiting sentencing that could have locked him up for 45 years.

Investors should also have questioned how, despite sales growing tenfold over this period, profits failed to even double. The sales figures and their unprecedented annual rise year after year should have raised alarms for investors. Chapters 3 and 4 of this book will share some of Enron's darkest secrets in how it inflated revenue without detection for all those years by using a little-understood method known as mark-to-market accounting and by improperly "grossing up" sales to give the illusion of being a much larger company.

**Key Lesson:** When reported sales growth far exceeds any normal patterns, revenue recognition shenanigans may likely have fueled the increase.

### **ENRON: FINANCIAL SHENANIGANS IDENTIFIED**

#### *Earnings Manipulation Shenanigans*

- Recording Revenue Too Soon
- Recording Bogus Revenue
- Boosting Income Using One-Time or Unsustainable Activities
- Employing Other Techniques to Hide Expenses or Losses

#### *Cash Flow Shenanigans*

- Shifting Financing Cash Inflows to the Operating Section
- Shifting Normal Operating Cash Outflows to the Investing Section
- Inflating Operating Cash Flow Using Acquisitions or Disposals
- Boosting Operating Cash Flow Using Unsustainable Activities

#### *Key Metrics Shenanigans*

- Showcasing Misleading Metrics That Overstate Performance
- Distorting Balance Sheet Metrics to Avoid Showing Deterioration

### **WorldCom: Most Brazen Creation of Fictitious Profit and Cash Flow**

WorldCom Inc. began life in 1983 as the American telecommunications company Long Distance Discount Services (LDDS). In 1989, LDDS merged into a shell company called Advantage Companies

in order to become publicly traded, and in 1995, LDDS changed its name to LDDSWorldCom.

Throughout WorldCom's history, its growth came largely from making acquisitions. (As we will explain later, acquisition-driven companies offer investors some of the greatest challenges and risks.) The largest of these occurred in 1998 with the \$40 billion acquisition of MCI Communications. Accordingly, the name was again changed, this time to MCI WorldCom. A few years later, the name was finally shortened to WorldCom.

### **The Accounting Games at WorldCom**

Almost from the beginning, WorldCom used aggressive accounting practices to inflate its earnings and operating cash flows. One of its principal shenanigans involved making acquisitions, writing off much of the costs immediately, creating reserves, and then releasing those reserves into income as needed. With more than 70 deals over the company's short life, WorldCom continued to "reload" its reserves so that they were available for future release into earnings.

This shenanigan would probably have been able to continue had WorldCom been allowed to acquire the much larger Sprint in a \$129 billion deal announced in October 1999. Antitrust lawyers and regulators at the U.S. Department of Justice and their counterparts at the European Union disapproved of the merger, citing monopoly concerns. Without the acquisition, WorldCom "lost" the expected infusion of new reserves that it needed, as its prior ones had rapidly been depleted by being released into income.

**Key Warning: Acquisitive Companies**—Financial shenanigans often lurk at companies that grow predominantly by making acquisitions. Moreover, acquisition-driven companies often lack internal engines of growth, such as product development, sales, and marketing.

By early 2000, with its stock price declining and intense pressure from Wall Street to "make its numbers," WorldCom embarked on a new and far more aggressive shenanigan—moving ordinary

business expenses from its Statement of Income to its Balance Sheet. One of WorldCom's major operating expenses was its so-called line costs. These costs represented fees that WorldCom paid to third-party telecommunication network providers for the right to lease their networks. Accounting rules clearly require that such fees be expensed and *not be capitalized*. Nevertheless, WorldCom removed hundreds of millions of dollars of its line costs from its Statement of Income in order to please Wall Street. In so doing, WorldCom dramatically understated its expenses and inflated its earnings, while duping investors. This trick continued quarter after quarter from mid-2000 through early 2002 until it was uncovered by internal auditors at WorldCom.

### **CEO Bernie Ebbers Spends Like a Drunken Sailor**

With WorldCom regularly meeting Wall Street's earning targets, its stock price rose dramatically. CEO Bernie Ebbers sold large blocks of his stock to support other business ventures (timber) and his lavish lifestyle (yachting). As the stock declined in 2001 during the technology meltdown, Ebbers found some extra cash that he needed by borrowing against (i.e., margining) his stock holdings. As margin calls from brokers increased, Ebbers convinced the board of directors to give him corporate loans and guarantees in excess of \$400 million. Ebbers had probably hoped that these loans would prevent the need for him to sell a substantial portion of his WorldCom stock, which would have further hurt the company's share price. However, this strategy to prevent the stock price from collapsing ultimately failed, and Ebbers was ousted as CEO in April 2002, just months before the fraud was revealed.

### **The Collapse of WorldCom**

Meanwhile, in early 2002, a small team of internal auditors at WorldCom, working on a hunch, were secretly investigating what they thought could be fraud. After finding \$3.8 billion in inappropriate accounting entries, they immediately notified the company's board of directors, and events progressed swiftly. The CFO was fired, the controller resigned, Arthur Andersen withdrew its audit opinion for 2001, and the Securities and Exchange Commission (SEC) launched an investigation.

WorldCom's days were numbered. On July 21, 2002, the company filed for Chapter 11 bankruptcy protection, the largest such filing in U.S. history at the time (a record that has since been overtaken by the collapse of Lehman Brothers in September 2008). Under the bankruptcy reorganization agreement, the company paid a \$750 million fine to the SEC and restated its earnings in an amount that defies belief. In total, the company reported an accounting restatement that exceeded \$70 billion, including adjusting the 2000 and 2001 numbers from the originally reported gain of nearly \$10 billion to an astounding *loss* of over \$64 billion. The directors also felt the pain, having to pay almost \$25 million to settle class-action litigation.

### **Postbankruptcy and the Fate of Bernie Ebbers**

The company emerged from bankruptcy in 2004. Previous bondholders were paid 36 cents on the dollar, in bonds and stock in the new company, while the previous stockholders were wiped out completely. In early 2005, Verizon Communications agreed to acquire MCI for about \$7 billion. Two months later, Ebbers was found guilty of all charges and convicted of fraud, conspiracy, and filing false documents. He was later sentenced to 25 years in prison.

### **Warning for WorldCom Investors—Evaluate Free Cash Flow**

Investors would have found some clear warning signs in evaluating WorldCom's Statement of Cash Flows (SCF), specifically, its rapidly deteriorating free cash flow. WorldCom *manipulated both its net earnings and its operating cash flow*. By treating line costs as an asset instead of an expense, WorldCom improperly inflated its profits. In addition, since it improperly placed those expenditures in the Investing rather than the Operating section of the SCF, WorldCom similarly inflated operating cash flow. While reported operating cash flow appeared consistent with reported earnings, the company's free cash flow told the story.

### **Reported Cash Flow from Operations Looked Solid**

As shown in Table 1-6, WorldCom cleverly hid its problems from investors, as the cash flow from operations (CFFO) regularly exceeded net income. (Part 3 of this book shows how investors



Table 1-6. WorldCom’s Cash Flow from Operations versus Net Income (as Originally Reported)

(\$ millions)	Q1, 3/01	Q4, 12/00	Q3, 9/00	Q2, 6/00	Q1, 3/00
Cash flow from operations (CFFO)	1,596	1,743	2,060	2,069	1,794
Subtract: Net income	610	732	967	1,291	1,301
CFFO less net income	986	1,011	1,093	778	493

Accounting Capsule: Free Cash Flow

Free cash flow measures the cash generated by a company, including the impact of cash paid to maintain or expand its asset base (i.e., purchases of capital equipment). Free cash flow typically would be calculated as follows:

Cash flow from operations *minus* capital expenditures *equals* free cash flow

could have known that WorldCom’s CFFO was artificially inflated.)

Free Cash Flow Told the Real Story

A key to uncovering WorldCom’s shenanigans required taking the analysis of cash flow a step further—computing its “free cash flow.” This metric removes line costs from cash flow, regardless of whether they are presented in the Investing or the Operating section of the SCF. Let’s examine Table 1-7, which gives free cash flow. During 1999, the period just before the company began capitalizing line costs, WorldCom generated almost \$2.3 billion in free cash flow. Let’s contrast that to the following year, when WorldCom experienced a \$3.8 billion decline in free cash flow—a staggering deterioration of over \$6.1 billion. Noting this dramatic and troubling turnabout, WorldCom investors should have concluded that the business was in deep trouble, fraud or no fraud.

Table 1-7. WorldCom's Free Cash Flow

(\$ millions)	Total 1999	Q4, 12/99	Q3, 9/99	Q2, 6/99	Q1, 3/99
Cash flow from operations	11,005	3,228	3,271	2,581	1,925
Subtract: Capital expenditures	(8,716)	(2,877)	(2,165)	(2,035)	(1,639)
Free cash flow	2,289	351	1,106	546	286
	Total 2000	Q4, 12/00	Q3, 9/00	Q2, 6/00	Q1, 3/00
Cash flow from operations	7,666	1,743	2,060	2,069	1,794
Subtract: Capital expenditures	(11,484)	(2,707)	(3,580)	(2,678)	(2,519)
Free cash flow	(3,818)	(964)	(1,520)	(609)	(725)

**Key Lesson:** When free cash flow suddenly plummets, expect big problems.

### WORLDCOM: FINANCIAL SHENANIGANS IDENTIFIED

#### *Earnings Manipulation Shenanigans*

- Recording Bogus Revenue
- Shifting Current Expenses to a Later Period
- Employing Other Techniques to Hide Expenses or Losses
- Shifting Future Expenses to an Earlier Period

#### *Cash Flow Shenanigans*

- Shifting Normal Operating Cash Outflows to the Investing Section
- Inflating Operating Cash Flow Using Acquisitions or Disposals
- Boosting Operating Cash Flow Using Unsustainable Activities

*Key Metrics Shenanigans*

- Showcasing Misleading Metrics That Overstate Performance
- Distorting Balance Sheet Metrics to Avoid Showing Deterioration

**Tyco: Most Shameless Heist by Senior Management**

Similar to WorldCom, Tyco International Ltd. loved doing acquisitions, making hundreds of them over a few short years. From 1999 to 2002, Tyco bought more than 700 companies for a combined total of approximately \$29 billion. While some of the acquired companies were large businesses, many were so small that Tyco did not even bother disclosing them to investors in its financial statements.

Tyco probably liked the businesses that it was buying, but more than that, the company loved to be able to show investors that it was growing rapidly. However, what Tyco seemed to like best about these acquisitions was the accounting loopholes that they presented. The acquisitions allowed the company to reload its dwindling reserves, providing a consistent source of artificial earnings boosts. Moreover, the frequent acquisitions allowed Tyco to show strong operating cash flow, even though it merely resulted from an accounting loophole. (We will come back to this in Cash Flow Shenanigan No. 3: Inflating Operating Cash Flow Using Acquisitions or Disposals.) Indeed, Tyco loved the acquisition accounting benefits so much that it even used them when no acquisitions at all occurred.

**Tyco's Clever Accounting Games**

Consider how Tyco accounted for payments that it made in soliciting new security-alarm business in its ADT subsidiary. Rather than hire additional employees, Tyco decided to use an independent network of dealers to solicit new customers. Tyco was so enamored with acquisition accounting that it decided to use this technique to record the purchase of these contracts from agents. In so doing, Tyco inflated its profits by failing to record the proper

expense. Moreover, Tyco inflated its operating cash flow by recording these payments in the Investing section of the Statement of Cash Flows.

But Tyco had many more tricks up its sleeve. It increased the price paid to dealers for each contract, and in return, required the dealers to pay that increased amount back to it as a “connection fee” for doing business. While this arrangement clearly had no impact on the underlying economics of the transaction, Tyco inappropriately decided to record this connection fee as income, providing an artificial boost to both earnings and operating cash flow. The boosts really added up when you consider that Tyco played this game with hundreds of thousands of contracts that it purchased.

### **The SEC Charges Tyco with Fraud**

The SEC reviewed Tyco’s arrangements with dealers and gave the company a “thumbs down” for its creative accounting. As part of an overall billion-dollar fraud, the SEC alleged that Tyco used inappropriate accounting for ADT contract purchases to fraudulently generate \$567 million in operating income and \$719 million in cash flow from operations. Moreover, the SEC charged that Tyco engaged in improper acquisition accounting practices that inflated operating income by at least \$500 million. Such practices included undervaluing acquired assets, overvaluing acquired liabilities, and misusing accounting rules concerning the establishment and utilization of reserves. If that were not enough, the lawsuit charged that Tyco had improperly established and used various reserves to enhance and smooth publicly reported results and meet Wall Street expectations.

### **The Tyco Piggy Bank**

Unfortunately for Tyco and its investors, the problems were far from over. During this period, senior executives (mainly CEO Dennis Kozlowski and CFO Mark Swartz) had been using the company’s cash account as their own piggy bank. The government charged that these executives had been stealing hundreds of millions of dollars from Tyco by failing to properly disclose to shareholders the existence of back-door executive compensation arrangements and related-party transactions. With the board unaware or asleep at the

wheel, senior executives granted themselves loans for personal expenses, many of which were secretly forgiven, effectively producing a large unreported compensation expense.

**Enormous Penalty and Jail Time**

The larcenous executives at Tyco paid an enormous price. On top of a \$50 million SEC penalty, the company agreed to pay a record-breaking \$3 billion in restitution to settle shareholder lawsuits. Moreover, Kozlowski and Swartz were convicted of looting the company and inflating its stock price, and both were sentenced to up to 25 years in prison.

**Warning for Tyco Investors—Negative Free Cash Flow, Net of Acquisitions**

Detailed cash flow analysis would have helped investors notice problems at Tyco. For acquisitive companies, however, we suggest computing an adjusted free cash flow that removes total cash outflows for acquisitions. By adjusting the free cash flow calculation for acquisitions, investors would have a clearer picture of a company’s performance. As a theme discussed throughout the book, acquisitions present numerous opportunities for companies to inflate earnings and both operating and free cash flow. In the case of Tyco, we spotted big drops in adjusted free cash flow. As shown in Table 1-8, between 2000 and 2002, Tyco generated a cumulative *negative* free cash flow (net of acquisitions), although it reported very large operating cash inflows for those years.

Table 1-8. Tyco’s Free Cash Flow after Acquisitions  
(from Continuing Operations)

(\$ millions)	2002	2001	2000
<b>Reported Cash Flow from Operations</b>	<b>5,696</b>	<b>6,926</b>	<b>5,275</b>
Subtract: Capital Expenditures	(1,709)	(1,798)	(1,704)
Subtract: Construction-in-Progress	(1,146)	(2,248)	(111)
<b>Free Cash Flow</b>	<b>2,841</b>	<b>2,880</b>	<b>3,460</b>
Subtract: Acquisitions	(3,709)	(11,851)	(4,791)
<b>Free Cash Flow after Acquisitions</b>	<b>(868)</b>	<b>(8,971)</b>	<b>(1,331)</b>

**TYCO: FINANCIAL SHENANIGANS IDENTIFIED***Earnings Manipulation Shenanigans*

- Recording Bogus Revenue
- Shifting Current Expenses to a Later Period
- Employing Other Techniques to Hide Expenses or Losses
- Shifting Current Income to a Later Period
- Shifting Future Expenses to an Earlier Period

*Cash Flow Shenanigans*

- Shifting Financing Cash Inflows to the Operating Section
- Shifting Normal Operating Cash Outflows to the Investing Section
- Inflating Operating Cash Flow Using Acquisitions or Disposals
- Boosting Operating Cash Flow Using Unsustainable Activities

*Key Metrics Shenanigans*

- Showcasing Misleading Metrics That Overstate Performance
- Distorting Balance Sheet Metrics to Avoid Showing Deterioration

**Symbol Technologies: Most Ardent and Prolific Use of Numerous Shenanigans**

Although much smaller in size, Long Island-based Symbol Technologies Inc., a maker of bar code scanners, earned its rightful place as a winner of our *As Bad as It Gets* Award in creative accounting for its audacious use of all seven Earnings Manipulation Shenanigans, all four Cash Flow Shenanigans, and both Key Metrics Shenanigans—an impressive and rare distinction. Even Enron, WorldCom, and Tyco could not match the breadth of Symbol's feat. (Of course, these three companies distinguished

and disgraced themselves by “specializing” in a few gigantic shenanigans.)

### **Some Tricks Used**

Symbol seemed to be obsessed with never disappointing Wall Street. For more than eight consecutive years, it either met or exceeded Wall Street’s estimated earnings—32 straight quarters of sustained success. In hindsight, though, such steady and predictable performance (particularly during the technology collapse of 2000–2002) should have alerted investors to take a closer look.

Symbol never wanted its earnings to get too high or too low, so it would record bogus adjustments to the company’s financial statements at the end of each quarter in order to align its results with Wall Street expectations. In very strong periods, for example, the company would take charges to create “cookie jar” reserves that could be used to boost earnings during weaker periods. That occurred in the late 1990s when Symbol won a large contract from the U.S. Postal Service that accounted for 11 percent of the company’s 1998 revenue. Symbol cleverly used restructuring charges to dampen its reported growth, and in so doing, both lowered the bar to meet future-period Wall Street expectations and created reserves that could be released when needed.

If, instead, Symbol’s business slowed and Wall Street targets went unmet, the company would “stuff the channel,” or ship products to customers too early in order to record additional revenue. Symbol also allegedly inflated revenue by shipping products that its customers did not want. The company even sold products to customers in order to record revenue, then repurchased the goods at a higher price (a bizarre arrangement in which Symbol actually lost money in order to create revenue growth).

Moreover, if Symbol’s operating expenses got out of control and needed some trimming, there was a ready solution. In one case, when paying bonuses in early 2001, Symbol conveniently (and improperly) deferred the related Federal Insurance Contributions Act (FICA) insurance costs, thereby inflating operating income. The company also tidied up messy issues that surfaced on the Balance Sheet, like accounts receivable that were not getting collected. In 2001, Symbol was concerned that Wall Street would re-

act unfavorably to surging receivables, so it simply moved them to another section of the Balance Sheet where they would be hidden from investors' view. (More on this in Part 4, "Key Metrics Shenanigans.")

### **And Justice for All—But One**

The regulators finally caught up with Symbol after all those years of duping investors. The SEC accused Symbol of perpetrating a massive fraud from 1998 until 2003. Unlike the scoundrels running Enron, WorldCom, and Tyco, however, Symbol's senior executive followed a different (and somewhat bizarre) course. After being indicted on securities fraud charges, CEO Tomo Razmilovic fled the country and was declared a fugitive. He even made the U.S. Postal Inspection Service's "most-wanted" list, with a \$100,000 reward offered for his arrest and conviction. (At that time, he was the only white-collar crime suspect on the agency's most-wanted Web site, which included rewards for the anthrax mailer, certain bombing suspects, and post office robbers.) He is still on the lam, apparently living comfortably in Sweden.

### **Warnings for Symbol Technologies Investors**

In addition to Symbol's unusually steady and predictable performance, there were many warning signs for investors about the company's struggles. Our forensic research firm, the Center for Financial Research and Analysis (CFRA, and now part of RiskMetrics Group), issued six separate reports between 1999 and 2001, warning investors about Symbol's aggressive accounting practices. Specific issues raised in our reports include the following:

1. Unusually large one-time charges seemed to be designed to create bogus reserves that could be used in future periods to benefit earnings. For example, when acquiring Telxon in 2000, Symbol wrote off 68 percent of the purchase price. Symbol also wrote off inventory that may have subsequently been sold, providing a boost to margins.
2. Symbol showed signs of aggressive cost capitalization, including a doubling of capitalized software and a surge in soft assets to 21 percent of total assets in Q2 2000 (from 11 percent the prior year).



3. Inventories jumped dramatically, raising concerns about margin pressure in future periods, possible product returns, or customers losing interest in the company's product.
4. Accounts receivable surged from early 1999 to 2001, signaling aggressive revenue recognition (stuffing the channels at the end of the period).
5. Symbol's allowance for doubtful accounts continuously declined as a percentage of accounts receivable, providing a benefit to earnings.
6. Symbol frequently fell half a penny short of earnings per share (EPS) targets, but kept its Wall Street "success" streak alive by rounding up (for example, rounding up \$0.1167 to achieve the target of \$0.12). We considered it highly unlikely that management was this lucky and consistent, instead seeing it as a sign of earnings manipulation.
7. Cash flow from operations routinely lagged behind net income, a sign of poor earnings quality.

#### **SYMBOL: FINANCIAL SHENANIGANS IDENTIFIED**

##### *Earnings Manipulation Shenanigans*

- Recording Revenue Too Soon
- Recording Bogus Revenue
- Boosting Income Using One-Time or Unsustainable Activities
- Shifting Current Expenses to a Later Period
- Employing Other Techniques to Hide Expenses
- Shifting Current Income to a Later Period
- Shifting Future Expenses to an Earlier Period

##### *Cash Flow Shenanigans*

- Shifting Financing Cash Inflows to the Operating Section
- Shifting Normal Operating Cash Outflows to the Investing Section
- Inflating Operating Cash Flow Using Acquisitions or Disposals
- Boosting Operating Cash Flow Using Unsustainable Activities

*Key Metrics Shenanigans*

- Showcasing Misleading Metrics That Overstate Performance
- Distorting Balance Sheet Metrics to Avoid Showing Deterioration

**Looking Ahead**

Many investors in Enron, WorldCom, Tyco, and Symbol Technologies paid heavy prices for failing to spot early signs of operating problems that had been camouflaged by financial shenanigans. Fortunately, investors, auditors, and other stakeholders can learn lessons from these debacles and better arm themselves with the knowledge of how to detect similar warning signs in the future.

Chapter 2 establishes the foundation for understanding the three categories of financial shenanigans: Earnings Manipulation (Part 2), Cash Flow (Part 3), and Key Metrics (Part 4), and where they are most likely to occur.

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# 2

## JUST TOUCH UP THE X RAYS

*I can't afford the operation, but would you accept a small payment to touch up the X rays?*

—WARREN BUFFETT, CEO of Berkshire Hathaway

Legendary investor Warren Buffett generously uses his annual letter to investors as a vehicle to educate all interested parties about the art of investing. In one such letter, the Oracle from Omaha, as he is affectionately known, gave a particularly poignant lesson concerning a subject that is near and dear to us: companies that use financial shenanigans to hide the unpleasant truth from investors. This letter described a conversation between a seriously ill patient and his doctor, just after an X ray revealed the bad news about his condition. Rather than accept the information about his deteriorating health, the patient's immediate response to the dreadful news was to ask the doctor to touch up the X rays. Buffett uses this story to warn investors about managements that try to hide the truth about a deteriorating business's economic health by *touching up* the financial statements. Buffett then prophetically adds, "In the long run, however, trouble awaits managements that paper over operating problems with accounting maneuvers. Eventually, managements of this kind achieve the same result as the seriously-ill patient."

No doubt, a company's use of financial shenanigans to paper over its poor economic health would be no more effective than a doctor touching up X rays to improve a patient's physical health. Such gimmicks are pointless, as the truth of the company's deterioration will remain unchanged and will ultimately come to light one day.

This book provides readers with the skills necessary to identify companies that are simply papering over their financial performance and economic health problems. Chapter 2 establishes the foundation for development of these skills by answering basic questions, including what financial shenanigans are and where they are most likely to occur.

## **What Are Financial Shenanigans?**

Financial shenanigans are actions taken by management that mislead investors about a company's financial performance or economic health. As a result, investors are often tricked into believing that a company's earnings are stronger, its cash flows more robust, and its Balance Sheet position more secure than are really the case.

Some shenanigans can be detected in the numbers presented by carefully reading a company's Balance Sheet, Statement of Income, and Statement of Cash Flows. Proof of other shenanigans might not be explicitly provided in the numbers and therefore requires scrutinizing the narratives contained in footnotes, quarterly earnings releases, and other publicly available representations by management. We classify financial shenanigans into three broad groups: Earnings Manipulation Shenanigans (Part 2), Cash Flow Shenanigans (Part 3), and Key Metrics Shenanigans (Part 4).

### **Earnings Manipulation Shenanigans (Part 2)**

Investors judge corporate executives harshly when they fail to meet Wall Street's earnings expectations when reporting each quarter. Share prices often suffer dramatic declines when disappointing earnings are reported. Not surprisingly, then, in order to steer the share price (and the executives' compensation package) higher,

some companies engage in a variety of shenanigans to manipulate earnings. We have identified the following seven Earnings Manipulation (EM) Shenanigans that result in misrepresentations of a company's sustainable earnings.

- EM Shenanigan No. 1: Recording Revenue Too Soon
- EM Shenanigan No. 2: Recording Bogus Revenue
- EM Shenanigan No. 3: Boosting Income Using One-Time or Unsustainable Activities
- EM Shenanigan No. 4: Shifting Current Expenses to a Later Period
- EM Shenanigan No. 5: Employing Other Techniques to Hide Expenses or Losses
- EM Shenanigan No. 6: Shifting Current Income to a Later Period
- EM Shenanigan No. 7: Shifting Future Expenses to an Earlier Period

### Cash Flow Shenanigans (Part 3)

The plethora of financial reporting scandals and earnings restatements in recent years has left many investors questioning whether reported earnings can ever be free of management manipulation. Increasingly, investors have expanded their focus to include the Statement of Cash Flows and, more specifically, the section that highlights cash flow from operations (CFFO).

Investors are beginning to harbor a troubling suspicion about corporate financial reporting: that management now plays tricks to pollute cash flow from operations. Sadly, these suspicions are well founded. Investors can no longer trust that management will report its cash flow honestly and without discretion. To help investors navigate through the cash flow deception, we have identified the following four Cash Flow (CF) Shenanigans that may result in misrepresentations of a company's ability to generate cash flow from its operations.

CF Shenanigan No. 1: Shifting Financing Cash Inflows to the Operating Section

CF Shenanigan No. 2: Shifting Normal Operating Cash Outflows to the Investing Section

CF Shenanigan No. 3: Inflating Operating Cash Flow Using Acquisitions or Disposals

CF Shenanigan No. 4: Boosting Operating Cash Flow Using Unsustainable Activities

### **Key Metrics Shenanigans (Part 4)**

So far we have addressed shenanigans that investors can generally identify by a careful reading of the numbers in the financial reports. Management, naturally, faces some restrictions under the accounting rules (called GAAP, or generally accepted accounting principles) on how it presents financial results to investors. To bypass many such restrictions and put on a positive spin, management has become more active and deceptive in creating and manipulating key non-GAAP metrics to impress investors. Such financial reporting misrepresentations tend to improperly highlight strong or consistent growth and robust health. Part 4 introduces two categories of Key Metrics (KM) Shenanigans.

KM Shenanigan No. 1: Showcasing Misleading Metrics That Overstate Performance

KM Shenanigan No. 2: Distorting Balance Sheet Metrics to Avoid Showing Deterioration

## **Using a Holistic Approach to Detect Financial Shenanigans**

### **Importance of “Checks and Balances”**

What began in June 1972 as a bungled burglary of the Democratic National Committee office located in the Watergate Hotel in Washington culminated in the unprecedented resignation of a

U.S. president in August 1974. The fact that President Nixon was driven out of office confirmed that our system of checks and balances really does work. Both the judicial and legislative branches played important roles in stopping a chief executive who abused his constitutional powers. The Supreme Court ruled unanimously that President Nixon could not plead executive privilege to prevent investigators from gaining access to White House tapes that were believed to contain damaging evidence, and the Judiciary Committee of the House of Representatives recommended impeachment to the full House. Facing the likely prospect of losing the impeachment votes in the House and the Senate, Nixon resigned the presidency.

More recently, in 1999, President Bill Clinton brought the executive office to the brink with another constitutional crisis over poor presidential behavior. The House of Representatives voted to impeach Clinton for lying under oath about his relations with a White House intern, stating that the president “willfully corrupted and manipulated the judicial process of the United States for his personal gain and exoneration.” However, with Supreme Court Chief Justice William Rehnquist presiding, the Senate had trouble finding an impeachable offense under “high crimes and misdemeanors,” and Clinton was found not guilty.

Whether the goal is preserving a democracy or upholding the integrity of financial reporting, a system of checks and balances is paramount for preventing, uncovering, and punishing improper behavior. And much like the U.S. government, financial reporting has three separate “branches”: a Statement of Income, a Statement of Cash Flows, and a Balance Sheet. When one of these financial statements contains shenanigans, warning signs generally appear on the other ones. Thus, Earnings Manipulation tricks can often be detected indirectly through unusual patterns on the Balance Sheet and the Statement of Cash Flows. Similarly, deciphering certain changes on the Statement of Income and the Balance Sheet often can help investors sniff out Cash Flow Shenanigans. (Part 5, “Putting It All Together,” summarizes how various checks and balances could have helped investors detect many of the shenanigans illustrated in this book.)



## What Environment Breeds Shenanigans?

Clearly, not all companies use tricks in reporting to investors. Indeed, we believe that the vast majority of companies report honestly. Nevertheless, when researching companies, investors must always be vigilant and actively search for warning signs of problems, since shenanigans occur with sufficient frequency and cause significant pain if left undetected.

Companies with structural weaknesses or inadequate oversight provide a fertile breeding ground for shenanigans. Investors should probe a company's governance and oversight by asking these basic questions: (1) Do appropriate checks and balances exist among senior executives to snuff out corporate misdeeds? (2) Do outside members of the board play a meaningful role in protecting investors from greedy, misguided, or incompetent management? (3) Do the auditors possess the independence, knowledge, and determination to protect investors when management acts inappropriately? and (4) Has the company improperly taken circuitous steps to avoid regulatory scrutiny?

Let's assume that a deceitful management team wishes to raise capital and prepares misleadingly glowing financial reports with inflated profits intended to trick investors. To successfully dupe investors, corporate management often tries to avoid unnecessary scrutiny and remain below the radar. Such management will create an organizational structure that avoids unwanted scrutiny by other corporate executives, board members, auditors, and regulators, who typically must sign off on offerings sold to investors. Here are some important red flags.

### Management Teams Devoid of Checks and Balances

In the best companies, senior executives can freely criticize and disagree with one another—sort of like a good marriage. In undesirable companies, a single dictatorial leader runs roughshod over the others—not unlike a bad marriage. Investors face great risks if that dictatorial leader is also bent on creating misleading financial reports. Who can stop him when a culture of fear and intimidation exists? (No marriage analogies here, as our wives will be reading this book.) It is important for investors that sufficient checks

and balances exist among senior management to prevent bad behavior.

**Be Alert for Companies That Lack Checks and Balances Among Management.** Investors are best served when the senior management team includes strong, confident, and (hopefully) ethical members who will thwart a dishonest CEO or CFO and report improper behavior to the board of directors and the auditor. Too often, though, financial shenanigans arise when no such checks and balances exist. For example, an organizational structure in which a small group of family and friends hold key executive positions may embolden management to engage in financial reporting trickery. Additionally, a powerful and bullying CEO, such as Sunbeam’s Al Dunlap or HealthSouth’s Richard Scrushy, along with weak complicit or conflicted underlings, raises the risk profile for investors.

**Be Particularly Alert When a Single Family Dominates Management and the Board.** You would have to search long and hard to find a public company with weaker checks and balances than Adelphia Communications. Members of founder John Rigas’s family made up a majority of the executive office and the board of directors, and they held a large percentage of the voting shares. Table 2-1 shows the family players, their roles, and the incestuous nature of the management team and the board.

Not surprisingly, this family management team was at the helm as a massive fraud that looted Adelphia and its investors of hundreds of millions of dollars was perpetrated. Today, John Rigas, leader of the clan, and his dutiful CFO son Tim are behind bars and will remain so for many years.

Table 2-1. Adelphia: The Rigas Family Business

The Player	The Role	The Relationship
John Rigas	Founder, chairman, and CEO	Pops
Tim Rigas	CFO and board member	Son
Michael Rigas	EVP and board member	Son
James Rigas	EVP and board member	Son
Peter Venetis	Board member	Son-in-law

**Tip:** An incestuous family-dominated company with weak checks and balances may be acting entirely properly, but don't count on it. Without independent checks and balances within the management ranks and on the board of directors, the risk for investors grows materially.

**Watch for Senior Executives Who Push for Winning at All Costs.** HealthSouth CEO Richard Scrushy was renowned for pushing hard to meet or beat Wall Street estimates. Such a “win at all costs” culture can lead to aggressive accounting practices and, in some cases, fraudulent reporting. The Securities and Exchange Commission's (SEC) description of what went on behind closed doors at HealthSouth (HRC) reveals much about the culture of fear and intimidation:

*If HRC's actual results fell short of expectations, Scrushy would tell HRC's management to “fix it” by recording false earnings on HRC's accounting records to make up the shortfall. HRC's senior accounting personnel then convened a meeting to “fix” the earnings shortfall. By 1997, the attendees referred to these meetings as “family meetings” and referred to themselves as “family members.” At these meetings, HRC's senior accounting personnel discussed what false accounting entries could be made and recorded to inflate reported earnings to match Wall Street analysts' expectations. [Italics added for emphasis.]*

**Be Skeptical of Boastful or Promotional Management.** Investors should be particularly careful when a management publicly boasts about its long consecutive streak of meeting or exceeding Wall Street's expectations. Invariably, tough times or speed bumps emerge, and such a management may feel pressured to use accounting gimmicks and perhaps fraud to keep the streak alive, rather than announcing that its run of success has ended. This was certainly the case at Symbol Technologies and its 32-consecutive-quarter “winning streak” that we discussed in the previous chapter. Companies engaged in many other blockbuster frauds had similar winning streaks, including supermarket giant Royal Ahold, auto parts maker Delphi Corporation, industrial conglomerate General Electric Company, and doughnut shop Krispy Kreme Doughnuts Inc. Royal Ahold, one of Europe's largest frauds, enjoyed boasting about its streak on its earnings calls with investors:

This is *the thirteenth consecutive year* in which our net earnings have grown significantly. Ahold has always met or exceeded expectations during this 13-year period *and we intend to continue to do so.* [Italics added for emphasis.]

**Warning Sign:** An extended streak of meeting or beating Wall Street expectations.

## Boards Lacking Competence or Independence

It may be the best part-time job in the world. Sitting as an outside director on a corporate board brings prestige, perks, and a nice paycheck, with cash and noncash compensation often exceeding \$200,000 per year.

While we know that this situation works out just fine for the lucky directors, often it is less clear whether investors receive the necessary and expected protection from these fiduciaries. Investors must evaluate board members on two levels: (1) do they belong on the board, and are they qualified for the committees on which they sit (e.g., audit or compensation), and (2) are they appropriately performing their duties to protect investors?

## Inappropriate or Inadequately Prepared Board Members

Baseball fans surely remember longtime Los Angeles Dodgers manager and later corporate pitchman Tommy Lasorda. For sure, Tommy possessed talent on the baseball diamond and a personality and charisma that helped companies hawk their products. But as a board member for publicly traded Lone Star Steakhouse, Tommy may have been out of his league. While his seven decades in baseball are quite impressive, they probably did not provide him with strong financial analysis skills. Worse yet, former Heisman Award-winning running back and National Football League gridiron great (and later convicted felon) O. J. Simpson was assigned the duty of faithfully protecting investors' interests by serving on the *audit committee* of Infinity Broadcasting in the 1990s. It's difficult to imagine O. J. navigating his way through the intricacies of a Balance Sheet, let alone overseeing financial reporting and disclosure. Investors should ensure that outside board members have the essential skills and serve only on appropriate committees that suit their technical skills.

### Failure to Challenge Management on Related-Party Transactions

Management at India's information technology giant Satyam decided to make an acquisition in 2008 that needed board approval. The board met and acquiesced to management's request, despite the fact that the CEO's sons controlled the target company. Specifically, Satyam's board approved the recommendation to invest \$1.6 billion for 100 percent of Maytas Properties and 51 percent of Maytas Infrastructure. (The word *Maytas* is *Satyam* spelled backward—another clue for all you Sherlock Holmeses about the related-party nature of the deal.)

The board should have raised objections not only because of the related-party nature of the acquisition, but also because it made little sense. Any Satyam director should have been puzzled that the company was proposing to invest \$1.6 billion in related-party real estate ventures at a time when its core business was under pressure and additional investments should have been poured into staving off the competition.

While the board agreed to the acquisition, it was aborted the next day after an investor uproar. Satyam's CEO later told authorities that the deal was the last attempt to replace Satyam's fictitious assets with real ones. A sign of a healthy and effective board is when a dissenting view overturns a management-driven consensus. That clearly did not happen at Satyam.

### THE "SPORTS ILLUSTRATED JINX" EQUIVALENT FOR INVESTORS

The *Sports Illustrated* Jinx is a myth that states that individuals or teams that appear on the cover of *Sports Illustrated* magazine are tempting fate and will soon experience bad luck.

It seems that there are similar "indicators of doom" in the corporate world for accolades given to public companies and their executives. Exhibit A: Ernst & Young's prestigious Entrepreneur of the Year award for 2007 was given to Satyam's CEO, Ramalinga Raju (currently in jail). Exhibit B: Recipients of *CFO* magazine's respected Excellence Awards include the 1998 winner, WorldCom's Scott Sullivan (currently in jail); the 1999 winner, Enron's Andrew Fastow (currently in jail); and the 2000 winner, Tyco's Mark Swartz (currently in jail).

### **Failure to Challenge Management on Inappropriate Compensation Plans**

Setting appropriate compensation falls squarely on the shoulders of outside directors, specifically those who serve on the compensation committee. Management may propose some outlandish scheme that inappropriately rewards executives far beyond reason. For example, in the mid-1990s, Computer Associates instituted a plan that later paid senior executives more than \$1 billion in additional stock as a reward for keeping the stock price above a designated threshold for a 30-day period. Shockingly, the board went along with this excessive compensation plan.

Even more outrageous than the Computer Associates scheme was another compensation-related swindle that ripped off millions of investors in many different companies: the options backdating scandal. Hundreds of companies played this game, which was actually quite simple: the companies would grant stock options to executives and other employees, and “backdate” the options to reflect a price that was much lower than the one on the date the options were granted. As a result, employees received substantial unrecorded and undisclosed compensation in the form of bogus stock price gains. (We discuss the audacious option backdating scandal more completely in Chapter 7.)

When evaluating outside directors, investors must always ask whose interests they are favoring—management’s or investors’. Investors should also always question compensation plans that could easily be abused to improperly inflate executives’ wallets.

### **Need for Outside Directors to Avoid Inappropriate Actions That Lessen Their Independence**

In addition to being engaged and challenging management over acquisition decisions, outside directors should refrain from any conflicting activities. For example, receiving loans or being permitted to purchase products from the company for less than the market price would be inappropriate. Moreover, even receiving remuneration for providing professional services to the company would cloud an outside director’s objectivity and appearance of independence.

Consider the relationship between Satyam and one of its independent directors, Professor Krishna Palepu of Harvard University. Palepu, a Satyam director since 2003, is considered

a leading authority on corporate governance. Among the executive education programs he has taught is Audit Committees in a New Era of Governance. He also co-led Harvard's Corporate Governance, Leadership, and Values initiative, launched in response to the recent wave of corporate scandals and governance failures.

Professor Palepu seemed to have had a lapse in good governance judgment. While serving on Satyam's board, he also accepted "special remuneration" of nearly \$200,000 in 2007 for providing professional services. While we are not questioning either the quality of the professor's services or the fairness of the amount of remuneration received, it is hard to see how Palepu can be considered "independent." We believe that independent directors should not be involved in such related-party arrangements, as they may impair their objectivity and the appearance of independence on important decisions.

In December 2008, Satyam's board approved the related-party Maytas acquisition described earlier. Shortly thereafter, Palepu resigned as a director along with several other board members. Just nine days later, Satyam's massive fraud was publicly revealed. Palepu stated that he learned about the fraud only after resigning from the board.

### **Auditor Lacking Objectivity and the Appearance of Independence**

The independent auditor plays a crucial role in protecting investors from dishonest management and an indifferent and ineffective board of directors. Chaos would ensue if investors ever came to question the competence or integrity of the independent auditors. That is indeed exactly what happened in 2002 after Enron and WorldCom collapsed, Arthur Andersen disbanded, and the financial markets nosedived.

The auditor, however, can be either a friend or a foe of investors: a friend if the auditor is competent, independent, and fastidious in sniffing out problems; a foe if he is incompetent, lazy, or a rubber stamp for management. Sometimes the very high fees and close personal relationships built up over years lead to botched audits

and big losses for investors. Here are the key factors to consider when evaluating in which camp the auditor actually falls—friend or foe.

### **Astronomical Fees Lead to a Conflicted Independent Auditor**

Arthur Andersen, with its 85,000 employees in 84 countries, generated \$9 billion in revenue in 2001, the year Enron collapsed and declared bankruptcy. Arthur Andersen had served as Enron's sole auditor for 16 years, also performing internal audits and providing consulting services. According to Enron's SEC filings, Arthur Andersen earned a whopping \$52 million (\$25 million for audit and \$27 million for nonaudit services) in 2000.

As the investigation into the auditors' role in the Enron collapse proceeded, Arthur Andersen fired its lead audit partner for Enron, David Duncan, after learning that he had destroyed documents from the audit file. Subsequently, a federal jury convicted Arthur Andersen of destroying Enron-related materials to impede an investigation by securities regulators. It vowed to appeal, but before the appeal and its subsequent exoneration, Arthur Andersen ceased auditing public companies and disbanded.

### **Too Long and Close a Relationship Prevents a Fresh Look at the Picture**

The fraud and collapse of Parmalat, the Italian dairy behemoth, has been referred to as the "European Enron." While the businesses and accounting issues differ, both Enron and Parmalat had one obvious similarity: independent auditors missed the fraud.

One intriguing fact in this case concerns Parmalat's change in primary auditors from Grant Thornton to Deloitte & Touche. Indeed, Parmalat's chicanery might have continued longer had it not been for an Italian law that requires companies to switch audit firms every nine years. Deloitte & Touche replaced auditor Grant Thornton in 1999 and may have been the first to scrutinize certain nonexistent offshore accounts (many of which were still audited by Grant Thornton, as they were not subject to Italian law). As a result, fraudulent offshore entities were exposed, including Bonlat, a Cayman Islands subsidiary of Parmalat and one of the primary vehicles used to hide fake assets.



### INVESTORS SHOULD DEMAND AUDITOR ROTATION EVERY FEW YEARS

The fact that Italian regulations concerning auditor change precipitated the discovery of the Parmalat fraud lends strength to the argument that *this type of policy should be more broadly implemented*. Auditor term limits were nearly included in the Sarbanes-Oxley legislation, but they were ultimately excluded in favor of rotating audit partners within the same accounting firm. In light of Parmalat's crimes, risk managers might wonder if Sarbanes-Oxley is missing a very important component, given that auditor complacency or collusion may contribute to inappropriate financial reporting.

Opponents of auditor limits point to the benefits of having a long-term relationship with an auditor who knows the company's business, but Parmalat has shown that such a relationship can breed complacency and that an auditor may overlook or encourage behavior (either by design or by accident) that can prove fatal to the business.

Like Parmalat, the biggest recent accounting fraud to hit Japan went undetected for far too long because the auditor had too long and cushy a relationship with company management. Kanebo, a cosmetic and textile company, had been audited by an affiliate of PricewaterhouseCoopers for *at least 30 years*. When one of the company's consolidated subsidiaries hit a very bad stretch, the auditors allegedly advised management to reduce its shareholding in the subsidiary and deconsolidate it. The auditors also allegedly turned a blind eye to the booking of fictitious sales to pad the revenue numbers during slack periods. Kanebo reported about \$2 billion in nonexistent profits from 1996 to 2004. The regulators were so incensed with the treacherous behavior of the auditors that they immediately brought legal action against these auditors and imposed a two-month business suspension.

### Incompetent Auditors Can Serve as Shills for Management

As you have no doubt seen from these vignettes, financial shenanigans and audit failures are not just an American affliction.

The United States gave the world Enron and WorldCom and the meager effort by the auditor of both companies, Arthur Andersen; Italy's contribution was Parmalat and its auditors Grant Thornton and Deloitte & Touche; and Japan's gift to investors was Kanebo and the compliant work of auditor PricewaterhouseCoopers. And the most recent entrant to the "Hall of Shame," India's contribution, Satyam, provides another wonderful effort by PricewaterhouseCoopers.

*Satyam* ironically means "truth" in Sanskrit. But with CEO Ramalinga Raju's admission of the company's bald-faced lies to investors for years, maybe he was a bit confused when he selected the company name. Perhaps he really had planned to use the more apt Sanskrit name *Asatyam*, meaning "untruth."

PricewaterhouseCoopers, which had been Satyam's auditor since 1991, failed to detect *inflated cash and bank balances on the order of over \$1 billion*, according to Raju's own confession. Current allegations claim collusion between Satyam and its auditor. According to a member who joined Satyam's board after the scandal broke out, the documents were "obvious forgeries" and would have been visible as such to anyone.

## Management Schemes to Avoid Regulatory Scrutiny

As we pointed out, shenanigans tend to breed freely in environments in which no checks and balances exist among senior management, when the outside board of directors lacks the skills and the desire to protect investors, and when the auditors fail to detect signs of problems. One other substantial line of defense for investors exists in the form of regulators. In the United States, the SEC oversees setting reporting requirements and reviews their content. If the reports don't pass muster, the SEC can prevent the securities from being issued or suspend any future stock trades.

While the SEC has mostly served investors well over the years, it has occasionally failed to catch serious reporting infractions. For this it deserves some criticism. Moreover, some companies truly go out of their way to avoid SEC reviews and scrutiny. The following section shows just how this is done and when investors should be especially cautious.

### **Lack of Usual Regulatory Scrutiny before Going Public**

If management really wants to avoid serious scrutiny from SEC reviewers, it will first sidestep the normal registration process for an initial public offering (IPO) by merging into an already-public company. This is a backdoor approach to becoming a public company and avoiding the typical detailed review that is part of the normal IPO process. Thus, investors should be particularly wary of companies that avoid SEC review by merging into a “shell company” using either a reverse merger or a “special-purpose acquisition company” partner and immediately becoming a public company.

### **Techniques to Detect Investment Manager Shenanigans**

Clients of Bernie Madoff’s investment firm were shocked and saddened to learn in early December 2008 that they had been the victims of a Ponzi scheme and that their investment account balances were completely wiped out. Madoff had a sterling reputation as a money manager for delivering consistently strong returns, and for years investors had poured tens of billions of dollars into his coffers, only to learn later that the funds were used to support a Ponzi scheme in which early investors were paid back with later investors’ funds. In June 2009, Madoff was sentenced to a 150-year prison term after acknowledging the fraud and asserting that he had acted alone.

While this book mainly addresses the analysis of financial reports of public companies (rather than detecting crooked money managers), it teaches investors how to analyze companies, including a privately held investment firm like Bernard L. Madoff Investment Securities. In evaluating any company, a stakeholder should (1) understand the nature of the business and assess whether the numbers make sense, (2) assess the competence and ethics of management, and (3) evaluate the adequacy of checks and balances.

### **Understand the Business to Assess whether the Numbers Make Sense**

Two glaring warning signs would emerge in evaluating the key numbers related to Madoff’s business, investment returns and fees

charged to investors. First, *monthly* investment returns seemed unusually consistent over many years. Despite volatile bull and bear markets over these years, Madoff rarely reported a monthly loss—an illogical and impossible feat. Legitimate investment managers generate uneven returns, with certain periods of outperformance and others of underperformance.

Second, the fees typically charged to investors like Madoff's include a management fee (1 to 2 percent of assets managed) and, for hedge funds, an incentive payment based on positive returns (as much as 20 percent). Curiously, Madoff charged investors neither fee. Instead, he apparently was happy to receive only the puny brokerage commission of a few cents per share trading securities in the customers' accounts. On the face of it, investors should know that there is "no free lunch." Madoff lured investors to come in droves and keep funds with him by reporting consistently strong returns and charging customers virtually nothing. Remember the adage about something that seems "too good to be true"? Investors should know that they should never give an investment manager their money when the manager's performance looks too good to be true. Madoff's investors should have understood that an equity investment with no volatility in performance and no management or other fees made absolutely no sense.

### **Assess the Competence and Ethics of Management**

As discussed earlier in the chapter, structural weaknesses or inadequate oversight provide a fertile breeding ground for shenanigans. Like Adelpia's family business, Bernard Madoff's investment firm included many family members in the executive office. Specifically, Madoff's brother, two sons, and a niece held key management roles at the firm. Such an environment clearly represents a potential breeding ground for bad behavior and should be looked at with a skeptical eye by any potential investor.

Moreover, whenever someone boasts about being highly ethical, investors should be put off and do further investigation. Ethical people rarely brag about such virtues, as it is unbecoming and inappropriate; others should reserve judgment on who acts honorably. Consider the following boastful passage found on the Madoff Web site.

Clients know that Bernard Madoff has a personal interest in maintaining the unblemished record of value, fair dealing and high ethical standards that has always been the firm's hallmark.

### **Evaluate the Adequacy of Checks and Balances**

Investors should also expect their money managers to have other checks and balances in place, such as competent independent auditors and third-party bank or brokerage custodians to safeguard their assets. For Madoff investors, it seems that neither of these safeguards existed. For one thing, Madoff's independent auditor, Frierling & Horowitz, was a tiny unknown shop, which certainly should have seemed odd given the size of Madoff's investment funds. The SEC charged this auditor with helping to enable Madoff's fraud by, among other things, pretending to conduct an audit on Madoff's investment firm and signing off on Madoff's financial statements as if it had done so. Another obvious warning sign for Madoff investors was the absence of a third-party custodian to safeguard cash and securities for the investors to prevent theft. Without such an intermediary, investors have no independent assurance that the assets actually exist. A word of caution to any investor who outsources money to an investment manager—always require a third-party custodian to handle your money.

## **Looking Back**

### **Warning Signs: Breeding Ground for Shenanigans**

- Absence of checks and balances among senior management
- An extended streak of meeting or beating Wall Street expectations
- A single family dominating management, ownership, or the board of directors
- Presence of related-party transactions

- An inappropriate compensation structure that encourages aggressive financial reporting
- Inappropriate members placed on the board of directors
- Inappropriate business relationships between the company and board members
- An unqualified auditing firm
- An auditor lacking objectivity and the appearance of independence
- Attempts by management to avoid regulatory or legal scrutiny

## Looking Ahead

Now you are ready to jump in and learn about the three categories of Financial Shenanigans: Earnings Manipulation (Part 2), Cash Flow (Part 3), and Key Metrics (Part 4).

Earnings Manipulation (EM) Shenanigans highlight tricks used by management to inflate or smooth out earnings and portray a healthy company with predictable profits. Each of the seven EM Shenanigans we have identified is discussed in the next part, so please turn the page to begin the lesson.

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# PART TWO

# EARNINGS MANIPULATION SHENANIGANS

Investors rely on the information that they receive from corporate executives to make informed and rational securities selection decisions. This information is assumed to be accurate, whether the news is good or bad. While most corporate executives respect investors and their needs, some dishonest ones hurt investors by misrepresenting the actual company performance and manipulating the company's declared earnings. Part 2 fleshes out the seven most common Earnings Manipulation (EM) Shenanigans and suggests how skeptical investors can ferret out these tricks to avoid losses.

## **Earnings Manipulation Shenanigans**

Chapter 3	EM No. 1: Recording Revenue Too Soon
Chapter 4	EM No. 2: Recording Bogus Revenue
Chapter 5	EM No. 3: Boosting Income Using One-Time or Unsustainable Activities
Chapter 6	EM No. 4: Shifting Current Expenses to a Later Period



Chapter 7	EM No. 5: Employing Other Techniques to Hide Expenses or Losses
Chapter 8	EM No. 6: Shifting Current Income to a Later Period
Chapter 9	EM No. 7: Shifting Future Expenses to an Earlier Period

Management may use a variety of techniques to give investors the mistaken impression that its company is performing better than the underlying economic reality. We have categorized all of these earnings manipulation tricks into two major subgroups: inflating current-period earnings and inflating future-period earnings.

### **Inflating Current-Period Earnings**

Quite simply, in order to inflate current-period earnings, management must either push more revenue or gains into the current period or shift expenses to a later one. Shenanigans No. 1, 2, and 3 push revenue or one-time gains into current-period operations, and No. 4 and 5 shift expenses to a later period.

### **Inflating Future-Period Earnings**

Conversely, to inflate tomorrow's operations, management would simply hold back today's revenue or gains and accelerate tomorrow's expenses or losses into the current period. Shenanigan No. 6 describes techniques to improperly hold back revenue, and Shenanigan No. 7 accelerates expenses into an incorrect earlier period.

Earnings can be *improperly inflated* by inappropriately including revenues or gains and by excluding rightful expenses or losses of that period. Conversely, earnings can be *improperly deflated* by inappropriately excluding revenues or gains of that period and by including expenses or losses that really pertain to another period. Of course, when management deflates current-period earnings, it plans to "release" those pent-up earnings into another (and more advantageous) period.

Of the seven Earnings Manipulation Shenanigans identified to distort earnings, the first five inflate earnings, and the last two de-

flate them. For most readers, the desire to use Shenanigans No. 1 through 5 to exaggerate earnings might seem logical or intuitive. After all, higher reported profits often lead to a higher stock price and higher executive compensation. The logic of using Shenanigans No. 6 and 7 may be less intuitive in that a company that chooses to report *less than* its actual profits does not stand to gain any sort of obvious advantage. Management's scheme, quite simply, would be to shift earnings from one period (with excess profits) to another (in need of profits). Alternatively, management may simply be attempting to smooth out volatile earnings in order to portray a more steady business.

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# 3

## EARNINGS MANIPULATION SHENANIGAN No. 1: RECORDING REVENUE Too Soon

*Thirty days has September,  
April, June, and November;  
Of twenty-eight there is but one,  
And all the rest have thirty-one.*

—A modern version of the fifteenth-century medieval British rhyme

As young children, many of us were taught this useful rhyme by parents and teachers to help us remember the number of days in each month. Frankly, it still comes in handy as a reminder well into our adult years. Only fairly recently did we learn that February was not necessarily the only exception to the 30- or 31-day rule. In fact, every month could be the exception for companies that wish to inflate their revenue. Computer Associates has become the poster child for this revenue inflation trick, regularly stretching out its

months to 35 days on the books. That scheme worked well for a while—or at least until the company was caught and CEO Sanjay Kumar was sent to jail.

Stretching out the number of days in a month is but one of the creative techniques that management may use to improperly record revenue too early. Chapter 3 describes a variety of ways in which management attempts to accelerate revenue to earlier periods and how investors can spot signs of this transgression.

## Techniques to Record Revenue Too Soon

1. Recording Revenue Before Completing Any Obligations under the Contract
2. Recording Revenue Far in Excess of Work Completed on the Contract
3. Recording Revenue Before the Buyer's Final Acceptance of the Product
4. Recording Revenue When the Buyer's Payment Remains Uncertain or Unnecessary

### 1. Recording Revenue Before Completing Any Obligations under the Contract

Some companies go to great lengths to record sales before the clock strikes midnight on the last day of the quarter. Sometimes they get creative in how they mark the quarter's end and push a future period's sale into the current period.

#### Computer Associates and the Endless Month

Executives at Computer Associates regularly stretched out the last month of the quarter to as much as 35 days and both backdated and forged sales contracts to trick their auditor and their investors into believing the company's fictitious sales growth.

**But, Boy, Did They Have a Billion Good Reasons.** What may have led management to embark with such great zeal on pushing sales

and Computer Associates' stock price higher and higher? The obvious answer would be oversized bonuses and stock options; however, the extent of this compensation defies the imagination. Let's go back to the terms of the company's 1995 Key Employee Stock Ownership Plan (KESOP), which would reward Computer Associates' top three executives with millions of additional shares if the share price reached certain levels and remained above those levels for at least 30 consecutive days.

The August 1995 plan initially authorized the grant of up to 6 million shares to three senior executives: Chief Executive Officer Charles Wang (60 percent), Chief Operating Officer Sanjay Kumar (30 percent), and Executive Vice President Russell Artzt (10 percent). After a certain amount of time (and a certain number of stock splits), more than 20 million shares were actually issued. Then finally it happened—drum roll, please! On one not-so-ordinary day in 1998, they hit the \$1.1 billion jackpot when the company's share price closed at just over \$55, with Wang receiving 12.15 million shares, Kumar 6.075 million, and Artzt 2.025 million (worth \$669.8, \$334.9, and \$111.6 million, respectively).

**But They Must Have Done an Unbelievable Job.** Well, not really. The price *did* appreciate significantly, but remember that this occurred within the great bull market of the late 1990s. From the date of the plan in 1995, the annual return looked impressive; however, the appreciation was not much greater than that of the S&P 500 during this raging bull market. Good results, sure, but certainly not All Star or Hall of Fame worthy. Oh, and one other small point—the results were achieved through cheating!

Let's go back to the terms of this bizarre plan. If management can figure out a way to produce good news so that the stock price jumps to the designated level and remains at that new higher level for a month, the house pays out. In the end, these executives split more than a billion dollars in bonuses. If investors had read about the bizarre arrangement in the 1995 Securities and Exchange Commission (SEC) filing, they surely would have realized that temptation existed for the company to use every trick in the book to manipulate earnings and inflate the stock price.

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### Accounting Capsule: Revenue Recognition

According to accounting guidelines, four conditions must be met in order for revenue to be recognized: (1) *evidence* of an arrangement exists, (2) *delivery* of the product or service has occurred, (3) the *price* is fixed or determinable, and (4) the *collectibility* of the proceeds is reasonably assured. Failure to meet any one of these conditions requires deferral of revenue until all requirements have been satisfied.

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**Be Wary of Companies That Extend Their Quarter End Date.** Not surprisingly, Computer Associates was not alone in improperly accelerating revenue by stretching its quarter end date. During the mid-1990s, “Chainsaw Al” Dunlap and his minions at Sunbeam changed the company’s quarter end from March 29 to March 31 to make up for a revenue shortfall. The two additional days permitted Sunbeam to record another \$5 million in sales from its operations and \$15 million from the newly acquired Coleman Corporation.

Not to be outdone by Computer Associates and Sunbeam, San Diego-based software maker Peregrine also routinely kept its books open well after the official quarter ended. The practice became so common at the company that officers joked about this ploy, characterizing these late transactions as having been completed on “*the thirty-seventh of December.*”

## 2. Recording Revenue Far in Excess of Work Completed on the Contract

The first technique reveals how companies improperly recognize revenue before the sale even happens. Next, we discuss revenue recognition in situations in which the seller has started to deliver on the contract; however, management records a far greater amount than is warranted. Our friends at Computer Associates were savvy at playing both tricks. Not only did the company extend its quarter to capture more revenue, but it also pulled forward license sales that would not actually be earned for many years to come.

### Up-Front Recognition of a Long-Term License Contract

Computer Associates sold long-term licenses allowing customers to use its mainframe computer software. Customers paid an up-front licensing fee for the software, as well as an annual charge to renew the license in subsequent years. Despite the long-term nature of these agreements (some contracts lasted as long as seven years), the company would recognize the present value of all licensing revenue for the entire contract immediately. Since all licensing revenue was recorded at the beginning of the contract, and cash was not collected for many years to come, Computer Associates recorded large amounts of long-term receivables on its Balance Sheet.

A November 1998 report by the Center for Financial Research and Analysis (CFRA) disagreed with Computer Associates management and deemed it aggressive for a company to record all this revenue up front. Economic reality dictates that revenue should be deferred until the billing period for each installment sale.

**RED FLAG!** A sharp jump in accounts receivable, especially long-term and unbilled ones.

**Regulators Also Strongly Disagreed with the Approach.** The SEC charged that from at least January 1998 through October 2000, Computer Associates prematurely recognized *over \$3.3 billion* in revenue from at least 363 software contracts with customers.

Computer Associates' bulging long-term receivables should have alerted investors to the company's aggressive revenue recognition. The CFRA report highlighted the firm's surging long-term and total receivables at September 1998. Investors should use a measure called days' sales outstanding (DSO) to evaluate whether customers are paying their bills on time. A higher DSO could indicate aggressive revenue recognition in addition to simply poor cash management. With the company's long-term installment receivables soaring at September 1998, its DSO reached an unsettling 247 days (based on product revenue)—a year-over-year increase of 20 days. Furthermore, *total* receivables, including both current and long-term, increased to 342 days—a jump of 31 days.



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### Accounting Capsule: Days' Sales Outstanding (DSO)

Days' sales outstanding (DSO) is generally calculated as follows:

Ending receivables/revenue  $\times$  number of days in the period  
(for quarterly periods, 91.25 days is a normal approximation)

Since DSO is a metric outside of generally accepted accounting principles, companies may present their DSO calculated in a different way (for example, by using average receivables instead of the ending balance). However, for financial shenanigan detection purposes, we advise using our calculation. We will discuss DSO in greater detail, including its uses and abuses by management, in Part 4, "Key Metrics Shenanigans."

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### Changing the Revenue Recognition Policy to Record Revenue Sooner

Like Computer Associates, software maker Transaction Systems Architects, Inc., jump-started its sluggish revenue growth by shifting future-period sales into earlier periods. Reported sales growth in 1999 excited investors; however, several cautionary signs were emerging. The company changed its revenue recognition policy to record the entire value of five-year customer contracts up front, as compared to its previous approach of spreading the revenue over the five-year contract period. And, did this ever change the results.

In March 1999, Transaction Systems Architects reported a misleading 26 percent jump in license revenue and a 21 percent increase in total revenue, as shown in Table 3-1. Virtually all of this impressive growth, however, came from the new and more aggressive revenue recognition approach, according to a CFRA report. Had investors realized that license revenue actually declined by 10 percent in March 1999, they probably would have considered selling their stock immediately.

**Watch for Cash Flow from Operations That Begins to Lag Behind Net Income.** A red flag that should have alerted investors to take a closer look at Transaction Systems Architects' revenue recognition was a trend in which the company's cash flow from opera-

Table 3-1. Licensing and Total Revenue Growth at Transaction Systems Architects

(\$ millions)	Q2, 3/99		Six Months Ended 6/99	
	Reported	CFRA-Adjusted	Reported	CFRA-Adjusted
License revenue	50.6	36.2	96.6	78.0
Growth, year over year	26%	(10%)	23%	0%
Total revenue	87.0	72.6	173.0	154.4
Growth, year over year	21%	1%	23%	10%

tions (CFFO) started to materially lag behind reported net income in the March 1999 quarter. As shown in Table 3-2, CFFO trailed net income by \$9.5 million in March 1999, whereas it exceeded net income in March 1998.

**Warning of Premature Revenue Recognition:** Cash flow from operations materially lags behind net income.

**Be Alert for a Jump in Unbilled Receivables.** A second warning sign for Transaction Systems Architects’ investors related to the sudden jump in accrued (unbilled) receivables. Under the company’s new accounting policy, revenue was recognized up front, yet customers paid much later. Unbilled receivables typically are not receivables at all. These accounts are generally created during the production period, when customers are not yet responsible for

Table 3-2. CFFO Growth Lags Behind Net Income at Transaction Systems Architects

(\$ millions)	Q2, 3/99	Q2, 3/98
Cash flow from operations (CFFO)	1.4	9.4
Net income (NI)	10.9	8.3
CFFO less NI	(9.5)	1.1

Table 3-3. Unbilled and Long-Term Receivable Growth at Transaction Systems Architects (as Originally Reported)

(\$ millions, except days)	Q4, 9/99	Q3, 6/99	Q2, 3/99	Q1, 12/98	Q4, 9/98	Q3, 6/98	Q2, 3/98
Revenue	92.6	89.1	87.0	86.1	79.3	69.1	71.8
Current billed receivables	50.6	57.1	61.2	66.4	58.1	42.5	44.7
Accrued (unbilled) receivables	41.9	39.2	40.0	34	33.0	35.2	24.1
Long-term installment receivables	26.9	13.0	9.3	0.8	2.1	1.0	1.0
Total receivables	119.4	109.2	110.5	101.2	93.1	78.7	69.8
DSO, total receivables	118	112	116	107	107	104	89
DSO, unbilled and long-term receivables	68	53	52	37	40	48	32

payment. Notice in Table 3-3 that the company's unbilled receivables increased from \$24.1 million in March 1998 to \$40 million in March 1999 (a startling increase of 65 percent), during a period in which sales increased just 22 percent (from \$71.8 million to \$87.0 million). This clearly suggests more aggressive revenue recognition.

#### **Watch for Long-Term Receivables That Grow Faster Than Revenue.**

A third and even bigger red flag was Transaction Systems Architects' growth in long-term installment receivables. Normally receivables are collected within a month or two of a sale. Long-term receivables represent sales that the company will not collect *for more than a year after the Balance Sheet date*. In March 1999, long-term receivables jumped to \$9.3 million from just \$1.0 million a year earlier (and \$0.8 million the previous quarter). By September 1999, long-term receivables ballooned to \$26.9 million. The DSO calculation presented in Table 3-3 highlights the company's accelerated revenue recognition. Total DSO increased from 89 days in March 1998 to 116 in March 1999. DSO on unbilled and long-term receivables jumped from 32 to 52 days over the same time frame, and surged to 68 days by September 1999.

**You Have to Pay the Piper Eventually.** By accelerating future-period sales into an earlier period, Transaction Systems Architects successfully plugged its short-term revenue shortfall while creating enormous problems for the future. By recognizing virtually all of the revenue from the entire five-year contract up front, the company created two major problems for itself. First, because legitimate future-period revenue had been shifted to the present period, it would no longer be available in the future periods. Second, achieving comparable revenue growth in the future on top of the inflated sales figure would be an enormous challenge.

### **Management Discretion on Long-Term Contracts May Accelerate Revenue**

The previous examples demonstrated how Computer Associates and Transaction Systems Architects boosted revenue and profits by aggressively recording revenue on multiyear contracts up front. Certain types of long-term contracts, however, actually allow the seller to recognize some revenue even though future services remain to be provided. While these arrangements are guided by accounting methodologies permissible by generally accepted accounting principles (GAAP), the timing of revenue recognition is very sensitive to discretionary management estimates.

In this section we discuss several of these arrangements and provide advice on how to spot instances in which management might be using overly aggressive estimates. Specifically, we cover (1) long-term construction contracts that use percentage-of-completion accounting, (2) lease agreements, (3) arrangements with several distinct deliverables, and (4) utility contracts recorded using mark-to-market accounting.

### **Recording Revenue on Long-Term Construction Contracts Using Percentage-of-Completion Accounting**

Revenue from long-term construction or production contracts (e.g., building a power plant) can be recognized over the production period under an accounting rule known as *percentage-of-completion*. The amount of revenue recognized under percentage-of-completion accounting is subject to various estimates, and as a result, this accounting methodology creates opportunities for financial shenanigans.

**Look Out for Companies Inappropriately Using Percentage-of-Completion Accounting to Accelerate Revenue.** Service companies typically are ineligible to use percentage-of-completion accounting, since their projects have a shorter term. In addition, companies that sell products with very short production cycles should refrain from using percentage-of-completion.

**Be Alert for Companies Using Aggressive Assumptions in Applying Percentage-of-Completion Accounting.** When using percentage-of-completion accounting, management calculates revenue based on the *percentage* of the project that was *completed* during that period. For example, assume that on a \$1,500,000 contract, management estimates that total costs will be \$1,000,000, and that \$200,000 of costs were incurred during the first quarter. As shown in the accompanying accounting capsule, percentage-of-completion accounting would dictate that 20 percent of the revenue be recorded in the first quarter (even if a different amount would be billed to the customer). This methodology relies on a number of estimates, and as a result, management can make aggressive assumptions. For example, if management simply assumed that total estimated costs would be \$800,000 (instead of \$1 million), revenue in the first quarter would be 25 percent of the total contract value (instead of 20 percent). A warning sign for investors that a company has been using percentage-of-completion accounting improperly would be a large increase in unbilled receivables when sales and billed receivables grow more moderately.

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Accounting Capsule: Percentage-of-Completion  
Accounting

Percentage-of-completion accounting is typically used for long-term construction or production contracts. Under percentage-of-completion accounting, the amount of revenue recognized in a given period is determined by the *percentage* of the total contract that was *completed* during the period. To calculate revenue, companies first determine the amount of costs they incurred under the contract as a percentage of the estimated total costs to be incurred over the entire life of the contract. Then, this percentage is applied to the total revenue expected to be recognized under the contract, as illustrated here.

Costs incurred this period: \$200,000; total estimated costs to complete the contract: \$1,000,000

$$\$200,000 / \$1,000,000 = 20\%$$

Total contract revenue value: \$1,500,000

$$\text{Revenue recognized} = \$1,500,000 \times 20\% = \$300,000$$

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Even when it is appropriate for companies to use percentage-of-completion accounting, incorrect estimates and bad luck can lead to inflated revenue and earnings. That's what happened at defense contractor Raytheon Company. Raytheon recorded revenue for several years based on estimates of costs and expected unit sales. When it became clear that the revenue from the contract would materially lag behind the original estimates, Raytheon announced that the previously reported revenue was too high, and it was forced to take a one-time charge.

### **Potential Problems in Using Percentage-of-Completion Accounting**

- Companies may use percentage-of-completion accounting when it is not appropriate.
- Companies may make aggressive assumptions to accelerate revenue.
- Revenues may be inflated simply because honest estimates are off the mark.

### **Recording Revenue from Assets Leased to Customers**

Lease accounting is another topic that, like percentage-of-completion accounting, relies heavily on management's estimates. Investors must monitor these inputs, since management might begin using unreasonably optimistic projections. In the case of Xerox Corporation, management inflated revenue and earnings by billions of dollars using lease accounting tricks, some of which are

discussed in this section. When the shenanigans finally caught up with Xerox, the company restated equipment revenue by \$6.4 billion and pretax earnings by \$1.4 billion.

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### Accounting Capsule: Capital Leases

Certain equipment leases should be treated in a fashion similar to the treatment for an outright sale. These are called *capital leases*. At the inception of the lease, the seller (called a lessor) recognizes as revenue a large portion of the present value of future lease payments. Estimates such as the discount rate, residual value, length of the contract, and other lease terms dictate the timing of revenue recognition over the course of the lease.

For example, the discount rate is used to calculate the current value of future lease payments, adjusted for the time value of money. This present value is recognized as revenue immediately, and the remainder of the payments is recorded as interest income over the lease term. A higher discount rate yields a lower present value for revenue recorded, while a lower discount rate yields a higher present value. By choosing an inappropriately low discount rate, management could aggressively accelerate the recognition of revenue.

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**Watch for Companies That Select Inappropriately Low Discount Rates.** Xerox selected unrealistically low discount rates, which allowed it to record more of the lease payments as up-front revenue. For example, in the late 1990s, it assumed discount rates ranging from 6 to 8 percent on many Brazilian leases, even though the average local borrowing rates regularly exceeded 20 percent. The SEC contended that had Xerox used a discount rate more in line with the market, revenue on Brazilian leases would have been \$757 million lower during the period 1997 to 2000.

**Be Aware When Companies Alter the Terms of Existing Lease Arrangements.** Xerox also allegedly accelerated revenue by incorrectly accounting for price increases and lease extensions imposed on existing lease customers. Accounting rules state that companies should recognize the impact of these changes over the lease term.

However, Xerox was impatient, and in 1997 through 1999 it pulled forward approximately \$300 million of equipment revenue that should not have been recognized until much later.

### **Recording Revenue on Long-Term Arrangements with Multiple Deliverables**

A third type of long-term arrangement that is subject to accelerated revenue recognition as a result of aggressive management estimates is one that has “multiple deliverables.” In this type of arrangement, the seller provides several distinct, but intermingled deliverables over an extended period of time. For example, wireless telecom companies often package mobile phone service and a cell phone handset together in the same contract. Sometimes the handset is sold to the customer at a greatly discounted price (or even given away for free), as long as the customer also agrees to a two-year service contract. Accounting rules require the seller to allocate a portion of the total contract value to the handset (to be recognized as revenue up front) and a portion to the service contract (to be recognized over the life of the contract). The seller uses assumptions in estimating how to split the revenue between the two deliverables.

By changing these assumptions or contract details, companies can influence the distribution of revenue in a way that may allocate more revenue to the “front end” of the contract (handset) and less to the “back end” (phone service). Investors should therefore keep an eye on the inputs (often discussed in company footnotes), including any structural changes to standard contracts. For example, Japanese telecom service provider Softbank changed the payment structure on its mobile phone contracts in 2006 in a way that increased the price of the handset and decreased the price of the monthly service, which may have allowed more revenue to be recognized up front. Monitoring receivable balances can help spot changes, as well. Softbank’s days’ sales outstanding increased from 51 days in the quarter it changed the payment structure to 61 days and 74 days in the two subsequent quarters.

### **Recording Revenue on Utility Contracts Using Mark-to-Market Accounting**

Enron got creative with its accounting by conveniently forgetting that it was primarily a utility company, and instead pretending to



be a financial institution. As a utility, Enron entered into long-term commodity delivery contracts with customers (e.g., selling future delivery of natural gas). Economic sense should have told investors that Enron, a utility company, must record revenue on these long-term service contracts only when the service, such as delivery of gas, had been provided. However, Enron curiously failed to treat these arrangements as service contracts. Instead, it defined them as the sale of financial trading securities or, more specifically, the sale of commodity futures contracts. Totally inappropriate, but quite clever!

Using this wacky interpretation as justification, Enron adopted an accounting methodology that was specifically intended for use by financial institutions that trade securities such as futures contracts: mark-to-market accounting. Under this method, the service contract would be viewed the same way as any other tradable security, which meant that all expected profits under this contract should be recorded immediately. As estimates of contract profitability changed over time (resulting from actual activity under the contract), the value of the “security” would be adjusted, as well.

Moreover, there were no actual markets for many of the contracts Enron was selling, which allowed Enron to use its own aggressive assumptions in determining the fair value of the contracts and any future markups or markdowns. This gave Enron’s management a tremendous amount of discretion in determining its quarterly earnings, effectively allowing the company to mark not to the market, but rather to its own desired results as dictated by its internal financial model (jokingly referred to as “mark to model” or “mark to make-believe”).

**Warning of Premature Revenue Recognition:** Companies adopting an acceptable methodology (such as percentage-of-completion or mark to market) that was intended for other industries.

**Mark-to-Market Accounting Became a Revenue-Enhancing Drug for Enron.** When a company selects a permissible accounting method (such as mark to market) that is intended for a different industry (such as financial institutions) or a different type of transaction, investors should view this act no differently from selecting an approach that is

explicitly prohibited by GAAP. (Auditors, take note of this point!) By adopting an accounting methodology that completely belied the economics of its utility business, Enron rapidly accelerated revenue that should not have been earned for many years.

Now it should be clear to you how Enron's revenues grew at an unprecedented rate—from \$10 billion to \$100 billion in four short years, while it took most of the others in the elite "\$100 billion club" decades longer to reach that lofty peak. Mark-to-market accounting used inappropriately by Enron and undetected (or simply blindly unquestioned) by its auditor can be viewed for what it really was: a "revenue-enhancing drug" that seduced investors.

### **3. Recording Revenue Before the Buyer's Final Acceptance of the Product**

In the first two sections of this chapter, we focused on the seller's performance of its obligations under the contract. In the next two sections, we shift our focus to the buyer. This section deals with three types of tricks that produce revenue before final acceptance by the buyer, specifically, recording revenue (1) before the shipment of product to the buyer, (2) after shipment, but to someone other than the buyer, and (3) after shipment, but while the buyer still has the ability to void the sale.

#### **Seller Records Revenue Before Shipment**

One problematic and often controversial method of revenue recognition involves so-called bill-and-hold arrangements. Under this approach, the seller bills the customer and recognizes revenue, but continues to hold the product. For most sales, with a few exceptions discussed in the prior section, revenue recognition requires shipment of product to the customer. Accounting guidelines allow revenue to be recognized in bill-and-hold transactions, however, provided that the customer requests this arrangement and is the main beneficiary. For example, if the buyer does not have adequate storage space, it may ask the seller to hold on to the purchased goods as a courtesy. Under no circumstances can early recognition of revenue occur under a bill-and-hold arrangement if the arrangement is initiated by the seller for the benefit of the seller (i.e., to record revenue at an earlier date).

**Watch for Bill-and-Hold Transactions Initiated by the Seller.** If a seller initiates a bill-and-hold transaction, investors should assume that the seller is attempting to recognize revenue too early. For example, Sunbeam CEO Al Dunlap used a bill-and-hold strategy in order to make the company's financial performance appear better than it really was by artificially inflating Sunbeam's revenue.

Sunbeam, anxious to boost sales in its "turnaround year," hoped to convince retailers to buy grills nearly six months before they were needed. In exchange for major discounts, retailers agreed to purchase merchandise that they would not physically receive until months later and would not pay for until six months after billing. In the meantime, the goods would be shipped out of the grill factory in Missouri to third-party warehouses leased by Sunbeam, where they would be held until the customers requested them.

Nonetheless, Sunbeam booked the sales and profits from all of the \$35 million in bill-and-hold transactions. When outside auditors later reviewed the documents, they reversed a staggering \$29 of the \$35 million and shifted the sales to future quarters. In doing the audit, Arthur Andersen questioned the accounting treatment of some transactions. But in almost every case, it concluded that the amounts were "immaterial" to the overall audit. Sometimes detecting signs of aggressive accounting is close to impossible. In the case of Sunbeam, it required nothing more than reading the revenue recognition footnote in the company's 10-K.

#### **SUNBEAM'S 10-K FOOTNOTE DISCLOSURE TOLD THE STORY**

The Company recognizes revenues from product sales principally at the time of shipment to customers. In limited circumstances, at the customers' request the Company may sell seasonal products on a bill-and-hold basis provided that the goods are completed, packaged and ready for shipment, such goods are segregated and the risks of ownership and legal title have passed to the customer. The amount of such bill-and-hold sales at December 29, 1997 was approximately 3 percent of consolidated revenues.

Eventually, Dunlap was fired when the board of directors realized that he had done little to improve the company's financial

situation and had used improper financial engineering to drive the stock price higher.

### **Seller Records Revenue upon Shipment to Someone Other Than the Customer**

The auditors often look at shipping records as evidence that the seller delivered the product to the customer, allowing revenue to be recorded. Management might attempt to trick its auditors (and its investors) into believing that a sale occurred by shipping products to someone other than the customer. Consider the case of Krispy Kreme Doughnuts.

Part of Krispy Kreme's revenue comes from selling doughnut-making equipment to its franchisees. It certainly would be appropriate for the company to record sales revenue upon shipment of a machine to a franchisee—provided, of course, that the machine was actually *received* by the franchisee. In 2003, Krispy Kreme went to great lengths to fool its auditors by pretending to ship equipment to franchisees. It actually shipped the equipment out, but to company-owned trailers to which the franchisees had no access. Krispy Kreme still recorded the revenue, even though the franchisees had failed to take possession of the machines shipped.

**Be Wary of Consignment Arrangements.** Another technique for prematurely recording revenue at the point of shipment involves consignment sales. With such sales, the products are shipped to an intermediary, called a *consignee*. Think of the consignee as an outside sales agent who is given the task of finding a buyer. The manufacturer (called the *consignor*) should recognize no revenue until the sales agent consummates a transaction with an end customer. If the consignor records revenue upon sending products to the consignee, but before the goods are sold to the end user, no revenue should be recognized. Sunbeam, not surprisingly, failed to account for consignment sales appropriately by recording \$36 million in consignment sales before an end user had been found.

**Who Is the Actual Customer—the Distributor or the End User?** In certain industries, a complication arises in recording revenue concerning who should be considered the “customer.” In the semiconductor industry, for example, a manufacturer may sell products to

a distributor, who then resells them to end users. The manufacturer can choose to record revenue when the products are sold to the distributor (called *sell-in*) or when they are ultimately purchased by the end user (called *sell-through*). Both approaches are widely used and indeed permissible under GAAP. Investors should be wary, however, when a company switches from the more conservative sell-through to the more aggressive sell-in model. By doing so, the company accelerates recognition of revenue and artificially boosts profits.

Consider the change made by electronic storage company McDATA Corporation (now part of Brocade Communications Systems Inc.). McDATA buried a change in revenue recognition policy in its October 2004 10-Q, stating that revenue would now be recognized much earlier—at the point of sell-in rather than sell-through. (See the company’s statement on the next page.) What was particularly troubling was that even with the more aggressive revenue recognition method, sales growth remained flat. In the absence of this change, revenue clearly would have been declining.

Investors could have quickly spotted this problem by identifying a large increase in accounts receivable while sales remained unchanged, causing DSO to increase to 60 days from 50 days the quarter before. (See Table 3-4.) Diligent investors would have tracked down the reason for this increase and found McDATA’s change in revenue recognition policy. This example demonstrates the importance of investors going beyond evaluating whether an accounting change complied with GAAP. Investors should always ask the question, why make this change, and why now? In many cases, an accounting change—even a permissible one—is an attempt to hide an operational deterioration.

Table 3-4. McDATA’s Revenue Policy Change Causes Days’ Sales Outstanding (DSO) to Jump

(\$ millions, except days)	Q3, 10/04	Q2, 7/04	Q1, 4/04	Q4, 1/04	Q3, 10/03	Q2, 7/03	Q1, 4/03
Accounts receivable	64.4	53.5	58.2	62.7	59.5	51.9	38.1
Revenue	98.5	98.2	97.2	114.0	94.7	107.0	103.2
DSO	60	50	55	50	57	44	34

**MCDATA'S CHANGE IN REVENUE RECOGNITION POLICY,  
10/04 10-Q**

*Through the second quarter of fiscal 2004 McDATA had recognized revenue on distributor sales of non-configured products when proof of sell-through was obtained. This was due to insufficient historical experience regarding returns or credits under price protection or inventory rotation rights. McDATA has been monitoring and tracking distributor returns and purchasing patterns since 2001. We believe we have obtained sufficient historical experience as of the end of the second quarter of fiscal 2004. Therefore, during the third quarter of fiscal 2004 we began recognizing distributor revenue at the time of shipment. [Italics added for emphasis.]*

**Seller Records Revenue, but Buyer Can Still Reject the Sale**

The final part of the section will discuss revenue that is recorded prematurely even though product was shipped and received by the customer. This may occur if (1) the customer received the wrong product, (2) the customer received the correct product, but too early, or (3) the customer received the correct product at the right time but still reserves the right to reject the sale. When a buyer has received a product but can still reject the sale, the seller must either wait until final acceptance to record revenue or recognize the revenue but record a reserve estimating the amount of anticipated returns.

**Be Wary of Sellers Deliberately Shipping Incorrect or Incomplete Products.** Sometimes companies scheme to inflate revenue by intentionally shipping out the wrong product and recording the related revenue, although they know full well that the product will be returned. Not surprisingly, our friends at Symbol Technologies allegedly shipped incorrect product without customer approval. Similarly, at the end of the fourth quarter of 1996, Informix recorded a sale but failed to deliver the required software code prior to year-end. Then, in January 1997, Informix delivered a "beta" version of the software code that did not function with the hardware. It took the company another six months to deliver usable software code. As a result, Informix recorded revenue in the fourth quarter of 1996 rather than the third quarter of 1997.

**Be Alert to Sellers Shipping Product Before the Agreed-Upon Shipping Date.** The fiscal quarter is coming to a close, and profits are sagging. What can a company do? Why not simply start shipping out merchandise and recording revenue, thereby boosting sales and profits? Merchandise is rushed out of the warehouse to customers toward the end of the year (even before the sales have taken place), and sales revenue is recorded. Since under this method, revenue is recognized when an item is *shipped* to retailers or wholesalers, some manufacturers may be tempted to keep shipping their products during slow times—even if the retailers' shelves are overstocked. Automobile manufacturers have been doing this for years, thereby artificially increasing their sales. By shipping a product late in a quarter, rather than during the following quarter when a customer expects to receive it, a seller can improperly record revenue too soon. An increase in DSO can often be an indicator that a product was shipped late in a quarter.

Even if a company ships products to the actual customer and the customer receives them, the company still may not be permitted to recognize revenue. The final hitch involves terms in many contracts that give the customer an unconditional right of return for a specified period. The accounting rules require that revenue recognition be deferred until final acceptance or the expiration of the return period.

**Be Mindful of Sellers Recording Revenue Before the Lapse of the Right of Return.** Many businesses permit the buyer a “right of return” if it is not satisfied with the goods. Companies are required to either delay revenue recognition until the right of return lapses or estimate an amount of expected returns and reduce revenue by that amount. If the amount of product being returned is in excess of the company's plans or estimates, the company may be guilty of recognizing too much revenue up front.

#### **4. Recording Revenue When the Buyer's Payment Remains Uncertain or Unnecessary**

Continuing our focus on the buyer, we turn our attention to the revenue recognition requirement concerning customer payment. The seller may be accelerating revenue recognition if it records sales when the buyer lacks the ability to pay (payment remains uncer-

tain) or when the seller aggressively induces the sale by not requiring the customer to pay until long after the sale (payment remains unnecessary).

### **Buyer Lacks the Ability or the Necessary Approval to Pay**

In earlier sections, we discussed the requirement that the seller complete its obligations and the requirement that a buyer convey final acceptance. At computer systems maker Kendall Square Research Corporation, all of that took place—the product was shipped, and the customer accepted it. The final question was whether the customer had the wherewithal and the intention to pay. Many of Kendall Square's customers—mainly universities and research institutions—required a third party to provide the funds. In reality, the sale was contingent on the receipt of outside funding, and no revenue should have been recognized until such funding had been secured. In addition, Kendall Square provided customers with “side letter” agreements that essentially voided the sale if they failed to receive funding.

A shareholder lawsuit charged that nearly half of Kendall Square's reported revenue in the first quarter of 1993 had been improperly booked. Most of this revenue came from shipments to the University of Colorado and the Applied Computer Systems Institute of Massachusetts before these customers had received the required funding. The company eventually restated its financial statements for fiscal 1992 and the first half of 1993, reversing approximately half of its previously reported revenue.

Another company that recognized revenue before its customers had secured the necessary financing was Stirling Homex Corporation, a manufacturer of completely installed modular dwelling units. Stirling sold homes to low-income buyers who had limited resources, most of whom obtained financing through the U.S. Department of Housing and Urban Development (HUD). Stirling improperly recorded revenue when HUD signed a preliminary commitment of funding, rather than waiting for the final approval. As a result, Stirling recorded revenue for certain customers who ultimately failed to receive financing. Thus, the financial statements that portrayed Stirling as a healthy, prosperous company with increasing sales and earnings in reality covered up the company's serious business and financial problems.



**Watch for Companies That Change Their Assessment of Customers' Ability to Pay.** Management's assessment of a customer's ability to pay is what determines the estimates used to account for uncollectible receivables. Changes in these assessments may provide companies with a nonrecurring boost to revenue. Consider the revenue recognition policy change made by software company Openwave Systems in December 2005.

Openwave initially waited until the receipt of cash before recognizing any revenue from deadbeat customers that it feared would not pay. Under the new policy, Openwave was able to recognize revenue immediately simply by concluding that the customer no longer was a deadbeat.

Investors who noticed this subtle management change to accelerate revenue would have recognized that Openwave's actual business grew more slowly than reported. Openwave's change in policy indeed reflected its desperation. Revenue growth slowed dramatically in the following years, and Openwave's stock price, which spent much of the March 2006 quarter above \$20, plummeted to \$6 in July. Diligent investors who reviewed the company's December 10-Q would have easily spotted this change in the revenue recognition footnote, as shown here. However, investors who relied only on the company's quarterly earnings release and conference call may have missed the boat, as those disclosures were less revealing about the change in accounting.

#### **OPENWAVE SYSTEMS REVENUE RECOGNITION CHANGE DISCLOSURE, 12/05 10-Q**

*As of the quarter ended December 31, 2005, the Company revised its policy regarding the determination factor for deferrals of revenue recognition for arrangements deemed not probable for collection. Prior to the quarter ended December 31, 2005, the Company continued to defer revenue recognition on arrangements originally deemed not probable for collection until the receipt of cash from that arrangement. As of the quarter ended December 31, 2005, the Company revised its policy such that revenue on arrangements previously deemed not probable for collection, which are subsequently deemed probable for collection is recognized in the period of the change in the*

*assessment of collectibility*, rather than upon receipt of cash, provided all other revenue recognition criteria have been satisfied. This change in policy did not have a material impact for the quarter ended December 31, 2005. [Italics added for emphasis.]

**Seller Induces Sale by Allowing an Exceptionally Long Time to Pay.**

Rather than using a third-party institution for financing, some cash-strapped customers use financing provided by the seller itself. Investors should be cautious about seller-provided financing arrangements (including very generous extended payment terms), as they may indicate the acceleration of revenue into the current period, tepid customer interest in the product, or the buyers' lack of ability to pay.

**Watch for Seller-Provided Financing.** To accelerate revenue in recent years, a number of high-tech companies lend money to customers to enable them to pay for their products. In moderation, customer financing can be considered a sound selling technique; when it is abused, however, it can be a dangerous way to do business. As the technology bubble burst, the amount of financing provided by telecommunication equipment suppliers to their customers should have made investors nervous. At the end of 2000, these suppliers were collectively owed as much as \$15 billion by customers, a 25 percent increase in a single year.

**Watch for Companies That Offer Extended or Flexible Payment Terms.** Sometimes companies offer sweet payment terms in order to entice their customers to purchase additional products earlier than normal. While offering favorable payment terms to customers may be a completely appropriate business practice, it may also add a level of uncertainty to the eventual collectibility of receivables. Moreover, even when extending terms to creditworthy customers, overly generous terms may effectively shift sales that originally were slated for future periods into the current one. This shift would allow for unsustainably high near-term revenue growth and produce pressure to fill the void created in that later period.

**Be Wary of Extended Payment Terms on New Products.** To stimulate sales of new products, a seller may allow customers to pay over an extended period of time. However, sometimes a lengthy payment term makes investors question whether revenue was accelerated into an earlier period. For example, during the September 1995 quarter, Chicago-based software seller System Software, Inc., started offering customers extended payment terms of *up to 14 months* on its new product. By enticing customers to “buy” the new products, the company may have pulled future-period sales into the current period, artificially inflating revenue and profits.

**Sound the Alarm When New Extended Payment Terms Are Disclosed and DSO Jumps.** Investors should be particularly concerned about accelerated (or even improper) revenue recognition when a company begins extending very generous payment terms and DSO spikes. The deck materials supplier Trex Company, for example, provided extended payment terms to customers under what it called an “early buy program” in late 2004 and early 2005. As demand declined, it seemed that Trex enticed customers to accept products earlier than normal (without having to pay for them). This arrangement had minimal impact on the buyers’ total purchases, but allowed Trex to record revenue in an earlier period. A CFRA report at the time stated that these extended payment terms might have been needed to avoid reporting disappointing sales growth. Several months later, Trex predictably announced that its revenue for June 2005 would be much lower than Wall Street expectations. Trex’s sharp increase in receivables (see Table 3-5), together with the company’s disclosure of extended payment terms and an early

Table 3-5. Trex’s Extended Payment Terms Cause Receivables to Jump

(\$ millions, except days)	Q1, 3/05	Q1, 3/04	Q1, 3/03	Q4, 12/04	Q4, 12/03	Q3, 9/04	Q3, 9/03	Q2, 6/04	Q2, 6/03
Accounts receivable	68.8	31.9	13.9	22.0	5.8	12.8	13.1	31.2	21.9
Revenue	89.9	76.3	68.7	29.6	21.9	64.4	41.2	83.4	59.2
DSO	70	38	18	68	24	18	29	34	34

buy program, should have alerted investors to the coming slowdown in sales growth.

## **Concluding Thoughts and Commentary**

This chapter focused on attempts to shift future-period revenue to an earlier period. Two additional pertinent issues require some clarification at this point: (1) what will be the impact on future periods' revenue, and (2) what happens if management gets caught using this shenanigan?

### **Impact on Future Periods' Revenue**

When management employs Shenanigan No. 1, it clearly has concluded that the current period takes precedence over a later one, as it is depleting revenue from the later period and adding it to an earlier one. Had management properly posted a credit to the reserve account with services still to be provided, that credit reserve would be released as revenue in future periods.

### **Impact of Management's Getting Caught Cheating and Correcting Financial Reports**

One of the ironies that is little known to investors concerns the financial reporting benefit that management receives when it restates results caused by premature revenue recognition.

### **A Gift That Keeps Giving—The Result of Accounting Restatements**

Companies that are found to be recognizing revenue prematurely must restate the beginning retained earnings on the Balance Sheet. Think of the retained earnings as the repository of all previously recorded profits. Thus, any previously recognized revenue would have been transferred to this account from the Statement of Income.

Consider a software company that sells a five-year licensing deal for \$1,000,000, receiving \$200,000 up front and the remainder ratably over the contract term. Assume that the company records the entire \$1,000,000 as revenue during the first year and defers nothing. Also assume that this error was not found until the beginning

of year 3, at which time the auditors require an accounting restatement resulting from premature revenue recognition of \$600,000 (the difference between the \$1,000,000 recognized and the correct \$400,000 total for the first two years). Let’s now analyze the impact of the premature revenue recognition on profits.

Error Impact on Profits and Retained Earnings

Year	Profits	Retained Earnings
1	\$800,000	\$800,000
2	<u>\$(200,000)</u>	<u>\$(200,000)</u>
Total	\$600,000	\$600,000

Since the profit accounts for each year would have been transferred to retained earnings, the correcting entry would remove the inflated \$600,000 profit from retained earnings and establish a deferred revenue account.

Accounting Entry to Correct Error

Year 3	Retained earnings	\$600,000	
	Deferred revenue		\$600,000

Now that the error has been corrected for the premature revenue recognized for years 1 and 2, the company is now ready to record the correct \$200,000 revenue for years 3 through 5.

Accounting Entry, Years 3, 4, and 5

Deferred revenue	\$200,000	
	Revenue	\$200,000

Who Says Crime Does Not Pay?

Had the company played by the rules, it would have recorded revenue totaling \$1,000,000 ratably over the five years. In using Shenanigan No. 1 and prematurely recognizing the \$1,000,000 at the outset, then restating for the error, the company *actually reported to investors* \$1,600,000 over the five years (reversal of past years’ revenue is often ignored by Wall Street, particularly if it can be recognized again). And they say crime does not pay!

Well, in the short term, companies might indeed receive an unfair gift from the restatement and a “second helping” of revenue. However, prudent investors know that management’s use of any accounting shenanigans should be viewed in a negative light and should avoid owning companies with suspect financial reporting practices.

## Looking Back

### **Warning Signs: Recording Revenue Too Soon**

- Recording revenue before completing any obligations under the contract
- Recording revenue far in excess of work completed on a contract
- Up-front revenue recognition on long-term contracts
- Use of aggressive assumptions on long-term leases or percentage-of-completion accounting
- Recording revenue before the buyer’s final acceptance of the product
- Recording revenue when the buyer’s payment remains uncertain or unnecessary
- Cash flow from operations lagging behind net income
- Receivables (especially long-term and unbilled) growing faster than sales
- Accelerating sales by changing the revenue recognition policy
- Using an appropriate accounting method for an unintended purpose
- Inappropriate use of mark-to-market or bill-and-hold accounting
- Changes in revenue recognition assumptions or liberalizing customer collection terms
- Seller offering extremely generous extended payment terms

## Looking Ahead

Chapter 3 outlined the following four techniques used to recognize revenue prematurely: (1) recording revenue before completing any obligations under the contract, (2) recording revenue far in excess of the work completed on the contract, (3) recording revenue before the buyer's final acceptance of the product, and (4) recording revenue when the buyer's payment remains uncertain or unnecessary.

While Chapter 3 addressed tricks involving mainly legitimate sources of revenue (albeit reported in an incorrect period), Chapter 4 moves to an arguably more audacious revenue recognition transgression: recording bogus or fictitious revenue.

# 4

## EARNINGS MANIPULATION SHENANIGAN No. 2: RECORDING BOGUS REVENUE

The previous chapter discussed situations in which companies record revenue too soon. While this is clearly inappropriate, the acceleration of legitimate revenue is less audacious than simply making the revenue up out of thin air. This chapter describes four techniques that companies employ to create bogus revenue and some warning signs for investors to spot this nefarious shenanigan.

### Techniques to Record Bogus Revenue

1. Recording Revenue from Transactions That Lack Economic Substance
2. Recording Revenue from Transactions That Lack a Reasonable Arm's-Length Process



3. Recording Revenue on Receipts from Non-Revenue-Producing Transactions
4. Recording Revenue from Appropriate Transactions, but at Inflated Amounts

### **1. Recording Revenue from Transactions That Lack Economic Substance**

Our first technique involves simply dreaming up a scheme that has the “look and feel” of a legitimate sale, yet in reality lacks economic substance. In these transactions, the so-called customer is under no obligation to keep or pay for the product, or nothing of substance really was transferred in the first place.

In his brilliant 1971 hit song, John Lennon challenged us to “imagine” a perfect world. Imagination has undoubtedly helped the world become a better place, as people’s creativity has broken boundaries and led to countless innovations. Imagination has inspired talented scientists, for example, to diagnose the unknown and find cures for diseases. Similarly, technological entrepreneurs like Bill Gates and Steve Jobs have imagined exciting ways to create new products, such as Microsoft’s Windows and Apple’s iPod, that enhance our enjoyment of life.

Occasionally, though, the imagination can run amok. Many corporate executives have given imagination a bad name when they’ve used theirs to get too creative with company revenue. One such example comes from financial innovators in the insurance industry. Several years ago, industry leader AIG began imagining a perfect world for its clients (and itself) in which they would always achieve Wall Street’s earnings expectations. Imagine, AIG must have thought, how happy clients would be if they never had to experience the indignity (and stock price decline) that accompanies an earnings shortfall.

And one day that dream became a reality. AIG and several other insurers began to market a new product called *finite insurance*. This magic solution would guarantee clients the ability to always produce earnings that were acceptable to Wall Street by “insuring against” earnings shortfalls. In a sense, this product was an addic-

tive drug that allowed companies to cover up quarterly blemishes by inappropriately smoothing their earnings.

And not surprisingly, customers were hooked. Everybody was happy. AIG found a new revenue stream, and customers found a way to prevent earnings shortfalls. However, there was a big problem: some of these “insurance” contracts were not really legitimate insurance arrangements at all; rather, they were actually financing transactions.

**How Was Finite Insurance Abused?** Let’s turn to Indiana-based wireless company Brightpoint Inc. to see how some finite insurance transactions were economically more akin to financing arrangements. It was late 1998 and the bull market was racing, but Brightpoint had a problem: earnings for the December quarter were tracking about \$15 million below the guidance given to Wall Street at the beginning of the quarter. As the quarter closed, management feared that investors would be unprepared for this news, and that, as a result, the firm’s stock price would be hammered.

Enter AIG and its “perfect world” products. AIG created a special \$15 million “retroactive” insurance policy that would “cover” Brightpoint’s unreported losses. Here’s how the policy worked: Brightpoint agreed to pay “insurance premiums” to AIG over the next three years, and AIG agreed to pay out an “insurance recovery” of \$15 million to cover any losses under the policy. This sounds like your normal insurance policy, except for one big problem: there was no transfer of risk, since the policy covered losses that had already happened. You can’t insure your house after it burns down!

Brightpoint proceeded to record the \$15 million “insurance recovery” as income in the December quarter (which blotted out its unreported losses). AIG recorded what amounted to bogus revenue on the insurance premiums over the next three years. Economic sense dictates that this transaction was not an insurance contract because no real risk had been transferred. Indeed, the transaction was nothing more than a financing arrangement: Brightpoint deposited cash at AIG, which AIG eventually refunded as purported “insurance claim payments.”

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Accounting Capsule: Legitimate Insurance  
Contracts Require a Transfer of Risk

Just because two parties call an agreement an insurance contract does not mean that they can book it as such in their financial statements. In order to be considered an insurance policy for accounting purposes, an arrangement must involve a *transfer of risk* from the insured to the insurer. Without this transfer of risk, GAAP treats the arrangement as a financing transaction, with premium payments being treated like bank deposits and recoveries being treated like the return of principal.

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**The Regulators Considered This Scheme to Be a Scam.** Brightpoint got into trouble with the Securities and Exchange Commission (SEC) for inappropriately masking its problems. AIG found itself in the SEC's crosshairs as well for knowingly structuring the insurance policy in such a way that it allowed Brightpoint to misrepresent its actual losses as "insured losses." In November 2004, AIG agreed to pay \$126 million to settle litigation with the Department of Justice and the SEC on charges that it had sold products that helped companies inflate earnings via the use of finite insurance.

**Charity Begins at Home—After Helping Its Clients, AIG Finds Time to Help Itself**

After several years of helping its clients smooth out rough patches in their earnings, AIG decided to use its expertise to help rid itself of nasty questions raised by its own Wall Street analysts. AIG's September 2000 earnings release did not go well. Many analysts were unsettled by an unexpected decline in AIG's insurance liability reserve. They were asking questions about this decline, and some worried that AIG had released reserves to make its numbers for the quarter.

To help solve its "Wall Street problem" and boost the troubling anemic reserve balance, AIG sought the assistance of Gen Re to structure a sham reinsurance arrangement. Since AIG was one of Gen Re's largest clients, Gen Re acquiesced and actively participated in the fraud, for which it would later pay dearly.

Here's how it went down. AIG received \$500 million in purported insurance premiums from Gen Re, which it used to beef up its loss reserves. At the same time, AIG paid \$500 million to Gen Re to reinsure a risk. As in the Brightpoint transaction, there was no real economic substance or transfer of risk behind this exchange—it was really just a round trip of cash. However, AIG did not account for it that way. It used the transaction to inappropriately prop up its loss reserves.

**Beware: Bogus Reserves Will Often Lead to Bogus Revenue or Income.** In its sham arrangement with Gen Re, AIG could just as easily have decided to record bogus revenue instead of propping up its reserves. However, AIG's goal was to increase its reserve account, not to inflate revenue—at least not yet. If a reserve is bogus and no future payment exists, a company can easily make a bookkeeping entry that releases the reserve to report phony income.

So AIG actually improperly benefited twice from this shenanigan. First, when it created a bogus liability reserve, Wall Street analysts were mollified by the high reserve balance. Then, with the “reloaded” reserve, AIG gave itself an opportunity to “flip the switch” and release these reserves into income. The plan worked great for a while—or until the regulators started sniffing around.

**AIG Pays Big Time for Its Shenanigans in Its Settlement with the SEC.** In May 2005, AIG announced a staggering \$2.7 billion restatement, correcting misstatements for the previous five years. The following February, AIG paid another \$1.6 billion to settle litigation as part of a global resolution of federal and state actions.

### **Peregrine Duples Investors with Software Sales That Lack Economic Substance**

Not surprisingly, creating bogus revenue from transactions that lack any economic substance extends far beyond insurance companies. Plenty of technology companies seemed to get the memo on how easy it is to employ this shenanigan. Take, for instance, San Diego-based Peregrine Systems, which got busted for a massive fraud scheme that involved recognition of bogus revenue.

The SEC charged that Peregrine improperly recorded millions of dollars of revenue from nonbinding sales of software licenses to resellers. The company apparently entered into secret side agreements that waived the resellers' obligation to pay Peregrine, which means that revenue should not have been recorded. Employees at Peregrine had a great name for the scheme: "parking" the transaction. Sales that were near the finish line were often parked in order to help Peregrine achieve its revenue forecasts. Peregrine engaged in other deceptive practices as well to create bogus revenue, including entering into reciprocal transactions in which the company essentially *paid for its customers' purchases* of its software. In 2003, Peregrine restated its financial results for those quarters, reducing previously reported revenue of \$1.34 billion by \$509 million, of which at least \$259 million was reversed because the underlying transactions lacked substance.

#### **And with Bogus Revenue Come Those Troublesome Receivables.**

Peregrine obviously did not receive cash from customers on these nonbinding bogus revenue contracts, resulting in bogus receivables festering on the Balance Sheet. As we have learned, a rapid increase in accounts receivable is often an indication of deteriorating financial health. Peregrine knew that analysts would naturally begin questioning the "quality of earnings" if the bulging receivables balance remained stubbornly high. To prevent these questions, Peregrine played several tricks that made it seem that the receivables had actually been collected. These shenanigans inappropriately lowered the receivables balances, and in doing so, improperly inflated cash flow from operations (CFFO). We will break down the mechanics of this chicanery and discuss Peregrine's Cash Flow Shenanigans further in Chapter 10.

#### **Symbol, Of Course, Wants In on the Action**

Symbol Technologies found a creative way to recognize revenue that lacked economic substance. From late 1999 through early 2001, Symbol conspired with a South American distributor to fake more than \$16 million in revenue. It instructed the distributor to submit purchase orders for random products at the end of each quarter, even though the distributor had absolutely no use for those products. Symbol never shipped the products to either the distributor

or any of its customers. Instead, to fool the auditors into believing that a sale had actually occurred, Symbol sent the products to its own warehouse in New York; however, it still retained all “risks of loss and benefits of ownership.” The distributor, naturally, did not have to pay for the warehoused product and could “return” or “exchange” the goods at no cost when it placed legitimate new orders for any product that it actually needed. Without a doubt, the only purpose of this charade was to give the appearance of a legitimate sale so that Symbol could record revenue.

**Symbol’s Three-Ring Circus.** Symbol would do virtually anything, including losing money, just to recognize a sale. In a bizarre story, Symbol concocted a three-party circular scam to create fake revenue out of thin air. Typically, Symbol sold its product to a middleman (a distributor), who then sold the product to the actual customer (the reseller). Symbol found a way to use this structure to create bogus revenue: it improperly enticed (really, bribed) the reseller to purchase more of Symbol’s product from the distributor. The distributor would, in turn, purchase more products from Symbol. What a way to create artificial demand!

How did Symbol entice its resellers to go along with this scheme? Well, Symbol allegedly gave the resellers the cash they needed to make these purchases. Symbol also paid a substantial markup so that the resellers could turn a profit on these transactions. On top of that, Symbol paid resellers a bonus equal to 1 percent of the purchase price (referred to by the Symbol schemers as “candy”). The net result of this transaction was that Symbol purchased its own product back at a much higher price than that at which it had initially sold it. Symbol did not mind the loss, however, as the scheme was all in the name of revenue growth.

During 2000, for example, Symbol improperly recognized approximately \$10 million of revenue on transactions for which it had first paid out \$15 million to resellers. In this bizarre scheme, Symbol actually lost millions of dollars on this circular sham transaction. The scheme produced the desired revenue, but Symbol suffered losses by effectively buying back its own products at a higher price and paying what amounted to a bribe. This is clearly one of the more ridiculous financial shenanigans you will ever see!

## **2. Recording Revenue from Transactions That Lack a Reasonable Arm's-Length Process**

While recognizing revenue on transactions that lack economic substance can never be considered legitimate, transactions that lack a reasonable arm's-length process are sometimes appropriate. But prudent investors should bet against it. That is, most related-party transactions that lack an arm's-length exchange produce inflated, and often phony, revenue.

### **Transactions Involving Sales to an Affiliated Party**

If a seller and a customer are also affiliated in some other way, the seller's quality of revenue on sales may be suspect. For example, a sale to a vendor, a relative, a corporate director, a majority owner, or a business partner raises doubt as to whether the terms of the transaction were negotiated *at arm's length*. Was a discount given to the relative? Was the seller expected to make future purchases from the vendor at a discount? Were there any side agreements requiring the seller to provide a quid pro quo? A sale to an affiliated party or a strategic partner may be an entirely appropriate transaction. However, investors should always spend time scrutinizing these arrangements, as it is important to understand whether the revenue recognized is truly in line with the economic reality of the transaction.

### **Be Wary of Related-Party Customers and Joint Venture Partners.**

A representative case in point is the alleged fraud at Syntax-Brilliant Corp., the Arizona-based maker of high-definition televisions. In 2007, Syntax-Brilliant was flying high. Extraordinary demand in China sent sales of TVs soaring, and a new marketing relationship with ESPN and ABC Sports generated a buzz about its Olevia HDTVs. The company more than tripled its revenue in fiscal 2007, with sales approaching \$700 million, up from less than \$200 million the prior year. Yet one year later, Syntax-Brilliant was bankrupt and under investigation for fraud.

Syntax-Brilliant's demise was not a surprise to investors who understood the extent to which the company's reported results benefited from transactions with related parties. For example, the company's staggering revenue growth came from a tenfold in-

crease in sales to a related party that accounted for nearly half of its total revenue—an Asian distributor named South China House of Technology (SCHOT). Syntax-Brilliant's relationship with SCHOT was much more incestuous than a typical customer-supplier arrangement, according to a study by RiskMetrics Group. The two companies seemed to be involved in a tangled web of joint ventures (which also, oddly, included Syntax-Brilliant's primary supplier). Syntax-Brilliant was close enough with SCHOT that it granted it 120-day payment terms and routinely extended those terms even further.

Syntax-Brilliant described SCHOT as a distributor that would purchase its TVs and then resell them to retail outlets and end users in China. Many investors failed to question the company's significant uptick in sales to SCHOT, as they believed that demand in China was high, with people upgrading their TV sets heading into the 2008 Summer Olympics in Beijing. Investors were also cheered by reports that the Beijing Olympic Village itself was planning to fit its facilities with Olevia TVs.

Then all of a sudden, in February 2008, Syntax-Brilliant cryptically announced that the Olympic facilities would no longer be installing the TVs that the company had "sold" to South China House of Technology. Even though Syntax-Brilliant had already recorded revenue from the sale of these TVs, it agreed to "repurchase" more than 25,000 TVs for nearly \$100 million. The company did not need to come up with the cash because the receivable from SCHOT was, of course, still outstanding. With this significant right of return and no receipt of cash, Syntax-Brilliant should never have recognized this revenue in the first place!

Syntax-Brilliant's elaborate related-party transactions (and many other red flags, such as surging receivables) were in plain sight for any investor who read the SEC filings. Take, for example, the following reference to SCHOT found in Syntax-Brilliant's March 2006 10-Q that would have led even the most novice investor to raise questions.

At March 31, 2006, the accounts receivable balance from one of our Asian customers, that is also a joint venture partner, totaled \$9.6 million, or 70.8 percent of the outstanding balance of accounts that had not been assigned to CIT.



**Watch for Unusual Sources of Revenue at the Time of an Acquisition.** Revenue between two parties that are about to merge clearly lacks an arm's-length process. Consider Krispy Kreme's nifty scheme to inflate revenue when it was about to reacquire one of its franchises in 2003.

Before the acquisition closed, Krispy Kreme sold doughnut-making equipment to the franchise for \$700,000. As part of the deal, Krispy Kreme increased the amount that it would pay to acquire the franchise by the same \$700,000 in order to cover the price of the equipment. This arrangement clearly had no real net economic impact, so no revenue should have been recorded. Krispy Kreme, however, did not see it that way, and so it recorded the sale of equipment as revenue rather than as an offset to the increased franchise purchase price. Not surprisingly, this ruse helped Krispy Kreme maintain its streak of consistently exceeding Wall Street expectations.

**Be Alert to Two-Way Transactions with a Nontraditional Buyer.** Symbol Technologies simultaneously purchased software for \$8.5 million and sold one of its products to that vendor-customer company for \$4.25 million (of which \$2 million was returned). Curiously, Symbol retained possession of the inventory it had "sold" and provided the funds for the software company to "purchase" its product. In a side agreement, the software company had an unlimited right of return for an indefinite period. Incidentally, Symbol never used the software it had purportedly purchased; it still remained packed up in the original box years after the transaction.

### **3. Recording Revenue on Receipts from Non-Revenue-Producing Transactions**

So far, we have addressed bogus revenue generated from transactions that are completely lacking in economic substance and ones that may have some economic substance but lack a necessary arm's-length process. We now investigate situations in which bogus revenue arises from misclassification of cash received from non-revenue-producing activities.

Investors understand that not all cash received represents revenue or even directly pertains to a company's core operations. Some inflows are related to financing activities (borrowing and stock

issuance), and others to the sale of businesses or sundry assets. Companies that recognize revenue or income from non-revenue-producing sources should be deemed guilty of reporting phony revenue to inflate earnings.

**Question Revenue Recorded When Cash Is Received in Lending Transactions.** Never confuse money received from your friendly banker with money received from a customer. A bank loan must be repaid and is considered a liability. In contrast, money received from a customer in return for a service rendered is yours to keep and should be considered revenue.

Apparently, auto parts manufacturer Delphi Corporation failed to understand the distinction between a liability and revenue. In late December 2000, Delphi took out a \$200 million short-term loan, posting inventory as collateral. Rather than recording the cash received as what it was (a liability that needed to be paid back), Delphi improperly recorded it as the sale of goods. As you will see with Delphi in Chapter 10, this twisted interpretation not only allowed Delphi to record bogus revenue, it also provided bogus cash flow from operations.

**Challenge Advances Received from a Partnership That Are Classified as Revenue.** An equally suspect source of revenue involves cash from a joint venture partner. Consider the research and development partnership on waste technology formed between Molten Metal and Lockheed Martin. Lockheed provided the funding, and Molten performed the research. Molten took \$14 million from the partnership and recorded that amount as revenue. Molten was still essentially a development-stage company; it derived virtually none of its revenue from actual sales to unaffiliated customers. The \$14 million taken from the partnership should have been considered a distribution or a loan from the partnership to fund the research, not revenue.

**Be Wary of Revenue Recorded on Receipts from Vendors.** Generally, cash flows with vendors involve cash outflows to purchase products or services. Occasionally, a company will agree to overpay a vendor for inventory upon purchase, provided the vendor rebates that excess charge with a cash payment in a later period. Recording that cash rebate as revenue is clearly inappropriate, as

it should be considered an adjustment to the cost of the inventory purchased. However, our good friends at Sunbeam did not see it that way. Sunbeam played a neat trick to boost revenue in which it advanced cash to vendors and then recorded revenue when that cash was repaid. Additionally, Sunbeam would commit to future purchases from a particular vendor in exchange for an immediate “rebate” from that vendor, which Sunbeam, of course, recorded as revenue.

**Consider How Retailers Account for Returned Goods.** While the Sunbeam example illustrates a fraudulent transaction, certain retailers may receive cash refunds or credits from suppliers or other vendors in the normal course of business. The proper accounting to use for these credits would be to reduce the value of the inventory purchased. Sometimes, however, retailers aggressively overstate their sales by recording these credits as revenue. For example, the SEC charged that retailer L.A. Gear improperly classified as income one-time vendor credits (for supplier misshipments and other sourcing troubles) that it had not actually collected.

#### **4. Recording Revenue from Appropriate Transactions, but at Inflated Amounts**

The first three sections of this chapter focused on sources of revenue that were wholly inappropriate, as they lacked any economic substance, failed the necessary arm’s-length test, or derived from non-revenue-producing activities. Companies profiled in this section, on the other hand, generally meet the broad guidelines for recognizing revenue. The transgression, however (and not an insignificant one), concerns recording revenue in an amount that seems excessive or misleading to investors. Excessive or misleading revenue might result from (1) using an inappropriate methodology to recognize revenue or (2) grossing up revenue to make a company appear much larger than it really is.

##### **Using an Inappropriate Methodology to Recognize Revenue**

Surging revenue growth always wows investors, especially when it occurs in an industry that does not normally grow at breakneck speed. While meteoric sales growth is often found in the technol-

ogy industry, rarely do investors find it at small management and consulting companies. However, back in 1993, one such darling consulting company, Education Alternatives Inc., enchanted Wall Street with revenue leaping tenfold in a single year. And boy did Wall Street notice, as the firm's share price doubled in three short months. Let's take a close look and review a key warning sign that those investors missed.

Education Alternatives provided consulting services to school boards on topics such as security, maintenance, and improving student performance. The company was tiny (with a few dozen employees and a few million dollars in revenue), and its business model was simple. Such small and uncomplicated consulting companies rarely present complicated accounting issues for auditors or investors.

Things changed dramatically for the company in 1992, however, when it won a contract to manage the entire budget for nine Baltimore public schools. This was more than a plain-vanilla consulting arrangement. Education Alternatives was charged with improving student performance, and it was given control of the school board's checkbook in managing the \$133 million budget over the next five years.

**Education Alternatives' Unique Consulting Gig.** How would Education Alternatives be compensated for this unique consulting gig? The terms seemed to be a bit unusual, but they were certainly unambiguous. Let's start with the \$133 million total for the five years. That works out to \$26.6 million available to spend each year for the schools. The deal worked as follows: Baltimore would pay no more than the amount allocated in the budget, \$26.6 million annually. If, for example, Education Alternatives spent \$25 million on the schools, the remaining \$1.6 million would be considered its fee. If, instead, it spent the entire \$26.6 million (about \$5,900 per student), the company would get nothing; and if it went over the budget, the company would have to dig into its pocket to make up the shortfall. It could actually lose money on the deal.

Although Education Alternatives' fee provided by the contract was nebulous and uncertain, it would appear logical for the firm to book revenue in the same way as a typical management consulting company, that is, by calculating an imputed hourly or daily rate.

While the method used is certainly subject to management discretion, this would seem to be the most accurate approach for estimating revenue. Surely, during the contract bidding, the company priced out its costs in order to make a rational decision on whether to accept this engagement.

### **Education Alternatives' Creative Approach to Revenue Recognition.**

Education Alternatives shunned the traditional consulting revenue model and came up with something that might be considered a bit crazy. The company decided to recognize *as its own revenue* the entire \$26.6 million received each year (or \$133 million over five years). As a result, the company's revenue jumped from approximately \$3 million to \$30 million in the first year of the contract. How were investors to interpret this dramatic growth? Well, they must have come to one of three conclusions: either (1) there was a typo in the company's revenue line, with a zero mistakenly added, (2) the company was an unbelievably attractive investment opportunity, or (3) the company was a complete fraud.

The following year, Education Alternatives hit an even bigger jackpot when the city of Hartford decided to turn the management of its entire school system over to the company. Revenue raced to \$214 million in 1995, as Education Alternatives treated the entire budget for Hartford's schools as though it were its own sales. As a result, revenue that in 1992 had barely reached \$3 million climbed to over \$200 million in three short years. (Enron executives must have been studying this meteoric revenue rise and taken it upon themselves to outdo Education Alternatives!)

### **Testing Education Alternatives' Revenue Recognition Methodology.**

Let's extend Education Alternatives' business model beyond the Hartford and Baltimore contracts to test the legitimacy of the company's revenue recognition policy. Imagine if the company won a contract to manage New York City's budget. Using this unconventional revenue model and reasonably assuming approximately 1 million public school students and \$6,000 per student, the company's sales would have jumped by \$6 billion, a figure higher than the total revenue of Arthur Andersen, the largest of the "Big Eight" accounting firms at that time. Would any sane investor believe that Education Alternatives and its few dozen employees generated

revenue equivalent to that of the global behemoth accounting and consulting firm?

So, which of the three conclusions do *you* believe investors should have come to [(1) there was a typo in the company's revenue line, with a zero mistakenly added, (2) the company was an unbelievably attractive investment opportunity, or (3) the company was a complete fraud]? If you picked (2), you need to read this book a bit more carefully and put away that beer you are drinking! We hope that you did not blow this one, but fortunately you will have another chance to show your mastery of detecting financial shenanigans with a final exam question at the end of Chapter 15.

**Tip:** If you spot signs of a questionable accounting approach, test it by comparing the results and practices to those of a similar company that is much larger. With Education Alternatives, let's compare it to the biggest firms in its industry—consulting firms. During the early 1990s, the Big Eight accounting and management firms dominated the industry.

In addition to inflating revenue by using an unorthodox accounting methodology, companies might be able to properly report higher revenue based on their business model or on assumptions made by management. That is the focus of the final section of this chapter.

### **Grossing Up Revenue to Appear to Be a Larger Company**

Unlike companies that produce or purchase inventory and then sell it to customers (called “principals” of the sale), some companies are simply matchmakers (called “agents” of the sale)—they facilitate the sale between a buyer and a seller. Real estate agencies, auction houses, and travel agencies are examples of agents—they normally do not sell inventory that they own; rather, they connect a buyer and a seller.

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#### Accounting Capsule: Revenue Recognition for Principals versus Agents

Principals recognize sales revenue at the *gross* amount of the transaction (i.e., the cost of the product plus the markup). In

contrast, agents simply recognize revenue at the *net* amount (i.e., the agent’s fee, which is the difference between the cost of the product and the sales price paid by a customer).

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Principals recognize much more revenue than agents for a transaction that looks the same to an end customer, and rightfully so, because they actually own the inventory and bear the risk of loss. Creative and misleading practices arise whenever a company that effectively bears no inventory risk (an agent) accounts for sales as a principal and records revenue at the much higher gross amount.

Let’s look at eBay, the online auction house, to understand the difference between a principal and an agent more clearly. Essentially, eBay’s business is a matchmaking arena in which buyers and sellers find each other, and eBay earns a fee for providing the platform. For example, if you sell your car on eBay for \$20,000, eBay will keep a portion of the sale (say \$500) as a service fee. As an agent, eBay naturally uses the net method and records the \$500 service fee as its revenue. Certainly, eBay should not be entitled to record the gross amount of the sale (\$20,000), as it did not really sell the car. As shown in the illustration in Table 4-1, if eBay were to inappropriately recognize revenue under the *gross* method, its revenue would be massively overstated (although its profit would be the same). Thus, eBay would be fooling investors into thinking that it was a much larger company than its economic reality.

**Is Priceline a Travel Agency or an Airline/Hotel Conglomerate?** In contrast to eBay, Internet travel agency Priceline.com Inc. uses the

Table 4-1. Illustration of Gross versus Net Methods of Revenue Recognition

	Gross Method	Net Method
Sales	\$20,000	\$500
Cost of sales	\$19,500	\$0
Gross profit	\$500	\$500

gross method for some of its transactions. For example, on certain transactions in which you “name your price” and purchase a \$200 hotel room, Priceline records the entire \$200 as revenue. This policy appears to belie the underlying economics of Priceline’s business, which seems to be nothing more than a matchmaking service that bears limited risk of economic loss on the hotel and plane tickets that it sells.

**Enron Couldn’t Resist.** Similarly, Enron’s dazzling revenue growth in the late 1990s was aided by its aggressive accounting practice of grossing up sales in its trading business. When typical Wall Street trading firms like Goldman Sachs and Citigroup broker a trade, they understand that they are merely serving as the middleman or agent of the transaction. Accordingly, they record as revenue the related brokerage fee or commission. They would not dare (we hope) to record the gross amount of a trade (i.e., the price of the security plus the fee) as revenue.

Enron, however, accounted for trades considerably more aggressively. Rather than recording just the brokerage fee as revenue, Enron brazenly recognized the *entire value* of the security or asset traded. Between this ruse and the company’s aggressive use of mark-to-market accounting (discussed in the previous chapter), you now understand two magic tricks that Enron used to rapidly ascend to the “\$100 billion club.” If all financial institutions accounted for their trading businesses the “Enron way,” revenue for many banks would be in the trillions.

## Looking Back

### Warning Signs: Recording Bogus Revenue

- Recording revenue from transactions that lack economic substance
- Recording revenue from transactions that lack a reasonable arm’s-length process
- Lack of risk transfer from seller to buyer



- Transactions involving sales to a related party, affiliated party, or joint venture partner
- Boomerang (two-way) transactions to nontraditional buyers
- Recording revenue on receipts from non-revenue-producing transactions
- Recording cash received from a lender, business partner, or vendor as revenue
- Use of an inappropriate or unusual revenue recognition approach
- Inappropriately using the gross rather than the net method of revenue recognition
- Receivables (especially long-term and unbilled) growing much faster than sales
- Revenue growing much faster than accounts receivable
- Unusual increases or decreases in liability reserve accounts

## Looking Ahead

Chapters 3 and 4 addressed techniques for inflating revenue. These tricks included either recognizing revenue too early or recording revenue that, in whole or in part, was bogus. Chapter 5 looks at techniques for inflating income, but it moves further down the Statement of Income. While they are not part of revenue, one-time gains may create distortions in the operating or net income of a company.

# 5 EARNINGS MANIPULATION SHENANIGAN No. 3: BOOSTING INCOME USING ONE-TIME OR UNSUSTAINABLE ACTIVITIES

When a magician wants to make a rabbit appear out of thin air, he may tap a wand or say the magic word *abracadabra*. Not to be outdone, corporate executives have their own way of creating something out of nothing when it comes to reporting earnings. Executives don't need special props, though, and they don't need to use special words like *abracadabra*. All they need is a few simple techniques.

One-time gains are akin to the proverbial rabbit in the hat, magically appearing from nowhere. A struggling company may be tempted to use certain techniques that boost income by using one-time or unsustainable activities. Chapter 5 explores such methods,

which, if undetected, might confuse investors. This chapter examines the following two techniques used by management to give income a quick, but temporary “shot in the arm.”

## **Techniques to Boost Income Using One-Time or Unsustainable Activities**

1. Boosting Income Using One-Time Events
2. Boosting Income through Misleading Classifications

### **1. Boosting Income Using One-Time Events**

#### **The Dot-Coms Were Coming, and the Blue Chips Were Scared**

During the late 1990s, “dot-com” technology start-ups captivated investors’ attention, while older technology stalwarts yearned to regain their luster. Just the simple act of adding “dot-com” to the end of a company name led investors to immediately pay more for the stock. The actual economic performance and fundamental health of these businesses seemed to be of little interest to investors, who became intoxicated with the potential for insane growth in the new economy or the potential for the company to be acquired at a tremendous premium. Some of these companies flourished (Yahoo!), others joined forces with old-line businesses (AOL merged with Time Warner), and many just went bust (eToys went from a market value of \$11 billion in 1999 to bankrupt in 2001). Investors were so focused on these up-and-comers that technology blue chips like IBM, Intel, and Microsoft were viewed as old fuddy-duddies.

IBM indeed ran into a rough patch during 1999, as the company’s costs increased faster than revenue. As Table 5-1 shows, cost of goods and services (CGS) grew 9.5 percent in 1999, while revenue was up 7.2 percent, resulting in a lower gross margin. However, somehow IBM’s operating and pretax profits jumped a very impressive 30 percent.

The large discrepancy between revenue and operating income growth should have tipped off diligent investors to do some further digging. Since by reading this book, you are now considered a diligent investor, let’s take a close look at the Statement of Income

Table 5-1. IBM's 1999 Statement of Income, as Reported

(\$ millions, except %)	1999 Reported	1998 Reported	% Change
Revenue	87,548	81,667	<b>7.2%</b>
Cost of goods and services	(55,619)	(50,795)	9.5%
Gross profit	31,929	30,872	3.4%
Selling, general, and administrative expenses	(14,729)	(16,662)	<b>(11.6%)</b>
Research and development	(5,273)	(5,046)	4.5%
Operating income	11,927	9,164	<b>30.2%</b>
Nonoperating expenses	(170)	(124)	
Net income before taxes	11,757	9,040	<b>30.0%</b>
Income taxes	(4,045)	(2,712)	
Net income	7,712	6,328	<b>21.9%</b>

found in IBM's 10-K filing (shown in Table 5-1). One thing that should immediately stand out is the 11.6 percent *decline* in selling, general, and administrative (SG&A) expenses, in contrast to the 9.5 percent *increase* in the CGS category. Second, the 30 percent growth in both operating and pretax income seems very surprising on just 7.2 percent sales growth, unless the company also had a large one-time gain that was hidden from view—or had chosen another shenanigan to boost income or hide expenses.

And that is precisely what happened. A footnote in the 1999 10-K disclosed that IBM booked a \$4.057 billion gain from selling its Global Network business to AT&T and curiously included that gain as a *reduction in the SG&A expense*. In so doing, IBM magically hid its deteriorating operations from many investors.

As Table 5-2 illustrates, the results, excluding the one-time gain, would have appeared dreadful in comparison to IBM's reported numbers. Adjusting IBM's 1999 results by simply removing the gargantuan gain that was improperly bundled into SG&A expense would cause the expense to jump from \$14.729 to \$18.786 billion. Operating income would, in turn, decline by the same amount, from \$11.927 to \$7.870 billion. As a result, both operating and pretax income would be sliced by \$4.057 billion.

Now we can compare the results (as reported versus our adjusted figures that excluded the gain) and clearly see the dramatic

Table 5-2. IBM's 1999 Statement of Income, Adjusted to Exclude One-Time Gain

(\$ millions, except %)	1999 Adjusted	1998 Reported	% Change
Revenue	87,548	81,667	<b>7.2%</b>
Cost of goods and services	(55,619)	(50,795)	9.5%
Gross profit	31,929	30,872	3.4%
Selling, general, and administrative expenses	(18,786)	(16,662)	<b>12.7%</b>
Research and development	(5,273)	(5,046)	4.5%
Operating income	7,870	9,164	<b>(14.1%)</b>
Nonoperating expenses	(170)	(124)	
Net income before taxes	7,700	9,040	<b>(14.8%)</b>
Income taxes (at 34.4%)	(2,649)	(2,712)	
Net income	5,051	6,328	<b>(20.2%)</b>

differences. SG&A really *increased* by 12.7 percent (rather than the reported *decline* of 11.6 percent), and operating and pretax profits actually *declined* by 14.1 and 14.8 percent, respectively (rather than the reported *increases* of 30.2 and 30.0 percent).

### Turning the Sale of a Business into a Recurring Revenue Stream

Some companies will sell a manufacturing plant or a business unit to another company, and, at the same time, enter into an agreement to buy back product from that sold business unit. These transactions are common in the technology industry and are often used by companies as a way to quickly “outsource” an in-house process. For example, a cellular phone manufacturer that decides that it no longer wants to make its own batteries may sell its battery manufacturing division to another company. At the same time, since the phone manufacturer still needs batteries for its phones, the two companies may enter into another agreement in which the phone manufacturer purchases batteries from the division that it just sold.

Not surprisingly, such transactions that commingle a one-time event (the sale of a business) and normal recurring operating activities (the sale of product to customers) create opportunities for management to use financial shenanigans. For example, the phone company may take less money for the sale of its battery business if the buyer also agrees to give the company a good deal on future

battery purchases. In another type of commingled transaction, a company may sell a business at a deflated price if the buyer also agrees to purchase other goods from the seller at an inflated price.

Consider the structure of a November 2006 deal between semiconductor giant Intel Corp. and fellow chip manufacturer Marvell Technology Group. Intel agreed to sell certain assets of its communications and application business to Marvell. At the same time, Marvell agreed to purchase a minimum number of wafers from Intel over the next two years. A careful reading of Marvell's description of the transaction reveals something odd: Marvell agreed to purchase these wafers from Intel at *inflated* prices. (Interestingly, Intel did not disclose this, perhaps considering the amount to be insignificant.) Why would Marvell agree to overpay for this inventory?

#### MARVELL'S 10-Q DISCUSSION OF ITS TRANSACTION WITH INTEL

In conjunction with the acquisition of the ICAP Business, the Company entered into a supply agreement with Intel. The supply agreement obligates the Company to purchase certain finished product and sorted wafers at a contracted price from Intel for a contracted period of time. The contracted period of time can differ between finished products and sorted wafers. *Intel's pricing to the Company was greater than comparable prices available to the Company in the market in almost all cases.* In accordance with purchase accounting, the Company recorded a liability at contract signing representing the difference between Intel prices and comparable market prices for those products for which the Company had a contractual obligation. [Italics added for emphasis.]

**Tip:** Be sure to always review both parties' disclosures on the sale of businesses to best grasp the true economics of the transactions.

Marvell certainly would not have agreed to pay an inflated price for purchases from Intel unless it was receiving something of equal

value in return. Remember that Marvell and Intel negotiated the asset sale and the supply agreement concurrently. To understand the true economics of this arrangement, we must analyze both elements of the transaction together.

Economically, it would make sense for the total cash paid by Marvell for both the business and the future products to correspond with the value that Marvell was receiving from both the business acquired and the products that were later purchased. It follows, then, that if Marvell overpaid for the products, it must have underpaid for the business. In other words, Intel probably received less cash up front from the sale of the business in exchange for more cash later in the form of revenue from the sale of product. This certainly works out well for Intel, as a recurring revenue stream impresses investors far more than cash received from the sale of a business. Let’s wade into the numbers to understand exactly how this shenanigan works.

**Mechanics of the Intel-Marvell Transaction.** Using hypothetical numbers, let’s assume that the value of the business is \$1,000,000 and that the structure of the deal involves Marvell paying Intel as follows: \$800,000 up front and the remaining \$200,000 later as the inflated price of products to be purchased. Also, assume that the business sold by Intel had a book value of \$700,000; the gain from the sale of the business would therefore be \$300,000 (sale price less book value). The economics of the transaction suggest that Intel should record the sale of the business as follows:

Cash	\$800,000	
Receivable from Marvell	\$200,000	
Asset sold (at book value)		\$700,000
Gain		\$300,000

Notice that the total one-time gain is included immediately, even though \$200,000 is still due from Marvell. Then, let us assume that, as originally agreed, Marvell later purchases \$350,000 of products from Intel at the inflated prices so as to make Intel whole for having “discounted” the sales price of its business. The journal entry for the product sale by Intel would be the following:

Cash	\$350,000	
Receivable from Marvell		\$200,000
Revenue		\$150,000

Notice that the \$350,000 received by Intel reflects both the \$200,000 due from Marvell and the \$150,000 in revenue that would be consistent with the normal selling price (not the inflated one). Had Intel recorded the transaction in this way, then investors would probably have understood the economics of the concurrent transactions more clearly: in the first period, Intel would have recorded a one-time gain of \$300,000 from selling a business, and in a later period, it would have generated \$150,000 in revenue from selling product to Marvell.

By commingling the current sale of a business and the future sale of products, Intel probably produced results that failed to capture the underlying economics by understating the one-time gain and inflating the product revenue. While Intel’s public disclosure does not provide specific details about the accounting entries surrounding this transaction, it seems likely that Intel first recorded

Cash	\$800,000	
Asset sold (at book value)		\$700,000
Gain		\$100,000

And then, when it received the inflated \$350,000 for the subsequent product sale (which included \$200,000 of gain held back), Intel probably recorded

Cash	\$350,000	
Revenue		\$350,000

**The Net Result.** In this hypothetical example, Intel probably recorded \$350,000 in revenue and a \$100,000 one-time gain rather than \$150,000 in revenue and a \$300,000 one-time gain. Intel cleverly structured terms that legally permitted it to understate the one-time gain and overstate the more desirable stream of revenue.



While some may claim that this ploy technically follows generally accepted accounting principles, in our judgment it fails to capture the underlying economics of the transaction.

Needless to say, Marvell's financial reporting also benefited from paying less for the business and more for the products. (In Chapter 7, we return to Marvell and show how this arrangement provided the company with the opportunity to exert discretion over its earnings each quarter.)

**Beware of Commingling the Sale of a Business with the Sale of Product.** Certainly the Intel-Marvell scheme is not a uniquely American phenomenon. On the other side of the Pacific, Japanese technology conglomerate Softbank also reported impressive results from its unusual method of accounting for the sale of a business. Specifically, it seems that rather than including the entire gain in the period of the sale, Softbank deferred some of the gain and used it to benefit future-period revenue and income.

In December 2005, Softbank sold its modem rental business and concurrently entered into an agreement to provide some services to the buyer. Softbank received a total of ¥85 billion, which it split between the sale and the service agreement, allocating ¥45 billion to the business sale and the remaining ¥40 billion to future revenue under the service agreement. By commingling the asset sale with later product sales, Softbank, like Intel, could report a smaller one-time gain and a larger stream of product revenue. As a result, investors might have been tricked into believing that Softbank's sales were growing faster than the underlying economic reality. (We will return to discuss Softbank in Chapter 12 on Cash Flow Shenanigan No. 3.)

**Warning Sign:** Commingling future product sales with buying a business.

The second section of this chapter illustrates the techniques that management may use to shift income or losses around so as to obfuscate any deterioration in a company's operating profits.

## 2. Boosting Income through Misleading Classifications

When assessing a company's business performance, it is of course important to analyze the earnings generated by the actual operations of the business (operating income). Gains and losses from interest, asset sales, investments, and other sources unrelated to actually operating the business (nonoperating income) are important to analyze as well; however, not in a review of a company's operating performance. Some companies will misclassify income or losses and blur the line for investors in order to make operating income look better.

This section identifies three types of financial statement classifications that could inflate operating (above-the-line) income: (1) shifting the "bad stuff" (i.e., normal operating expenses) out to the nonoperating section, (2) shifting the "good stuff" (i.e., nonoperating or nonrecurring income) into the operating section, and (3) using questionable management decisions regarding Balance Sheet classification to help offload the bad stuff or upload the good stuff.

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### Accounting Capsule: Above-the-Line and Below-the-Line Income

The Statement of Income can be divided into two broad sections: operating (often called *above-the-line*) and nonoperating or nonrecurring (often called *below-the-line*). Investors typically pay much more attention to the operating income in assessing a company's health. So naturally, companies prefer to show-case strong recurring operating income. In so doing, they may improperly shift nonoperating income or gains to the operating section or, conversely, shift operating expenses or losses to the nonoperating section. This type of intraperiod shifting of income to benefit the above-the-line presentation, while having no impact on the "bottom line" net income, can create a very misleading picture for investors.

- Above-the-line: income from the core business (revenue *minus* operating expenses)
  - Below-the-line: noncore or nonrecurring gains or losses
-

### Shifting Normal Expenses Below the Line

The most common way to shift normal operating expenses below the line involves one-time write-offs of costs that would normally appear in the operating section. For example, a company taking a one-time charge to write off inventory or plant and equipment would effectively shift the related expenses (i.e., cost of goods sold or depreciation) out of the operating section into the nonoperating section and, as a result, push up operating income.

**Watch for Companies That Constantly Record “Restructuring Charges.”** Struggling companies often enter restructuring plans, in which they incur nonrecurring costs. For example, if a company closes down one of its offices, it may have to pay severance to employees or a fee to break the office lease. Companies often strip out charges related to a restructuring plan and present them below the line. If done appropriately, this treatment is helpful for investors, as it provides insight into the performance of the company’s recurring operations. In general, with proper disclosure of restructuring charges by management, investors should be better armed to assess the more important recurring activities of a company.

Some companies, however, abuse this presentation by recording “restructuring” charges in virtually every period. Investors should view these charges with skepticism, as the company may be bundling normal operating expenses into these charges and trying to pass them off as one-time in nature. For example, telecom network equipment supplier Alcatel (now Alcatel-Lucent) has recorded below-the-line restructuring charges in just about every quarter since the early 1990s, according to a RiskMetrics Group study. Annually, these charges amounted to hundreds of millions of dollars, and occasionally billions.

If you encounter a company with frequent “one-time” or “restructuring” charges listed in its Statement of Income, investigate these charges more closely to understand what exactly the company is trying to keep out of its operating income. A quick way to understand the economic reality at a company like Alcatel that records restructuring charges every quarter is to simply reduce operating income by the amount of those charges.

**Watch for Companies That Shift Losses to Discontinued Operations.**

A fairly easy trick that can magically improve a company's operating profits starts with an announcement of plans to sell off a money-losing division. Consider a struggling company with three divisions producing the following operating results: Division A, \$100,000 income; Division B, \$250,000 income; and Division C, \$400,000 *loss*. The company would report a \$50,000 net loss—unless it had decided to put Division C up for sale at the beginning of the period and account for it as a “discontinued operation.” In so doing, that entire \$400,000 loss would be moved below the line and most likely be ignored by investors. Magically, although the company still operates all three divisions at a combined loss of \$50,000, it would report all-important operating income of \$350,000 and an “unimportant” \$400,000 below-the-line loss. We consider this trick no different from a dishonest golfer who counts only those shots that he likes and ignores those that wind up in the water or completely off the course. Using that approach, all golfers would shoot under par.

**Shifting Nonoperating and Nonrecurring Income Above the Line**

As we pointed out, bundling normal operating expenses into a restructuring charge would be a relatively easy game to play. Management would simply need to convince the somewhat pliant auditor that a write-off would produce more conservative earnings. Shifting nonoperating income above the line, in contrast, is a bit more complicated and might sometimes be harder for management to put past careful investors. But that won't stop companies from trying. As we illustrated with IBM, inflating operating income by including a one-time gain from selling a business could mislead investors about a company's true underlying economic health.

**Watch for Companies That Include Investment Income as Revenue.**

Investors should be particularly alert when companies include nonoperating gains or investment income in revenue. Boston Chicken, the franchisor of the Boston Market restaurant chain, camouflaged its deteriorating business by including in revenue its interest income and various fees charged to the franchisees. While treating interest income as revenue clearly would be appropriate for banks and other financial institutions, it certainly sounds a bit unusual for a restaurant.

Boston Chicken's inclusion of investment income as part of revenue cleverly hid its dire financial situation. As a result, many investors failed to notice that Boston Chicken had been losing money in its core restaurant operations. Indeed, all of the company's profits came from noncore activities, such as interest income on loans or various service fees charged to these same franchisees. One huge (but apparently ignored) warning in the 1996 annual report was that franchisee-owned restaurants were losing a ton of money. The losses grew to \$156.5 million in 1996 from \$148.3 million during the prior year.

With franchisees losing so much money, investors should have wondered how Boston Chicken, the franchisor and owner of some of the restaurants, could be reporting such strong profits itself. A little digging would have answered that question. The main source of revenue and operating income was not restaurant customers but *the franchisees themselves*. Boston Chicken initially raised capital (equity and debt) from the market and lent the money to franchisees. As the franchisees began paying off the loans, Boston Chicken recorded large amounts of interest income and other fees and classified such inflows as *revenue*. Ominously, this ancillary revenue and income was becoming the predominant portion of the company's reported operating income. Because this income had been bundled with restaurant sales revenue, detection was difficult, but not impossible for careful investors.

#### WARNING SIGNS AND LESSONS FROM BOSTON CHICKEN

Boston Chicken cleverly hid signs that its business was deteriorating by including noncore sources of income in revenue. The company reported that 1996 pretax income doubled to \$109.9 million, yet CFRA calculated that it had *actually lost \$14.7 million* on its core operations. (We define income from core operations to include revenues from company-operated stores and from royalties and initial franchise and area development fees, but *not* from activities such as interest, real estate, and software fees. Expenses deducted include cost of products sold, salaries and benefits expenses, and general and administrative expenses.)

**Be Suspicious of Inflated Operating Income Related to Subsidiaries.** Companies can produce misleadingly strong revenue and operating income growth simply by benefiting from one of the quirks of consolidation accounting. Without going into unnecessary complexity, let's look at the accounting if a company decided to form several majority-owned joint ventures, owning 60 percent of each. Accounting rules require that the units be consolidated and that the "parent" report as its own all of the revenue and operating expenses as operating income (that is, above the line); the 40 percent owned by others would be subtracted later on the Statement of Income (shown below the line). Consider this hypothetical situation assuming a subsidiary with (1) total revenue of \$1,000,000 and (2) total expenses of \$400,000. Under accounting rules, the parent that owns 60 percent of the subsidiary still reports 100 percent of the revenue and operating expenses, or a \$600,000 operating profit. Since in reality it owns not 100 but 60 percent, the 40 percent difference, or \$240,000 (40 percent of \$600,000), is subtracted below the line. Thus, investors will see operating profit of \$600,000, not the real economic profit of \$360,000 (or 60 percent of \$600,000), which unfortunately would be less visible. Is it any wonder that so many subsidiaries are 51 percent owned? Surely, including 100 percent of the revenue above the line and subtracting those 49 percent profits owned by others below the line seems an awfully enticing prize.

**Pay Attention to Where Companies Classify Joint Venture Income.** Health-care information company Medaphis improperly included in revenue its \$12.5 million share of the profits from an investment joint venture. Under the equity method of accounting for investments, if an investor possesses the "ability to exercise significant influence" (generally held to be at least a 20 percent stake), its proportionate share of the profits should be included as nonoperating investment income, not as revenue. Although it met the 20 percent test, Medaphis erred by including this gain—a below-the-line item—as revenue. The misclassification resulted in sales being overstated by 10 percent and, more important, operating profit being inflated by 108 percent.

### **Using Discretion Regarding Balance Sheet Classification to Boost Operating Income**

The final part of this section shows how companies might produce misleadingly attractive income by offloading losses to or uploading income from the Balance Sheet.

As we pointed out in the last example involving Medaphis, non-consolidated joint ventures require management to assess whether it possesses the ability to exercise significant influence, often using a 20 percent stake as a general guideline. If management believes that such influence exists, the company's proportionate share of the joint venture's income or loss should flow to the Statement of Income (i.e., the equity method of accounting). Conversely, if the company lacks such influence, the Balance Sheet account related to the joint venture is simply adjusted to fair value. Thus, shenanigan opportunities abound for managements that wish to push income onto the Statement of Income by asserting that they possess that influence in periods when the income from the joint venture is strong, or to push losses off to the Balance Sheet by stating that no significant influence exists when the joint venture's operations are weaker.

**Oracle Changes Its Accounting for a Struggling Affiliate.** Consider a somewhat odd transaction at software giant Oracle and an affiliated company. Liberate had been a unit of Oracle until it was spun off as an initial public offering (IPO) in the late 1990s. After several additional stock sales by Oracle, the company still retained a 32 percent stake in Liberate. Since Oracle also concluded that it maintained an ability to exercise significant influence, it used the equity method of accounting for this investment in Liberate, thereby reporting its pro rata share of Liberate's earnings. At the time, Liberate had been moderately unprofitable. (Please refer to the discussion of the equity method in the accompanying accounting capsule on the next page.)

Then one sunny day in January 2001, Oracle made a curious change in the structure of its ownership of Liberate (red flag!). Oracle created a trust into which it placed its entire ownership interest in Liberate. Under the trust agreement, trustees would be obligated to vote on any shareholder issues in the same proportion as all other shareholders. Despite this change in Oracle's voting rights, the trust

structure failed to affect Oracle's monetary stake in Liberate or its right to sell the shares and collect the proceeds. In other words, Oracle's economic stake in the business remained unchanged.

While the economics of this investment remained unchanged, the same cannot be said for Oracle's accounting for it. Oracle determined that it should stop using the equity method to account for its ownership interest because it no longer had voting influence over Liberate. As a result, while its ownership stake still remained at 32 percent, Oracle abruptly began accounting for the investment as if it no longer had the ability to exercise significant influence. This change to the cost method (designating the investment as "available for sale") meant that Oracle would no longer record its pro rata share of Liberate's earnings (or losses) on the Statement of Income; instead, Liberate's periodic results would not affect Oracle's earnings at all.

And the timing could not have been more fortunate. It just so happens that the decision to cease using the equity method (which affects the Statement of Income) came at the exact time when Liberate's earnings were plummeting and would have dramatically hurt Oracle's profits. During that fiscal year, Liberate posted a \$306.4 million net loss, a huge drop from the \$80.6 million loss the previous year. The following year, the loss expanded to \$325 million, and by 2004, Liberate was bankrupt.

For the record, Oracle did indeed record significant impairment charges on its investment when Liberate was in free fall in 2002–2003. However, these charges to earnings would have come much earlier and would have appeared to investors as a recurring drag on earnings had Oracle not made this one-time accounting change.

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#### Accounting Capsule: Accounting for Investments in Other Companies

For a small investment in a company (typically under 20 percent), the owner presents the investment at fair value on its Balance Sheet. If the investment is designated as a *trading security*, changes in fair value are reflected on the Statement of Income. If it is instead designated as *available for sale*, changes in fair value are presented as an offset to equity, with no impact on earnings (unless permanent impairment exists).



For a medium-sized investment in a company (typically 20 to 50 percent), the owner reports its proportional share of the investment's earnings as a single line on the Statement of Income. This is called the *equity method*.

For a large investment in a company (typically over 50 percent), the owner fully merges the investment's financial statements into its own. This is called *consolidation*.

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**Enron Boosted Operating Income by Shifting Losses on Joint Ventures to the Balance Sheet.** Our friends at Enron understood perhaps better than anyone the benefit of using nonconsolidated joint ventures to offload debt and losses. In the mid-1990s, Enron began building out a series of new ventures that would require massive infusions of capital and would probably produce large losses during their early years. Management no doubt contemplated the potentially damaging impact of including the debt on the Balance Sheet and the big losses on the Statement of Income. Enron knew that lenders and credit rating agencies would blanch if it showed bulging loans payable, and that investors would be none too pleased with the big losses or earnings dilution if the company used its stock to finance these projects. Since these traditional forms of financing seemed problematic, Enron developed a somewhat unique and certainly very unorthodox strategy. It created thousands of partnerships (ostensibly under accounting rules) that it hoped would not be consolidated and, as a result, would keep all this new debt off its Balance Sheet. Moreover, Enron believed that this complicated structure would also help it hide the expected economic losses (or, whenever possible, pull in gains) from these early-stage ventures.

Interestingly, the capital that Enron contributed to some of these joint ventures turned out to be nothing other than its own stock. In some cases, the partnerships themselves even held Enron stock among their investment holdings. As its stock price jumped over time, the value of the joint venture assets likewise increased, as did Enron's own equity stake in these partnerships. This trick allowed Enron to recognize approximately \$85 million in earnings as a result of nothing more than an increase in its own stock price during a fabulous bull market.

So Enron's rapidly appreciating stock price became the "drug" that drove up the value of its partnership stakes and its income. In one period alone, for example, Enron generated a whopping \$126 million from a joint venture. Curiously, when the stock began its rapid descent, Enron must have developed a severe case of amnesia and simply forgotten that the resulting \$90 million loss should also be reported to shareholders. Instead, Enron conveniently announced that the results remained "unconsolidated" and, of course, not included on the Statement of Income. So, by Enron's rules, on the very same investment vehicle, gains get consolidated and losses are hidden from investors' view. In other words, for Enron it was—heads I win, tails I still win! Well, we all know how that sad story ended.

## Looking Back

### **Warning Signs: Boosting Income Using One-Time or Unsustainable Activities**

- Boosting income using one-time events
- Turning proceeds from the sale of a business into a recurring revenue stream
- Commingling future product sales with buying a business
- Shifting normal operating expenses below the line
- Routinely recording restructuring charges
- Shifting losses to discontinued operations
- Including proceeds received from selling a subsidiary as revenue
- Operating income growing much faster than sales
- Suspicious or frequent use of joint ventures when unwarranted
- Misclassification of income from joint ventures
- Using discretion regarding Balance Sheet classification to boost operating income

## Looking Ahead

Now we can catch our collective breaths for a moment and reflect, as we have reached an important stage in the book. The end of Chapter 5 marks the completion of the third of the three chapters that focus on techniques that inflate current-period profits by recognizing too much revenue or other income, such as one-time gains on events or from questionable management assessments.

The next two chapters complete the lesson on inflating profits, but they focus on reporting too few expenses. Chapter 6 (“Shenanigan No. 4: Shifting Current Expenses to a Later Period”) shows how expenses can be hidden on the Balance Sheet and, as a result, shifted to a later period. Chapter 7 (“Shenanigan No. 5: Employing Other Techniques to Hide Expenses or Losses”) describes gimmicks for keeping expenses out of investors’ view today and, in some cases, forever.

# 6

## EARNINGS MANIPULATION SHENANIGAN No. 4: SHIFTING CURRENT EXPENSES TO A LATER PERIOD

The Texas two-step is a vibrant country-and-western dance made popular by the 1970s film *Urban Cowboy*. Once a simple barn dance, the version of the two-step that is danced today has evolved to include moves borrowed from the foxtrot and swing. Dancers whirl around the floor and routinely swap partners, providing great entertainment for their fellow dancers and for observers as well.

Companies account for their costs and expenditures in a similar two-step accounting dance. Step 1 occurs at the time of the expenditure—when the cost has been paid, but the related benefit has not yet been received. At Step 1, the expenditure represents a *future benefit* to the company, and is therefore recorded on the Balance Sheet as an asset. Step 2 happens when the benefit is received. At

this point, the cost should be shifted from the Balance Sheet to the Statement of Income and recorded as an expense.

This accounting two-step is danced at different tempos, depending on whether the cost is related to a benefit with a long- or a short-term horizon. Costs with a long-term benefit sometimes require a slower dance in which the cost remains on the Balance Sheet and is recorded as an expense gradually (e.g., equipment with a useful life of 20 years). Costs that provide a short-term benefit require a fast-paced dance in which the two steps happen virtually simultaneously. Such costs spend no time on the Balance Sheet, but instead are recorded as expenses (e.g., most typical operating expenses, such as salaries and electricity costs).

Companies can exert their own influence over the speed at which they dance the two-step, and this discretion can have significant implications for earnings. Diligent investors should assess whether management is improperly keeping costs frozen at Step 1 on the Balance Sheet, instead of continuing the dance and moving them to Step 2 as expenses on the Statement of Income. Chapter 6 shows four techniques that management uses to exploit the two-step process by improperly keeping costs on the Balance Sheet, thereby preventing them from reducing earnings until a later period.

## **Techniques to Shift Current Expenses to a Later Period**

1. Improperly Capitalizing Normal Operating Expenses
2. Amortizing Costs Too Slowly
3. Failing to Write Down Assets with Impaired Value
4. Failing to Record Expenses for Uncollectible Receivables and Devalued Investments

### **1. Improperly Capitalizing Normal Operating Expenses**

The first section of this chapter focuses on a very common abuse of the two-step process: management's taking only one step when

two are required. In other words, management improperly records costs on the Balance Sheet as an asset (or “capitalizes” the costs), instead of expensing them immediately.

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### Accounting Capsule: Assets and Expenses

For this discussion, it is helpful to think of assets as falling into one of two categories: (1) those that are expected to produce a future benefit (e.g., inventory, equipment, and prepaid insurance) and (2) those that are ultimately expected to be exchanged for another asset such as cash (e.g., receivables and investments). Assets that are expected to provide a future benefit are actually close cousins of expenses: they both represent costs incurred to grow a business. The key distinction between these assets and expenses is timing.

For example, assume that a company purchases a two-year insurance policy. At its inception, the entire amount represents a future benefit and would be classified as an asset. After one year's benefit has been received, half the costs would be shown as an asset and the other half as an expense. After the second year, none of the costs would remain as an asset, and the remaining half still in the asset group would be expensed.

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### Improperly Capitalizing Routine Operating Expenses

At the height of the 1990s dot-com boom, telecom services behemoth WorldCom Inc. entered into many long-term network access arrangements to lease line costs from other telecommunication carriers. These costs represented fees that WorldCom paid for the right to use other companies' telecommunication networks. At first, WorldCom properly accounted for these costs as an expense on its Statement of Income.

With the technology meltdown beginning in 2000, WorldCom's revenue growth began to slow, and investors started paying more attention to the company's large operating expenses. And line costs were, by far, WorldCom's largest operating expense. The company became concerned about its ability to meet the expectations of Wall Street analysts. Disappointment would surely devastate investors.

So WorldCom decided to use a simple trick to keep earnings afloat. In mid-2000, it began concealing some line costs through a

sudden, and very significant, change in its accounting. (Red flag!) Rather than recording all of these costs as expenses, WorldCom capitalized large portions of them as assets on the Balance Sheet. The company did this to the tune of billions of dollars, which had the impact of grossly understating expenses and overstating profits from mid-2000 to early 2002.

**Warning Signs of Improper Capitalization of Line Costs.** When WorldCom began capitalizing billions in line costs, it clearly continued paying the money out, although the Statement of Income reported fewer expenses. As pointed out in Chapter 1, a careful reading of the Statement of Cash Flows would have flashed a bright light on deteriorating free cash flow (that is, cash flow from operations minus capital expenditures). Table 6-1 shows how free cash flow went from a *positive* \$2.3 billion in 1999 (the year before capitalizing the line costs) to a *negative* \$3.8 billion (an astounding \$6.1 billion deterioration). Investors should have seen this trend as a sign of trouble.

In particular, WorldCom’s large increase in capital spending should have raised questions. It belied WorldCom’s own guidance (given at the beginning of the year) for relatively flat capital expenditures, and it came at a time when technology spending, in general, was collapsing. Indeed, this reported increase in capital spending was fiction; in reality, it was largely the result of WorldCom’s changing its accounting practices to shift normal operating costs (i.e., line costs) to the Balance Sheet to inflate profits. Diligent investors should have spotted the 32 percent jump (from \$8.716 to \$11.484 billion) in capital expenditures and questioned why this spending made sense during a technology slowdown in which the company’s operating cash flow had been sliced by 30 percent. Flagging such a massive increase in spending would prove to be an

Table 6-1. WorldCom’s Free Cash Flow

(\$ millions)	2000	1999
Reported cash flow from operations	7,666	11,005
Subtract: Capital expenditures (capex)	(11,484)	(8,716)
Free cash flow	(3,818)	2,289

important first step in sniffing out one of the biggest accounting frauds in history.

### **Warning Signs of Improperly Capitalizing Normal Operating Expenses**

- Unwarranted improvement in profit margins and a large jump in certain assets
- A big unexpected decline in free cash flow, with an equally big drop in cash flow from operations
- Unexpected increases in capital expenditures that belie the company's original guidance and market conditions

**Watch for Improper Capitalization of Marketing and Solicitation Costs.** Marketing and solicitation costs are other examples of normal operating expenses that produce short-term benefits. Most companies spend money to advertise their products or services. Accounting guidelines normally require that companies expense these payments immediately as normal recurring short-term operating costs. However, certain companies aggressively capitalize these costs and spread them out over several periods. Consider Internet pioneer AOL and its accounting treatment of solicitation costs during its critical mid-1990s growth years.

Until 1994, AOL treated its solicitation costs for new customers as an expense, called "deferred subscriber acquisition costs" (DSAC). However, in 1994, AOL started recording these costs as assets on its Balance Sheet. As shown in Table 6-2, AOL initially capitalized \$26 million (representing 22 percent of sales and 17 percent of total assets) and then amortized those costs over the next 12 months.

Notice the dramatic increase in the DSAC balance over the next few years. By June 1996, DSAC on the Balance Sheet had ballooned to \$314 million, or 33 percent of total assets and 61 percent of shareholders' equity. Had these costs been expensed as incurred, AOL's 1995 pretax loss would have been approximately \$98 million instead of \$21 million (including the write-off of DSAC that existed as of the end of fiscal year 1994), and AOL's 1996 pretax income of



Table 6-2. AOL's Deferred Subscriber Acquisition Costs

(\$ millions)	1996	1995	1994	1993
Revenue	1,093.9	394.3	115.7	52.0
Operating income	65.2	(21.4)	4.2	1.7
Net income	29.8	(35.8)	2.2	1.4
Total assets	958.8	405.4	155.2	39.3
<b>Deferred subscriber acquisition costs</b>	<b>314.2</b>	<b>77.2</b>	<b>26.0</b>	—

\$62 million would have been *transformed to a loss of \$175 million*. On a quarterly basis, the effect of capitalizing DSAC was that AOL reported profits for six of the eight quarters in fiscal years 1995–1996, rather than reporting losses for each period.

Investors should have been alarmed when they reviewed these numbers for several reasons, including (1) the company made the initial *change from expensing* to the much more aggressive capitalizing, (2) the *enormous growth* in the unamortized DSAC represented a material underreporting of expenses and overreporting of profits during these three years, and (3) AOL merely shifted expenses from current to future periods, and those costs would *materially dampen expected earnings in those future periods*.

AOL naturally tried to justify its accounting choice, asserting that it fell under an exception provided in accounting rule SOP 93–7. To qualify for the exception and be permitted to capitalize solicitation costs, a company would have to show *persuasive evidence* that the advertising would result in future benefits *similar* to the effects of the company's prior direct-response advertising activities.

The Securities and Exchange Commission (SEC) disagreed with AOL's treatment, stating that the company had failed to meet the essential requirements of SOP 93–7 because *the unstable business environment precluded reliable forecasts of future net revenues*. Investors actually needed no basic understanding of this cryptic accounting rule to realize that something smelled funny. AOL's change to a more aggressive accounting policy and the sheer magnitude of that policy's impact on earnings should have been more than enough to give astute investors indigestion.

**Watch for Changes in Policy from Expensing Costs to Capitalizing Them.** Like AOL, Dallas-based telecom company Excel Communications changed from expensing to capitalizing regular operating costs at a pivotal time in its history—right before it registered with the SEC to become a public company in early 1996.

To ensure a successful initial public offering (IPO), the company apparently felt that it needed to dress up its rather modest earnings. Not a problem. It decided to change its accounting related to sales commissions. Until 1995, Excel had expensed these marketing costs immediately. Beginning in 1995, it capitalized them and then amortized them over a 12-month period. The immediate impact on profits was enormous. In 1995, earnings almost tripled, to \$44.4 million (or 46 cents per share) from \$15.9 million (or 18 cents per share) a year earlier. The aggressive accounting inflated profits by \$22.7 million (or 51 percent of the 1995 earnings). Stated differently, *simply by changing to a more aggressive accounting policy, Excel artificially boosted its profits by 105 percent.*

**EXCEL COMMUNICATION FOOTNOTE: REGISTRATION  
FOR IPO, CHANGING TO CAPITALIZING COSTS**

The Company has adopted an accounting convention of amortizing capitalized subscriber acquisition costs to expense over a period of 12 months in order to better match those costs with the revenues from subscribers' long distance usage during the first 12 months of service to such subscribers. Marketing services costs, as reflected in the Company's Consolidated Financial Statements, include the effect of the capitalization of the portion of commissions paid for the acquisition of new subscribers during a period, as well as the effect of the current period amortization of amounts capitalized in the current and prior periods. The net effect of capitalizing and amortizing a portion of commissions expense was a reduction in marketing services costs.

**Watch for Earnings Boosts After Adopting New Accounting Rules.** Occasionally, the decision to begin capitalizing operating costs comes not from a management whim but from compliance with a new accounting rule promulgated by the standard setters. While criticism

of management for making such a change would clearly be unfair and unjustified, investors should recognize that any improvement in profit resulting from the change would be ephemeral and unrelated to operational success. For example, Lucent (now part of Alcatel) obtained a nice earnings boost as a result of beginning to capitalize internal-use software costs, mandated by a new accounting rule.

**Tip:** Regardless of the legitimacy of an accounting change, investors must strive to understand the impact that this change had on earnings growth. Simply put: *any growth related to the change will not recur*. In order to be maintained, the growth must be replaced with improved operational performance.

**Be Wary of Unusual Asset Accounts on the Balance Sheet.** In the year before its bankruptcy and fraud investigation, our friends at HDTV maker Syntax-Brilliant Corp. began reporting curious new asset accounts on the Balance Sheet called “tooling” and “inventory” deposits. The company provided minimal, and confusing, details about these assets, stating that they represented deposits to the company’s primary supplier of inventory (Kolin), according to reports by RiskMetrics Group in 2007. Oddly, both accounts dwarfed the total amount of inventory on the company’s Balance Sheet. Moreover, not only was Kolin Syntax-Brilliant’s largest supplier, but it also was a related party, owning over 10 percent of the company’s stock and participating in joint ventures with the company.

Investors had reason to be skeptical about these new asset accounts, not only because of their unusual and related-party nature, but also because the balances were increasing very rapidly. As shown in Table 6-3, Syntax-Brilliant reported a startling \$70.0 million in “inventory deposits with Kolin” at June 2007, after having no such deposits in the preceding three quarters. Similarly, “tooling deposits with Kolin” were nonexistent in June 2006, but grew consistently over the next year, reaching \$65.3 million at June 2007. A surge in any unusual asset accounts like these, particularly ones that involve a related party, should send investors running for the exits.

Table 6-3. Syntax-Brilliant’s Unusual Asset Accounts

(\$ millions)	Q4, 6/07	Q3, 3/07	Q2, 12/06	Q1, 9/06	Q4, 6/06	Q3, 3/06
Inventory deposits with Kolin	70.0	—	—	—	5.1	8.0
Inventory deposits with Vendor	8.3	—	—	—	—	—
Tooling deposits with Kolin	65.3	39.6	26.3	15.2	—	—

**Warning Sign:** A new or unusual asset account (particularly one that is increasing rapidly) may signal improper capitalization.

**Capitalizing Permissible Items, but in Too Great an Amount**

Accounting guidelines permit companies to capitalize some operating costs, but only to a certain extent or if certain specific conditions can be met. We will call these costs *hybrids*—that is, the costs are recorded partially as an expense and partially as an asset.

**Capitalizing Software Development Costs.** One operating cost that commonly finds its way to the Balance Sheet, particularly at technology companies, is the cost incurred to develop software-based products. Early-stage research and development costs for software would typically be expensed. Later-stage costs (those incurred once a project reaches “technological feasibility”) would typically be capitalized. Investors should be alert for companies that capitalize a disproportionately large amount of their software costs or that change accounting policies and begin to capitalize costs, particularly if those costs are out of line with industry practices.

**Watch for Different Capitalization Policies within the Same Industry.** Companies within the same industry may apply the rules of capitalization in different ways. Since “technological feasibility” can be defined differently across industry players, similar companies may wind up with different levels of capitalized costs and

therefore different profitability trends. The sooner a company decides that technological feasibility has been achieved, the sooner it can begin capitalizing costs and no longer charging them on the Statement of Income.

The entertainment software industry provides an excellent example of different treatment among similar companies. A 2005 study by the Center for Financial Research and Analysis (CFRA) on major entertainment software companies showed a disparity surrounding the capitalization of software development and royalty costs. In the June 2005 quarter, THQ Inc. led its peers with \$2.58 in capitalized costs per share. Electronic Arts Inc., at the other end of the spectrum, had only \$0.38. The disparity in capitalized costs was the result of different accounting interpretations. Electronic Arts conservatively expensed all software development costs, believing that technological feasibility arrives only when a software project is basically complete (an assessment that hurts earnings now, but helps them later). THQ, on the other hand, believed that technological feasibility was established much earlier (an assessment that helps earnings now, but hurts them later).

**Watch for an Accelerating Rate of Software Capitalization.** Affiliated Computer Services Inc. (ACS), the Dallas-based outsourcing services provider, capitalized \$44 million of software costs during 2003, representing 21 percent of total capital expenditures (sometimes called “capex”). This amount represented quite a jump from the \$15.8 million (11 percent of capex) capitalized in 2002 and the \$7.7 million (8 percent) in 2001. An accelerating rate of software capitalization is often a red flag that earnings benefited from keeping more costs on the Balance Sheet.

**Improper Capitalization of Costs Also Inflates Operating Cash Flow.** While normal operating costs are reflected as an operating cash outflow, capitalized costs would be presented as capital expenditures in the Investing section of the Statement of Cash Flows. By capitalizing normal operating costs, companies inflate not only earnings, but also operating cash flow. We present this topic in Chapter 11, “CF Shenanigan No. 2: Shifting Normal Operating Cash Outflows to the Investing Section.”

## 2. Amortizing Costs Too Slowly

Okay, put those dancing shoes back on as we get ready for the second step in our two-step accounting dance. Now that we have completed step 1, we have those costs capitalized, but the related benefit has yet to be received. Step 2 involves recording those costs as expenses, shifting them from the Balance Sheet to the Statement of Income.

The nature of a cost and the timing of its related benefit dictate the length of time that this cost remains on the Balance Sheet. For example, expenditures to purchase or manufacture inventory remain on the Balance Sheet until the inventory is sold and revenue recorded. On the other hand, expenditures to purchase equipment or a manufacturing facility provide a much longer-term benefit. These assets remain on the Balance Sheet for the duration of their useful lives, over which they gradually become expenses through depreciation or amortization.

Investors should raise concerns if costs remain as assets for too long, as evidenced by an unusually long amortization horizon. Additionally, if management decides to lengthen the amortization period, that should raise a loud warning signal.

**Be Alert for Boosts to Income by Stretching Out the Amortization Period.** Remember how our friends at AOL were spending a boatload of money to solicit new clients (as seen in Table 6-1)? We discussed the 1994 change in accounting to an aggressive capitalization of advertising costs and the decision to spread those costs over the next 12-month period. This aggressive capitalization completely misled investors, who believed that the company had been profitable, although in reality it was hemorrhaging cash and sustaining real economic losses.

Unfortunately for investors, the story did not end with that one trick. Beginning on July 1, 1995, AOL doubled the amortization period for these exploding marketing costs from 12 to 24 months. Extending the amortization period meant that the costs remained on the Balance Sheet much longer and reduced expenses with only half the impact each period. That change alone inflated profits by \$48.1 million (to a *reported profit of \$29.8 million from a loss of \$18.3 million*). This creative accounting approach helped hide AOL's huge losses from investors.

Table 6-4. AOL 1996 Results Reported and Adjusted

(\$ millions)	As Reported	Adjustment	CFRA-Adjusted
Operating income	82.2	(237.0)	(154.8)
Net income	29.8	(154.0)	(124.2)

A careful review of the Statement of Cash Flows, however, would have highlighted the problem. Indeed, AOL's \$29.8 million of net income in June 1996 had been much higher than its operating cash outflow of \$66.7 million, a staggering shortfall of \$96.5 million. A CFRA report covering that period demonstrated the enormous impact of AOL's disturbing accounting policies. That report restated 1996 operating income and net income for the aggressive capitalization of marketing costs and provided a sobering reminder of what many investors had missed. (See Table 6-4.) With more conservative expense recognition of solicitation costs, AOL would have posted huge operating and net losses (\$154.8 million and \$124.2 million, respectively), which would surely have led to massive investor selling. (Stay tuned for our revisiting of AOL in Chapter 9.)

**Be Wary of Companies That Depreciate Assets Too Slowly.** By comparing depreciation policies with industry norms, investors can determine whether a company is writing off assets over an appropriate time span. Investors should be concerned when a company depreciates its fixed assets too slowly (thereby creating a boost to income), especially in industries that are experiencing rapid technological advances.

**Be Particularly Concerned When a Company Stretches Out Its Depreciable Life.** A company that chooses an overly long depreciation or amortization period generally would be considered guilty of using aggressive accounting. A more serious offense, however, is a company's *changing to a longer period*. This often suggests that the company's business may be in trouble and that it feels compelled to change accounting assumptions to camouflage the deterioration. Regardless of how management tries to justify such changes, investors should always be wary.

Consider how Time Warner Telecom changed its depreciable life for fixed assets in 2007. As it described clearly to its investors in a footnote, the company's March 2007 decision to lengthen the depreciable life on certain assets from 15 to 20 years inflated profits by about \$4.9 million in that quarter, and was presumed to add a similar amount to quarterly profits for years to come. The \$4.9 million represented nearly all of the company's \$5.4 million in operating income that quarter, and an annualized \$19.6 million certainly helped the company to improve on the \$16.3 million in operating income reported in the previous year.

Investors should be cautious when they see a company create profits simply by flipping an accounting switch. Let companies generate profits the old-fashioned way—by selling more product and controlling costs!

**TIME WARNER TELECOM FOOTNOTE (MARCH 2007)—  
CHANGE IN ACCOUNTING ESTIMATE**

During the first quarter of 2007, the company evaluated the depreciable life used for fiber assets and determined that to better reflect the economic utilization of those fiber assets the lives were extended from 15 to 20 years, or the lease term, if shorter, for leased fiber assets. The change lowered depreciation expense and reduced net loss by \$4.9 million for the three months ended March 31, 2007.

**Be Wary of Improper Amortization of Costs Associated with Loans.** Mortgage giant Federal National Mortgage Association (usually referred to as Fannie Mae or Fannie) engaged in a massive fraud from 1998 to 2004. In 2006, Fannie Mae restated its financial statements, stripping away more than \$6 billion in earnings and paying a \$400 million fine to the SEC and the U.S. Treasury. One of the games played by Fannie involved its failure to appropriately amortize costs associated with loans.

First, some background. If you take out a mortgage from your local bank, Fannie Mae may purchase that loan from the bank. The price Fannie pays will be dependent on the movement in interest rates since the time you took out the mortgage. For example, if



market interest rates had declined, Fannie would pay more for the loan (a “premium”) because it would still receive interest at the original, now above-market rate; conversely, if rates had increased, Fannie would pay less (a “discount”). To understand why, let’s assume that your original loan required paying 6 percent interest, and market rates later dropped to 5 percent. Unlucky for you, but that’s life. Fannie can easily lend to anyone in the market and charge the new lower market rate of 5 percent. If it wants to own your loan and its more attractive 6 percent payout, however, it surely will agree to pay a bit more for it. (If this is getting too complicated, simply remember that the mortgage value moves *inversely* with interest rates.)

Accounting rules (SFAS 91) require that any such premium or discount, as well as certain loan origination costs, be amortized over the life of the loan as an offset to interest income. In other words, when Fannie buys your loan at a premium, it amortizes that extra cost over the estimated life of the loan. However, the estimated loan life sometimes needs to be adjusted because borrowers pay off their loans more quickly or more slowly than was originally estimated (called the *prepayment rate*). If that happens, rules require that a “catch-up” adjustment be made in order to get the amortization back on schedule. With interest rates steadily dropping in the late nineties, many homeowners refinanced their loans at these lower rates, requiring Fannie to make catch-up adjustments. In December 1998, Fannie calculated that it would need to record a hefty \$439 million catch-up charge. However, it decided to record only \$240 million, providing an always-welcome \$199 million boost to pretax income. This end-of-year stunt not only allowed Fannie to impress Wall Street, but also helped management hit the earnings targets necessary to trigger its maximum bonuses.

**Watch for Slow Amortization of Inventory Costs.** In most industries, the process of turning inventory into expense is straightforward: when a sale takes place, inventory is transferred to the expense called cost of goods sold. In certain businesses, though, determining when and how inventory turns into expense can be more difficult.

In the film business, for example, the costs of making movies or TV programs are capitalized before the films’ release. These costs are then matched (charged as expense) against revenue based on

the receipt of revenue. Since revenue may be realized over several years, however, a film company must project the number of years of anticipated revenue flow. If it chooses too long a period, the inventory and profits will be overstated.

Consider, for example, a film that cost \$20 million. If the company assumed that revenue would be received evenly over two years, it would expense \$10 million each year. If, instead, it assumed that revenue would come in over four years, it would expense \$5 million each year. If the movie wound up generating revenue over only two years instead of the four that were estimated, the company would have inflated profits by \$5 million during those early years. As a result, the company would be left with a useless \$10 million inventory balance after two years. Since the film will no longer generate revenue, this inventory balance would need to be immediately expensed, or “written off.”

A classic example is provided by Orion Pictures’ now-famous problems with film accounting during the mid 1980s. The company had difficulty estimating future revenue and consequently amortized its film costs too slowly. Furthermore, it was slow in writing off the costs of failed films—in some cases waiting years before doing so. In 1985, for example, Orion posted a \$32 million loss, half of it resulting from the write-off of 40 films released since 1982. Clearly, not all of these losses were from 1985; on the contrary, they represented the residual from Orion’s fictitious reporting of profits in the prior years.

One of the more questionable estimates that Orion made was related to the projected revenue from its TV syndication rights to the *Cagney and Lacey* series. Orion was amortizing the costs slowly, assuming that revenues would continue for many years and would eventually total \$100 million. Unfortunately, revenues topped out at \$25 million, meaning that Orion had expensed its inventory costs far too slowly.

### **3. Failing to Write Down Assets with Impaired Value**

So far we have warned about two abuses of our two-step accounting dance. The first section discussed taking only one step when two steps would be required (i.e., improperly capitalizing a cost that should be expensed). The second section discussed taking the

second step way too slowly (i.e., amortizing assets over a much longer life than was appropriate). In this section, we warn about a third abuse: freezing the dance between step 1 and step 2—that is, failing to record an expense for costs that had been properly capitalized but that diminished in value before the expected benefit was received.

### **Failure to Write Off Impaired Plant Assets**

It is not enough for companies to simply depreciate fixed assets on a rigid schedule and assume that nothing can ever happen to change that plan. Management must continuously review these assets for possible impairment and record an expense whenever the assumed future benefits fall below book value. To illustrate, consider a piece of equipment that management first assumed would last for 10 years, but that breaks down permanently during year 5. Once it's out of service, the original depreciation schedule should be abandoned, and the remaining asset balance must be moved to the expense section immediately. If the company instead chooses to continue depreciating the asset according to the original 10-year plan, it will have failed to write down an appropriately capitalized cost that had later become impaired. Not surprisingly, companies that announce big restructuring charges (EM Shenanigan No. 7) are often trying to “clean house” after failing to write off impaired assets in the appropriate earlier periods.

### **Failure to Write Off Obsolete Inventory**

Companies naturally build up inventory in anticipation of selling product to customers. Sometimes, however, the demand for a product fails to meet a company's lofty expectations. As a result, the company may have to lower its prices in order to move the less-desirable inventory. Or it may have to scrap (write off) the inventory completely. Management must routinely estimate its “excess and obsolete” inventory and reduce its inventory balance accordingly by recording an expense (often called inventory obsolescence expense). However, unlike the depreciation of fixed assets such as equipment, no predetermined rate would have been established for which inventory would be reduced. Thus, these adjustments are subject to a higher level of management discretion and potential manipulation.

Management can inflate earnings by failing to record a necessary expense for excess and obsolete inventory. However, this omission will come back to bite the company, as earnings will be pressured at the time when the inventory is sold at a deep discount (or thrown on the trash heap). Investors should monitor a company's obsolescence expense (and the related inventory reserve) in order to ensure that the company does not inflate its profits by changing estimates. Regardless of the justification given by management for recording a lower expense, the impact is an artificial boost to earnings.

Vitesse Semiconductor conveniently decided to record no inventory obsolescence expense in 2003 after recording charges of \$30.5 million in 2002 and \$46.5 million in 2001. No doubt Vitesse's decision to record no obsolescence expense in 2003 helped its gross profit double to \$83.2 million from \$41.6 million the prior year on a mere 3 percent increase in sales. We'll check back in with Vitesse later in this chapter to see how things worked out for the firm.

**Watch for an Unexpected Inventory Buildup.** Investors should monitor a company's inventory level by calculating its days' sales of inventory (DSI). Just as days' sales outstanding (DSO), introduced in Chapter 3, standardizes receivables for the amount of revenue in a period, DSI standardizes the inventory balance for the amount of inventory sold (i.e., cost of goods sold) in a period. This calculation helps investors determine whether an increase in the absolute level of inventory is in line with the overall growth of the business, or whether it might be a harbinger of margin pressure.

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#### Accounting Capsule: Days' Sales of Inventory (DSI)

Days' sales of inventory (DSI) is generally calculated as follows:

$$\frac{\text{Ending inventory / cost of goods sold (COGS)}}{\text{period (for quarterly periods, 91.25 days is a normal approximation)}}$$

For financial shenanigan detection purposes, we recommend calculating DSI using the ending balance of inventory (rather than the average balance, as some companies and texts may

advise). The ending balance provides more relevant data about future margin pressure, potential obsolescence, product demand, and so on.

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Sometimes a company will stock up on inventory heading into a period of expected increased demand and rapid sales growth. While this may be a perfectly legitimate business strategy, companies use it as a common excuse to justify unwarranted inventory growth. When they are presented with this reasoning as an explanation for increased inventory, investors should determine whether the strategy had been planned before the inventory buildup, or whether the strategy was hatched as a defensive response to the inventory buildup. Investors should be skeptical if no mention of this growth strategy had previously been made.

Luckily, an alternative exists to test whether an inventory buildup might be justified by upcoming demand: simply compare the growth in the absolute level of inventory to the company's expected revenue growth. If inventory growth far exceeds the expected sales growth, the inventory bulge is probably unwarranted and a concern for investors.

**Coldwater Creek Finds Itself in Hot Water.** Consider the case of women's clothing retailer Coldwater Creek Inc., whose inventory swelled in the July 2006 quarter. Management told investors not to fret about the higher inventory balance with several justifications, including the need to fill the shelves at the 60 new stores that had opened in the past year. A quick calculation of DSI (98 days versus 78 days the year before), however, revealed that the inventory growth had exceeded the recent growth of the business, a signal of diminished profits in future periods. Moreover, the year-over-year growth in the company's inventory balance (67.2 percent) seemed completely unjustified when compared with management's expectations for revenue growth in the second half of 2006 (24.3 percent).

Astute investors would have been completely unsurprised when the company reported miserable results at the end of 2006 and throughout 2007. Deeply discounted clothes filled Coldwater Creek stores (including many 90-percent-off racks) as the company

struggled to move excess inventory. Coldwater Creek's earnings disappointed Wall Street, and its stock price fell from above \$30 per share at the beginning of the 2006 holiday season to below \$10 heading into the 2007 holidays.

#### **4. Failing to Record Expenses for Uncollectible Receivables and Devalued Investments**

Recall the two general categories of assets discussed earlier in the chapter: assets created from costs that management expects to produce a future benefit (e.g., inventory, equipment, and prepaid insurance) and assets created from sales or investments that will be exchanged for an asset such as cash (e.g., receivables and investments). The first three sections of this chapter featured games that are played with the flow of the first category of assets to the Statement of Income, or, as we presented it, manipulating the two-step accounting dance. In this final section of the chapter, we focus on games played with the other category of assets. Specifically, we show how companies inflate earnings by failing to turn these assets into expenses when a clear loss in value has occurred.

Some lucky companies have customers that always pay their bills in full and hold only investments that never decline in value. Such companies are rare indeed. Most companies will have a certain number of deadbeat clients and the occasional clunker in their investment portfolio. Heck, even Warren Buffett strikes out from time to time.

When this happens, companies cannot just close their eyes and pray that all their receivables will eventually be collected. Accounting rules require that certain assets be regularly written down to their net realizable value (accountants' lingo for the actual amount you expect to get paid). Accounts receivable should be written down each period by recording an estimated expense for likely bad debts. Similarly, lenders should record an expense (or loan loss) each quarter to account for the anticipated deadbeat borrowers. Additionally, investments that experience a permanent decline in value must be written down by recording an impairment expense. Failing to take any of these charges will result in overstated profits.

### **Failure to Adequately Reserve for Uncollectible Customer Receivables**

Companies must routinely adjust their accounts receivable balance to reflect expected customer defaults. This entails recording an expense on the Statement of Income (“bad debts expense”) and a reduction of accounts receivable on the Balance Sheet (the “allowance for doubtful accounts,” which offsets gross receivables). Failing to record sufficient bad debts expense or inappropriately reversing past bad debts expense creates artificial profits.

**Watch for a Decline in Bad Debts Expense.** Our friends at Vitesse Semiconductor must have conveniently forgotten what it means to accrue for expenses. In the last section, we saw that Vitesse failed to accrue any inventory obsolescence expense in 2003 after recording a \$30.5 million charge the previous year. The company also decided to record just \$1.9 million in bad debts expense after recording \$14.3 million in the previous year. Tack on an additional reduction in an expense for estimated sales returns, and Vitesse accrued just \$2.2 million in estimated expenses during 2003, after having recorded \$49.9 million in such expenses during 2002. Had Vitesse accrued these expenses at the same percentage of revenue as in the previous year, its operating income would have been approximately \$50 million lower. All these tricks at a company with only \$156 million in revenue created a huge distortion for investors. So it should be no surprise that a board investigation in 2006 uncovered a laundry list of accounting problems, many of which involved improper accounting for revenue and receivables.

**Warning:** When all reserve accruals are moving in the wrong direction (i.e., declining), head for the hills!

**Watch for a Drop in Allowance for Doubtful Accounts.** Under normal business conditions, a company’s allowance for doubtful accounts will grow at a rate similar to that for gross accounts receivable. A sharp decline in the allowance, coupled with a rise in receivables, often signals that a company has failed to record enough bad debts expense, and therefore has overstated earnings.



Such a decline apparently occurred at publisher Scholastic Corporation. Its accounts receivable balance jumped 5 percent in fiscal 2002, yet the allowance for doubtful accounts (ADA) *declined* by 11 percent. On a percentage basis (i.e., ADA as a percentage of gross receivables), ADA dropped to 20.4 percent of receivables in 2002 from 24.1 percent in 2001. Had Scholastic kept the allowance account at 24.1 percent, 2002 operating income would have been \$11.3 million lower. Like Vitesse, Scholastic was taking down several other reserves as well, including its inventory obsolescence reserve, royalty advances reserve, and a reserve related to a recent acquisition. According to a CFRA study at the time, Scholastic's operating income would have been about \$28 million (15 percent) lower in 2002 without all of these reserve reductions.

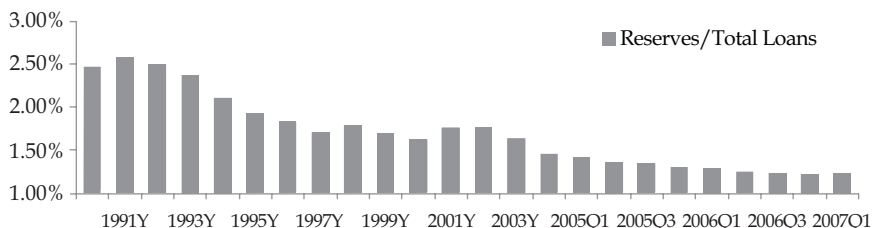
### **Failure by Lenders to Adequately Reserve for Credit Losses**

Financial institutions and other lenders must continually estimate the portion of the loans they make that they expect to never collect (called *credit losses* or *loan losses*). The mechanics of this accrual essentially mirror those that are used when reserving for uncollectible accounts receivable. The lender records an expense on the Statement of Income (called a "provision for credit losses" or "loan loss expense") and a reduction in total loans receivable on the Balance Sheet (called "allowance for loan losses" or "loan loss reserve"), shown as an offset to gross loans.

Ideally, the total amount in the loan loss reserve should be enough to cover all loans that the bank believes are now or are likely to be in default based on conditions that exist at the date of the financial statements. The additions to reserves charged against income each year should be enough to maintain the reserves at the appropriate level. When management fails to reserve a sufficient amount for losses, however, profits will be overstated. This overstatement will eventually catch up to the company when the loans go bad, as the company will be forced to write off bad loans with insufficient reserves accrued.

That's precisely what happened on a global scale leading up to the credit crisis that began in 2007. According to a mid-2007 study by RiskMetrics, from 1990 through 2006, major U.S. commercial banks had consistently reduced their loan loss reserve levels, which inflated their profits but left the companies woefully underreserved





**Figure 6-1. Loan Loss Reserves as a Percentage of Total Loans at U.S. Commercial Banks.**

Source: RiskMetrics Group.

and exposed to deterioration in credit quality. As shown in Figure 6-1, loan loss reserves fell to just 1.21 percent of total loans—a historic low, and well below the 2.50 percent range in the early 1990s. This very optimistic view of the world that loans would almost never go bad strikes us as completely unrealistic. More likely, it provided companies with the ammunition to continuously inflate their profits. These paltry industrywide reserve levels in 2006 not only boosted earnings and left companies exposed to the coming credit crisis, but indeed actually helped to create the crisis itself.

**Watch for a Drop in Loan Loss Reserves.** Heading into the painful real estate collapse of the late 2000s, many lenders failed to establish adequate reserves for bad loans and consequently hid their losses from investors. Lenders to the riskiest customers, the so-called subprime market, were especially exposed. Subprime borrowers often received substantial loans despite having poor credit histories, no income documentation, and plenty of debt. The subprime market eventually crashed when a large number of these bad borrowers defaulted on their payments.

As lenders began to see increases in borrower defaults and delinquencies, they should have increased their allowance reserves accordingly. However, these companies were hesitant to record the expenses necessary to increase their reserves (or even maintain them at the same level) because it would have meant showing lower earnings during what by all appearances seemed to be a vibrant bull market.

New Century Financial completely defied logic in late 2006 by *reducing* its allowance for loan losses in the face of higher delin-

quencies and increasing nonaccrual (bad) loans. In the September 2006 quarter, New Century shockingly lowered its loan loss reserve to \$191 million (23.4 percent of bad loans) from \$210 million (29.5 percent). Management probably understood that this action was inappropriate, as the company obfuscated its presentation of the loan loss reserve during the earnings release to make it seem as if the reserve had actually increased. (We explore such creative manipulation of important metrics in Part 4, “Key Metrics Shenanigans.”) Had the company kept its loan loss reserve at a similar percentage of nonaccrual loans as in the previous quarter, earnings in September 2006 would have been cut by a whopping 58 percent—to \$0.47 from the \$1.12 reported.

Investors who monitored New Century’s loan loss reserve had fair warning of the company’s impending demise. In early February 2007, one day before the scheduled release of its fourth-quarter results, the company announced a restatement of earnings for the first three quarters of 2006. The stock went into a free fall, and two months later New Century filed for bankruptcy. Lawsuits ensued, and the SEC charged senior management with securities fraud for misleading investors as the business was collapsing.

**RED FLAG!** Loan loss reserves decline relative to bad (nonaccrual or nonperforming) loans.

### **Failure to Write Down Impaired Investments**

Companies must also review their investment portfolio for clunkers. If an investment in a stock, bond, or other security experiences a sharp and permanent decline in value, the company must record an impairment expense. This principle especially pertains to certain industries, such as insurance and banks, for which investments represent a large portion of their assets.

When assets become permanently impaired, management cannot just keep reporting them at inflated values on the Balance Sheet and pretend that there has been no adverse impact on earnings. Rather, impairment charges must be recorded to reduce these assets to their appropriate fair value. Investors should watch for companies that fail to take impairment losses during market downturns, as occurred during the collapse of almost every asset class in

the late 2000s and the resulting devastation of company investment portfolios.

As you might imagine, many companies were in denial about the severe drop in portfolio values and considered impairment unnecessary. At first, many financial institutions barely took any charges at all for these declines. However, as the downturn deepened, it became more difficult for companies to ignore reality and justify maintaining these assets on their Balance Sheets at inflated values.

Consider the treatment of investments by Friedman, Billings, Ramsey & Co. (FBR), an investment bank and real estate trust hybrid, in mid-2005. Despite a collapse in the value of certain investment holdings, the company kept its earnings afloat by deciding not to take any impairment charges. Management initially had plenty of reasons to justify why impairment charges were unnecessary; however, in February 2006, management did an about-face and announced \$262 million in write-downs and losses on these investments.

Gauging the impairment of an asset may be one of the more difficult and subjective decisions for management, and during the credit crisis, there was little agreement among companies concerning when impairment charges became necessary. By delaying the tough decision to take the charges, many companies kept their earnings inflated, and in so doing, they sowed widespread investor distrust about the true value of their assets.

## Looking Back

### **Warning Signs: Shifting Current Expenses to a Later Period**

- Improperly capitalizing normal operating expenses
- Changes in capitalization policy or accelerated capitalization of costs
- New or unusual asset accounts
- Jump in soft assets relative to sales
- Unexpected increase in capital expenditures

- Amortizing or depreciating costs too slowly
- Stretching out depreciable asset life
- Improper amortization of costs associated with loans
- Failing to record expenses for impaired assets
- Jump in inventory relative to cost of goods sold
- Failure by lenders to adequately reserve for credit losses
- Decrease in loan loss reserve relative to bad loans
- Decline in bad debt expense or obsolescence expense
- Decrease in reserves related to bad debts or inventory obsolescence

## Looking Ahead

Chapter 6 described the metaphorical two-step dance that is employed to account for costs. Step 1 requires treating as assets those costs that generate long-term benefits. Step 2 requires moving those costs to expense when the benefit has been realized. Some assets (such as inventory or prepaid insurance) yield benefits quickly, while others (such as plant assets) yield them over a much longer period. Regardless, any asset that has become permanently impaired must be written off immediately.

The next chapter focuses on those costs that provide only a short-term benefit and follow a one-step process. While conceptually, all costs incurred to grow or maintain a business do provide some benefit (i.e., they remain as assets for a while), the period for these costs is quite short, and, by convention, they appear only as an expense. Shenanigan No. 5 shows techniques used by management to hide those expenses from investors.

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# 7

## EARNINGS MANIPULATION SHENANIGAN No. 5: EMPLOYING OTHER TECHNIQUES TO HIDE EXPENSES OR LOSSES

Failing to report all your expenses when filing your taxes with the Internal Revenue Service makes no sense, because you will only wind up with a higher tax bill. However, this trick works just fine if your goal is to impress (and deceive) your shareholders and bankers by showing higher profits. The previous chapter showed how management tries to hide expenses on the Balance Sheet, pretending that they are really assets. This chapter presents a more challenging financial shenanigan for investors to detect: when management decides not to even record certain expenses anywhere in the accounts. It's pretty amazing that people would

try this trick to begin with; what's even more amazing is that they often get away with it!

In the previous chapter, we discussed how certain costs with long-term benefits are initially recorded as assets on the Balance Sheet, while other costs with short-term benefits are expensed immediately. We showed that monitoring trends in assets, expenses, and capitalization policies is a helpful way to catch companies that are inflating their earnings by improperly keeping costs on the Balance Sheet. In contrast, costs that provide only short-term benefits never appear on the Balance Sheet at all because they are expensed immediately. This chapter focuses on tricks related to those short-term benefits that management simply decides to hide from investors. Along the way, we will also reveal the ploy that we crown King of All Shenanigans.

## **Employing Other Techniques to Hide Expenses or Losses**

1. Failing to Record an Expense from a Current Transaction
2. Failing to Record an Expense for a Necessary Accrual or Reversing a Past Expense
3. Failing to Record or Reducing Expenses by Using Aggressive Accounting Assumptions
4. Reducing Expenses by Releasing Bogus Reserves from Previous Charges

### **1. Failing to Record an Expense from a Current Transaction**

The first section of this chapter discusses hiding expenses by simply failing to record all or some of an expense from various transactions.

#### **Recording Only Part of a Transaction**

A fairly simple way to hide expenses would be to pretend that you never saw an invoice from a vendor until after the quarter has ended. For example, failure to account for an electricity bill received

in late March for that month's service would underreport the expenses (and the related accounts payable), and therefore would overstate income.

**Question the Failure to Record Invoices from Vendors Received Late in the Period.** Several weeks before the close of its 1999 fiscal year, Rent-Way's accounting department stopped recording bills from vendors and the related expenses. By doing so, the company artificially reduced expenses in fiscal 1999 by \$28 million, and then again in 2000 by \$99 million. At the beginning of fiscal 2001, Rent-Way disclosed accounting improprieties related to underreporting \$127 million of expenses during the previous two years. The stock price subsequently plummeted 72 percent, to \$6.50 from \$23.44.

The scheme became known when the chief accounting officer was away on vacation. The new CFO discovered that Rent-Way's inventory system indicated that there was less merchandise in the stores than was reflected in the accounting records.

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Accounting Capsule: Accruing Expenses

Suppose you have received something of value and you have received the invoice for it, but you have not yet paid for it. For example, suppose that on December 15, your attorney negotiates a deal for you and then sends you an invoice for her services. Here's the correct accounting entry to record this unpaid invoice:

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<i>Increase:</i>	Legal expense	\$1,000	
<i>Increase:</i>	Accounts payable		\$1,000

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If you decide to put the bill in your top drawer and not record the entry until after year-end, the excluded legal expenses will inflate your profits.

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Another example of failing to record end-of-period expenses involves the infamous Symbol Technologies. Symbol paid bonuses to employees in the March 2000 quarter, but failed to record the related obligation to pay \$3.5 million in Federal Insurance Contributions



Act (FICA) insurance. Instead, the company inappropriately decided that it would record the expense in a later period, when the cash was paid. By failing to properly accrue the FICA expense in March, Symbol overstated its quarterly net income by 7.5 percent.

### **Investigate Unusual Transactions in Which Vendors Send Out Cash.**

A less common ploy to artificially reduce expenses and inflate profits involves receiving sham rebates from suppliers. Naturally, this shenanigan needs the assistance of the supplier. Here's how it works.

Tell a supplier that you will agree to purchase \$9 million of office products over the next year, and that you will pay an inflated price of \$10 million. In exchange for this large order, you ask the supplier to pay you a \$1 million up-front "rebate" upon signing the agreement. You then improperly record the rebate as an immediate reduction of your office expenses. By using this trick, you have boosted earnings by the \$1 million receipt, which should have been recorded as a reduction of the inflated price of future office supplies purchases.

Consider Sunrise Medical's dealings with a supplier in which the company worked out a deal to receive a \$1 million rebate on purchases that had already been made during the year. What was in it for the supplier? Well, Sunrise agreed to a price increase on purchases made in the next year to offset the rebate. A "side letter" was executed to seal this caper. Sunrise recorded the rebate as a decrease in expenses, without disclosing to investors or to the auditor that the supplier had tied the rebate to a price increase on future purchases.

**Tip:** Always question any cash receipt from a vendor. Cash normally flows out to vendors, not in, so unusual cash inflows from vendors may signal an accounting shenanigan.

**Watch for Unusually Large Vendor Credits or Rebates.** Syntax-Brilliant Corp. took the concept of vendor rebates to a completely different and inappropriate level. The company received various vendor "credits" from its primary supplier (Kolin), which, as we discussed in the previous chapter, was also a significant share-

holder of the company. Syntax-Brilliant recorded these vendor credits as a reduction in cost of goods sold, which naturally provided a benefit to earnings. The problem was, however, that these were no ordinary credits. The size of these credits was absolutely shocking; it accounted for more than all of Syntax-Brilliant's gross profit over its brief history as a public company. Specifically, between December 2005 and June 2007, the company reported gross profit of \$142.7 million, which included credits from Kolin totaling an astounding \$214.7 million. Moreover, the company never received cash for these credits; they were just bookkeeping entries. As a result, Syntax-Brilliant showed decent profitability, but severely negative cash flow from operations. Even novice investors could have identified this scheme. A quick quality of earnings check would have revealed a huge disparity between cash flow and net income. Moreover, diligent investors could have found in the footnotes disclosures of unusually large vendor credits and significant related-party transactions.

### **Failing to Properly Account for Stock Option Backdating Expense**

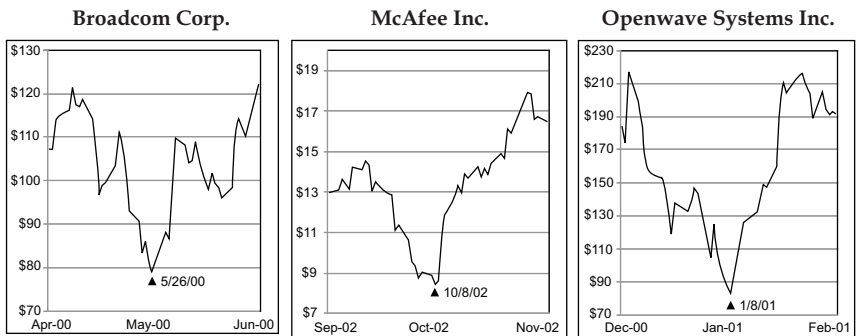
Most shenanigans discussed in this book share a common theme: company executives use accounting gimmicks to show impressive results in hopes of driving up the stock price so that their shares and options become very valuable. The options backdating scandal that erupted in 2006 is on a whole different level of dishonesty. Executives were able to skip the whole part about using accounting gimmicks, showing impressive results, and driving up the stock price. Instead, they cut right to the chase and secretly gave themselves stock options that had already increased in value. In so doing, executives found a simple way to loot the company's coffers without letting anyone know. They thought it was the perfect heist—and it was, until they were caught.

**The King of All Shenanigans.** If you were to put options backdating on one side of a scale that weighs dishonesty, and any other shenanigan on the other side, we believe that backdating would always be heavier. Why? Because all other shenanigans are designed to enrich management in a complicated, indirect manner, while backdating does so without any serious effort at all. Look at all the “hard work” Enron executives had to do to create all those crazy

joint ventures to make results appear better! Look at the acquisition activity at Tyco and the gyrations that Symbol Technologies went through in order to get positive results! And no matter how much cheating went on at these companies, *there was never a guarantee that the stock price would respond accordingly*. With options backdating, however, management barely had to lift a finger in order to cheat. And, of course, the process guaranteed a positive result. For this reason, we crown backdating as the King of all Shenanigans.

The options backdating scheme was really quite simple. Before finalizing an option grant, executives pulled up the stock chart and looked back in time to find a date on which the stock price was at a much lower level. They then said *hocus pocus* and “backdated” the paperwork to make it seem as if the stock option had really been granted on that earlier date. And voilà, the stock options had instant value. Of course, options backdating had accounting implications as well. By not reporting the compensation expense resulting from these “in-the-money” grants, companies were overstating their earnings to shareholders.

Few companies abused options backdating as much as semiconductor giant Broadcom Corp. The saga began when Broadcom’s board initiated a review of option-granting practices on May 18, 2006, two days after a seminal CFRA (Center for Financial Research and Analysis) survey on options backdating listed Broadcom as one of the companies “presenting the highest risk of having backdated options” (Figure 7-1 shows one of Broadcom’s backdating



**Figure 7-1.** Charts sourced from CFRA report, “Options Backdating—Which Companies Are at Risk?” on May 16, 2006.

charts). After two months of investigating, Broadcom finally admitted what it had done and estimated that this abuse of the system had allowed the company to avoid a whopping \$750 million in compensation expense. But that was not the end of the story. The following January, Broadcom shocked investors by announcing an unbelievable \$2.2 billion expense, which tripled the original estimate and trumped the \$1.5 billion estimated restatement record held by former backdating champion UnitedHealth Group.

Some executives still argue to this day that the media blew the backdating scandal out of proportion and that the misdated grants were simply caused by “careless record keeping.” *Au contraire*. (We weren’t permitted to use stronger language in this PG-rated book.) The sheer pervasiveness of this scandal across hundreds of companies actually makes it seem that many executives considered backdating to be a perk of running a public company. But don’t take our word for it—see for yourself. Figure 7-1 provides some snapshots depicting one of many dates on which three companies granted options to executives. Can anyone really say with a straight face that these grants were the result of careless record keeping?

### **Failure to Record a Portion of an Expense Related to a Transaction**

Remember our earlier discussion of the quirky two-part transaction between Intel and Marvell? Intel sold a business to Marvell in 2006 at what seemed to be a discount, and, simultaneously, Marvell agreed to pay above list price for a certain amount of product later to be purchased from Intel. (See Marvell’s footnote shown here.) As explained in Chapter 3, Intel appeared to structure this transaction in a way that allowed it to understate the gain from the one-time asset sale and overstate the more desirable stream of revenue (by overcharging on the product sales).

#### **MARVELL’S 10-Q DISCUSSION ABOUT ITS TRANSACTION WITH INTEL**

In conjunction with the acquisition of the ICAP Business, the Company entered into a supply agreement with Intel. The supply agreement obligates the Company to purchase certain finished product and sorted wafers at a contracted

price from Intel for a contracted period of time. The contracted period of time can differ between finished products and sorted wafers. *Intel's pricing to the Company was greater than comparable prices available to the Company in the market in almost all cases.* In accordance with purchase accounting, the Company recorded a liability at contract signing representing the difference between Intel prices and comparable market prices for those products for which the Company had a contractual obligation. [Italics added for emphasis.]

Now, let's look at this same two-way transaction, but from Marvell's perspective. Marvell essentially paid Intel less money up front to purchase the business, and in exchange, agreed to purchase inventory from Intel at an inflated price. While it sounds as if this transaction will cause Marvell's earnings to be lower in future periods, as it is overpaying for inventory, this is actually not the case. It appears that Marvell accounted for the entire overpayment by recording a liability (or reserve) on its Balance Sheet, which it would draw down over time as a reduction of cost of goods sold (to "offset" the inflated prices). There was no need for Marvell to record an expense to create this reserve, since it already had been set up in the purchase accounting for the acquisition. In essence, Marvell created a "cookie jar" reserve without recording an expense, and it used this reserve to offset overpayments as it saw fit. Indeed, this transaction actually provided Marvell with *more* discretion over its earnings each quarter.

## **2. Failing to Record an Expense for a Necessary Accrual or Reversing a Past Expense**

Management sometimes fails to record the necessary expense accruals for expected costs. These accruals are generally company estimates of routine liabilities incurred in normal business operations, such as a manufacturer's warranty. Often these costs are estimated and recorded at the very end of a quarter. In the previous chapter, we introduced the concept of expense accruals (reserves) and highlighted reserves that are recorded as reductions to assets, such as the allowance for doubtful accounts and the inventory

obsolescence reserve. In this section, we discuss reserves for estimated obligations that are shown as liabilities.

Failing to appropriately record an expense for these costs, or reversing past expenses, will inflate earnings. Since these costs rely on management assumptions and discretionary estimates, all management needs to do to generate more earnings (and achieve Wall Street targets) is to tweak these assumptions. To illustrate, consider the shenanigans that occurred at Dell Computer from 2003 through the beginning of fiscal 2007. The published findings of a special investigation conducted by Dell's audit committee in 2007 (as presented here) provide some fantastic, juicy details about Dell's games with reserves (don't skip the box; there is some amazing stuff in there).

#### **DELL'S DISCUSSION OF ITS AUDIT COMMITTEE INVESTIGATION FINDINGS IN AN AUGUST 2007 8-K**

The investigation raised questions relating to numerous accounting issues, most of which involved adjustments to various reserve and accrued liability accounts, and identified evidence that certain adjustments appear to have been motivated by the objective of attaining financial targets. According to the investigation, these activities typically occurred in the days immediately following the end of a quarter, when the accounting books were being closed and the results of the quarter were being compiled. The investigation found evidence that, in that timeframe, account balances were reviewed, sometimes at the request or with the knowledge of senior executives, with the goal of seeking adjustments so that quarterly performance objectives could be met. The investigation concluded that a number of these adjustments were improper, including the creation and release of accruals and reserves that appear to have been made for the purpose of enhancing internal performance measures or reported results, as well as the transfer of excess accruals from one liability account to another and the use of the excess balances to offset unrelated expenses in later periods.

**Watch for Declines in Reserves for Warranties or Warranty Expense.** Many companies bundle expensive warranties with their products, covering potential problems that could arise years

after the purchase. For example, if you were to purchase a laptop from Dell, it might come with a two-year warranty promising that Dell will replace or repair all defective parts during that period.

Dell cannot just wait and see how much it will wind up spending on warranty costs for your computer before recording the expense. Accounting rules require Dell to record an expense for expected future warranty costs at the time the product is sold. Naturally, management can exercise great discretion in the amount it records as warranty expense each period. If it chooses too little, the profits will shoot up; if it chooses too much, profits will be constrained (or simply held back for a rainy day).

Indeed, part of Dell's restatement involved improper accounting for warranty liabilities. Again, the audit committee's discussion of its findings is quite revealing and did such a great job of explaining the mechanics that we figured we'd let the committee teach you directly.

#### DELL'S DISCUSSION OF ITS AUDIT COMMITTEE INVESTIGATION FINDINGS IN AN AUGUST 2007 8-K

There were also instances where warranty reserves in excess of the estimated warranty liability, as calculated by the warranty liability estimation process, were retained and not released to the Statement of Income as appropriate. Additionally, certain adjustments in the warranty liability estimation process were identified where expected future costs or estimated failure rates were not accurate.

**Tip:** A decline in warranty expense or warranty reserve relative to revenue may signal that earnings are being inflated through underaccruing for warranty obligations. Monitor these trends quarterly!

**Watch for Declines in the Employee Bonus Accrual.** Employees earn bonuses over the course of the year, and naturally, accounting rules require that the expense be spread throughout the year even if the employees receive a single lump-sum payment. If management fails to record this accrual in any particular quarter, earn-

ings for that period will be overstated. Moreover, the inappropriate reversal of past bonus accruals will inflate earnings as well. Dell certainly was familiar with this simple trick, as the investigation found.

**DELL’S DISCUSSION OF ITS AUDIT COMMITTEE  
INVESTIGATION FINDINGS IN AN AUGUST 2007 8-K**

Certain employee bonuses were not accrued correctly, including the timing of the recording of the accrual for the employee bonuses. Additionally, in certain cases when excess accruals resulted from differences in the actual bonus payments, the excess accruals were not adjusted as appropriate.

**Be Alert for Companies That Fail to Accrue Expenses for Loss Contingencies.** Occasionally, management may be required to establish a contingency reserve and record an expense (or loss) for outstanding, yet unsettled disputes. Accounting rules require that losses be accrued for such contingencies (e.g., expected payments related to litigation or tax disputes) when the following two conditions exist: (1) there is a probable loss, and (2) the amount of the loss can be reasonably estimated.

Accounting Capsule: Estimating a Loss Contingency

When both requirements for a contingent loss have been met (i.e., the loss is probable and can be reasonably estimated), an expense should be accrued. For instance, assume that a company is about to lose in litigation and almost certainly will have to pay out \$6,000. Since both conditions for accruing the loss are present, the following entry should be made:

<i>Increase:</i>	Loss from Litigation	\$6,000	
<i>Increase:</i>	Estimated Liability		\$6,000

Recording this transaction increases liabilities and reduces net income. Conversely, failing to record the transaction would overstate profits.



**Remember to Review Off-Balance-Sheet Purchase Commitments.**

Existing obligations that result from past transactions are reported as liabilities on the Balance Sheet. Additionally, liabilities for certain contingent payments are accrued in some circumstances. However, what about *future* obligations and contingencies that companies have? For instance, a company may have agreed to purchase inventory over the following two years. Alternatively, a company may have committed to funding a project or renting real estate.

While these purchase obligations often cannot be rescinded, they are typically excluded from the liability section of the Balance Sheet and thus are considered “off-balance-sheet” liabilities. However, management often discloses their presence in the footnotes. Despite not being reflected on the financial statements, these obligations could doom the company. Investors who fail to notice them could be in serious jeopardy.

**NONACCRUED LOSS CONTINGENCIES**

Some obligations require only footnote disclosure and have no impact on reported earnings. However, investors should pay close attention to any commitments and contingencies discussed in the footnotes or the management discussion and analysis section of the financial report. Sometimes unrecorded liabilities for commitments and contingencies are more significant than the liabilities reported on the Balance Sheet.

**Tip:** Companies often provide helpful detail about their purchase commitments in the footnotes to their financial statements. Investors should always review this disclosure to get a better understanding of a company’s true obligations.

Sometimes dishonest management will be less than forthcoming in disclosing purchase obligations. Consider the case of Columbia Gas Systems. When Columbia released its first-quarter financial statements for 1991, most investors were bullish about the

company. Within weeks, Columbia dropped a bombshell: it was on the hook to purchase hundreds of millions of dollars of natural gas at above-market prices. Investors reacted quickly to this news and sent the stock price down 40 percent, erasing \$700 million in market capitalization in one day. Soon thereafter, Columbia filed for bankruptcy.

The company was criticized for having failed to highlight the significance of its future obligations to purchase a large amount of natural gas under “take or pay” contracts. As investors later learned, after Columbia committed to purchase gas at a certain price under these contracts, gas prices plummeted and Columbia could not sell the gas at a price anywhere near its cost. While Columbia had to live up to its commitments to producers, its utility customers were free to buy gas from the cheapest source.

### **3. Failing to Record or Reducing Expenses by Using Aggressive Accounting Assumptions**

This technique demonstrates how management’s flexibility in selecting accounting policies and estimates can be a tool for hiding expenses. Companies that provide pensions and other postretirement benefits to employees can change their accounting assumptions in ways that reduce the recorded expense. Similarly, companies that lease equipment make a variety of estimates that will have a bearing on the reported liabilities and expenses. Management can manipulate earnings (and reduce liabilities) by changing accounting or actuarial assumptions.

#### **Boosting Income by Changing Pension Assumptions**

Companies that provide pensions for employees must record an expense each quarter to account for the incremental costs incurred under the plan. Pension expense generally is not shown explicitly on the Statement of Income; instead, it is simply grouped with other employee salary costs (usually as a component of cost of goods sold [COGS] or selling, general, and administrative [SG&A] expense). Investors should carefully scrutinize the pension accounting assumptions in the footnotes, as they allow for considerable management discretion that might be used to reduce (or even eliminate) the expense.

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### Accounting Capsule: Pension Expense

Pension expense is essentially calculated by (1) taking the incremental annual costs of running a pension plan and (2) *subtracting* the (expected) investment return on pension plan assets. Management can exercise great influence on the underlying assumptions of both measures.

The investment return on pension plan assets (the second element) is not simply the *actual* return earned that year. Rather, accounting rules state that the investment return is a *smoothed* return that consists of two components: (1) the *estimated expected return* on the asset base (this is the estimate we are currently discussing) and (2) the amortization of the cumulative difference between the estimated return and the actual return (a slow “catch-up”).

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**Watch for Aggressive Assumptions for the Expected Return on Plan Assets.** One of the most important estimates in pension accounting is the expected return on pension plan assets. To understand why, let’s take a quick peek at how one aspect of pension accounting works. As discussed in the accounting capsule, the expected return serves to reduce pension expense. If management chooses a more aggressive expected return (say 10 percent when a 6 percent rate is a more reasonable estimate of market returns), the recorded pension expense will be smaller, and profits will be inflated. Thus, companies that consistently overestimate investment returns on plan assets are hiding the true economic costs associated with their obligations to both current and former employees.

Such aggressive assumptions might persist for years, with actual returns falling far short of expectations, leading to suppressed pension expense and inflated earnings year after year. Additionally, by simply *increasing* the expected return assumption, management can provide a nice little boost to earnings. Regardless of the legitimacy of increasing the expected return, this change reduces pension expense and provides a one-time boost to earnings. As a result, investors should monitor expected return assumptions closely for (1) *increases* in the rate of return and (2) an *aggressively high* assumed return. A representative case in point would be Delphi’s estimated return of 10 percent during the down-market years of 2001 and 2002.

What expected return rate should companies use? Well, that is an unfair question to ask investors, since they lack knowledge of the detailed components of pension investment portfolios. However, investors should certainly be aware of and ask questions about companies that use estimated return rates that are higher than those used by their peers. According to a recent RiskMetrics Group study, the average 2008 and 2007 expected return assumption used by U.S. companies was 8.1 percent. Using that figure as a benchmark, it is easy to spot outliers. Two companies in the study had rates higher than 9 percent in 2008 (Titanium Metals Corp. at 10 percent and General Mills Inc. at 9.43 percent), and another 25 companies had rates of 9 percent (including Alcoa Inc., Caterpillar Inc., Eli Lilly & Co., ExxonMobil Corp., and Johnson & Johnson). By using a higher rate, these companies get to record lower pension expense, and therefore higher income.

**Watch for Changes in Other Estimates and Assumptions.** Many actuarial assumptions must be used to calculate pension expense, including discount rates, mortality rates, and compensation growth rates, among others. Companies usually disclose changes to these assumptions in their footnotes. Simply read the pension footnote to find the changes. For example, Navistar International Corp. disclosed a restructuring of its pension plan in 2003, in which the company changed its assumption for the life expectancy of plan participants from 12 years to 18 years. By increasing the life expectancy assumption, Navistar spread “unrecognized losses” over a longer period, and in doing so, reduced its pension expense (and inflated its income) by \$26 million.

**Watch for Changes in Measurement Date.** Just a simple change in the month designated as the measuring date for the pension plan can inflate profits. For example, in 2004, Raytheon Co. changed the date on which it measured its pension plan from October 31 to December 31. This simple change provided a \$41 million (\$0.09) bottom-line boost, which accounted for about 10 percent of Raytheon’s earnings for the entire year.

**Watch for Outsized Pension Income.** Sometimes companies wind up with results that seem to make no sense at all—like a *negative*

*pension expense*. This phenomenon arises when expected gains from investing the plan assets become larger than the incremental annual costs of running the pension plan, resulting in *pension income*. What circumstances would lead to this outcome? Oversized gains for a company with very large plan assets could produce a sizable amount of pension income. Usually, these situations arise at companies with large legacy pension plans and few (or no) new employees entering the plan.

Lucent, for instance, recorded more than \$1.1 billion in pension income during 2004, accounting for virtually all (91 percent) of its operating income. Moreover, from 2002 to 2004, Lucent's *pension income* totaled \$2.8 billion while it reported a cumulative operating loss of \$6.0 billion. Like most companies, Lucent chose not to break out pension expense (or income) separately on its Statement of Income. As a result, investors who failed to read its pension footnote would have missed this critically important piece of information.

**Tip:** The pension footnote is required reading for any company with a large pension plan. Investors should monitor key assumptions and assess the impact of pension expense on earnings.

### **Boosting Income by Changing Lease Assumptions**

Lease accounting provides management with another massage parlor (*not* that kind of massage parlor) in which it can knead estimates to help inflate earnings. Recall our discussion in Chapter 3 of how Xerox accelerated the recognition of lease revenue in the late 1990s. At the same time it was playing that trick, the company also massaged certain estimates to reduce lease expenses.

One of the estimates that Xerox manipulated was the residual value on certain leases. The residual value is a company's estimate of what the leased equipment will be worth when it is returned by the customer at the end of the contract. When leasing equipment to customers, Xerox recorded revenue for the lease payments as well as a cost for the equipment provided, which is essentially depreciation on the equipment. Since equipment would be depreciated only down to its residual value, companies can boost profits by having a high residual value, as this would lower the amount that

would be subject to depreciation. Xerox decided to increase the residual value on certain leased equipment, allowing it to record less expense each period. The SEC alleged that increases in the residual value inflated Xerox's operating earnings by \$43 million from 1997 to 2000.

### **Self-Insurance Reserves**

Some companies balk at paying expensive business insurance premiums (for example, for employee health-care or disability insurance), and decide instead to "self-insure" certain risks. Companies that self-insure essentially operate like mini-insurance companies: they create a fund that they believe will be sufficient to pay out insurance claims, and record expenses each period for the amount needed.

How large should the self-insurance liability be, and how much self-insurance expense should be accrued each quarter? Well, of course, the answer is dependent on estimates. With a simple tweak of those estimates or a change in assumptions, management can provide itself with a nice boost to earnings.

**Be Alert for Changes in Self-Insurance Assumptions.** Rent-A-Center Inc., a large rent-to-own retail store operator, self-insures for workers' compensation, general liability, and auto liability insurance policies. In June 2006, Rent-A-Center decided that it would change the actuarial assumptions used to calculate its self-insurance accrual for that year. Rather than the previous approach of using only general industry loss assumptions, Rent-A-Center would now also include internally developed assumptions based on its own loss experience. Regardless of the legitimacy of this change, it seemed to provide Rent-A-Center with a nonrecurring boost to earnings. A report by RiskMetrics Group estimated that this change alone produced virtually all of Rent-A-Center's earnings growth over the subsequent four quarters by adding approximately \$0.24 to \$0.30 to the bottom line.

**Dollar Thrifty Grabs Two Cookies: Self-Insurance and Doubtful Accounts.** Rental car company Dollar Thrifty Automotive Group assumes the liability for bodily injury and property damage claims resulting from accidents involving its rental cars. Rather

than pay expensive premiums to an insurance company, Dollar Thrifty created its own self-insurance fund. Like Rent-A-Center, Dollar Thrifty reduced its expenses (and boosted earnings) in 2006 as a result of changes in assumptions related to its claims history. CFRA estimated that the earnings boost amounted to about \$0.19, or a whopping 95 percent of total earnings growth in 2006. Conveniently, Dollar Thrifty also reduced its allowance for doubtful accounts, providing another \$0.10 in earnings that year. Do you recall our advice from the previous chapter about heading for the hills if you see many reserves moving in the wrong direction?

**Warning Sign:** A decline in self-insurance expense as a percentage of revenue.

#### 4. Reduce Expenses by Releasing Reserves from Previous Charges

One benefit of taking a special charge is to inflate future-period operating income because future costs have already been written off through that charge. (This issue is covered in Chapter 9, “EM Sheenanigan No. 7: Shifting Future Expenses to an Earlier Period.”) A second benefit of taking a special charge is that the liability created with the charge becomes a reserve that can easily be released into earnings in a later period.

Reserves come in different shapes and sizes and can be found all over the Balance Sheet. In Chapter 6, we highlighted reserves that are recorded on the Balance Sheet as offsets to assets, including the allowance for doubtful accounts, the allowance for loan losses, and inventory obsolescence reserves. Earlier in this chapter, we discussed reserves that are recorded as liabilities and relate to current obligations, such as warranty accruals. In this section, we consider another type of reserve: generic liability reserves that management might have established by taking a charge at some point. These “cushion” reserves can be especially scary for investors because they get swept under the rug and are hidden so well and sometimes for so long that management may not even remember why they were set up in the first place.

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Accounting Capsule: Inflating Liabilities Today  
May Inflate Profits Tomorrow

Liabilities, like income, typically have credit balances. This is quite important and potentially valuable for a management that is intent on inflating future-period profits. The scheme is really quite simple: create a bogus liability with a desirable credit balance and then, whenever needed, make an accounting entry that moves the credit from the liability to an expense account—reducing the expense and boosting profits.

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**WorldCom Releases Reserves to Reduce Its Line Costs.** In the previous chapter, we discussed how WorldCom inflated its earnings in the early 2000s by aggressively capitalizing line costs rather than recording them as an expense. Well, that was not the only game that management played with line costs. It also reversed various generic reserve accounts and recorded the offset as a decrease to line cost expense.

**Watch for the Release of Restructuring Reserves into Income.** Sunbeam Corporation was the master of this trick. When “Chainsaw Al” Dunlap was brought in as CEO, he embarked on a large restructuring plan. Accordingly, the company recorded many restructuring charges, thereby creating reserves to be used for future expenditures related to the restructuring plan. However, according to the Securities and Exchange Commission (SEC), Sunbeam recorded many improper restructuring and other “cookie jar” reserves as a part of this plan. These improper reserves were later reversed into income, inflating profit margins and creating the illusion of a successful restructuring.

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Accounting Capsule: Release of a Restructuring Reserve

Assume that the company announces a 1,000-person layoff with a severance package totaling \$10 million.

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<i>Increase:</i>	Restructuring expense	\$10 million
<i>Increase:</i>	Liability for severance	\$10 million

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Six months later, the layoffs have been completed, yet only 700 employees lost their jobs. The company eliminates the remaining liability and boosts income by reducing an expense:

Decrease:	Liability	\$3 million	
Decrease:		Expense	\$3 million

**Tip:** Many of these liability reserves (especially the generic ones) are often grouped in a “soft” liability account sometimes called “other current liabilities” or “accrued expenses.” Investors should monitor soft liability accounts closely and flag any sharp declines relative to revenue. Often, companies discuss these soft liabilities in a footnote. Make sure to find them and track the individual reserves as well.

Looking Back

**Warning Signs: Employing Other Techniques to Hide Expenses or Losses**

- Unusually large vendor credits or rebates
- Unusual transactions in which vendors send out cash
- Failing to record an expense for a necessary accrual or reversing a past expense
- Unusual declines in reserve for warranty or warranty expense
- Declining accruals, reserves, or “soft liability” accounts
- Unexpected and unwarranted margin expansion
- Unusually “lucky” timing on the issuance of stock options
- Failing to accrue loss reserves
- Failing to highlight off-balance-sheet obligations
- Changing pension, lease, or self-insurance assumptions to reduce expenses
- Outsized pension income

## Looking Ahead

Chapter 7 completes our presentation on how management can improperly inflate *current-period* profits. Management can use two different vehicles to do this: (1) recording too much revenue or one-time gains, or (2) recording too few expenses.

Under certain circumstances, management might choose just the opposite strategy—to deflate current-period profits and shift them to a later period. The next two chapters discuss reasons for this choice and the techniques used to make it happen. Chapter 8 describes methods used by management to improperly shift revenue to later periods, and Chapter 9 presents methods used to improperly shift expenses to an earlier period. The end result of using these tricks leads investors to believe in “deceptively strong” future-period profit growth concocted by management. Read on and learn how not to be duped by these ploys.

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# 8

## EARNINGS MANIPULATION SHENANIGAN No. 6: SHIFTING CURRENT INCOME TO A LATER PERIOD

Here's a quiz. Why would management at a publicly traded company ever lie to its investors by reporting *smaller profits*? Many of you may be thinking that the goal would be to cut taxes. That would be the correct answer for private companies, which care more about shortchanging the tax collector. Publicly traded companies, however, certainly care about reducing taxes, but they often direct more attention toward impressing investors with smooth and predictable accrual-based earnings growth.

As you recall from Chapter 3, when we introduced EM Shenanigan No. 1, Recording Revenue Too Soon, management used the techniques in that chapter because it believed that current-period results were more important than future-period ones, and thus

decided to accelerate revenue from a later period into the current one. Let's now turn that picture 180 degrees and try to imagine certain times when management might wish to depress current-period results in order to benefit a later period. Consider a company that is growing like gangbusters and is unsure of what tomorrow holds, or one that has benefited from a large windfall gain or a huge new contract. Investors surely would love to see those delicious numbers, but they also would naturally expect management to duplicate or even exceed them tomorrow. Meeting those unrealistically high investor expectations may be virtually impossible, leading management to feel compelled to use the techniques we discuss in this chapter.

## Techniques to Shift Current Income to a Later Period

1. Creating Reserves and Releasing Them into Income in a Later Period
2. Improperly Accounting for Derivatives in Order to Smooth Income
3. Creating Reserves in Conjunction with an Acquisition and Releasing Them into Income in a Later Period
4. Recording Current-Period Sales in a Later Period

### 1. Creating Reserves and Releasing Them into Income in a Later Period

As we discussed in Chapter 3, companies should record revenue only when (1) evidence of an arrangement exists, (2) delivery of the product or services has occurred, (3) the price is fixed or determinable, and (4) payment is reasonably assured. EM Shenanigan No. 1 focused on recording revenue too early by failing to wait for the completion of these requirements. As a result, revenue and net income would be inflated.

However, when business is booming and earnings far exceed Wall Street estimates, companies may be tempted not to

report all their revenue, but instead to save some of it for a rainy day. Consider a situation in which management refuses to record some revenue that was rightfully earned during the current period, instead storing it on the Balance Sheet with all the legitimately recorded unearned revenue until it is needed during a later period. This is really simple to do, and the auditors may not even question the move, as they may consider it “more conservative.” All it takes is a bookkeeping entry to increase a Balance Sheet liability account called deferred revenue (or unearned revenue) in the current period; then, when the deferred revenue is needed in a later period (to boost earnings), another entry is made to move it to actual revenue. (The bookkeeping entries are illustrated in the accompanying Accounting Capsule.)

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Accounting Capsule: Creating Deferred (or Unearned) Revenue

Assume that a company made a cash sale for \$900. The correct journal entry would be

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<i>Increase:</i>	Cash	\$900	
<i>Increase:</i>	Sales revenue		\$900

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Instead, if management decided to only record \$600 of the sale this year and squirrel away the rest for next year, it would record

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<i>Increase:</i>	Cash	\$900	
<i>Increase:</i>	Sales revenue		\$600
<i>Increase:</i>	Deferred revenue		\$300

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Then next year, management would simply release that “pent-up” deferred revenue into revenue.

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<i>Decrease:</i>	Deferred revenue	\$300	
<i>Increase:</i>	Sales revenue		\$300

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### Saving Up for a “Rainy Day”

During the late 1990s, software giant Microsoft faced enormous scrutiny over its alleged monopolistic practices by both the U.S. Department of Justice and its European Union counterpart overseeing antitrust regulation. Presumably, the last thing Microsoft wanted to showcase was skyrocketing revenue and profits, as this would probably have become fodder for regulators. It certainly would have been tempting for the company to delay recognition of unexpectedly high revenue by deferring it to a later period and storing it on the Balance Sheet in the form of unearned revenue.

As shown in Table 8-1, Microsoft’s unearned revenue account grew by hundreds of millions of dollars every quarter from March 1998 to March 1999. Indeed, this reserve more than doubled over this period, from \$2.038 billion at the beginning of 1998 to \$4.195 billion at March 1999. Then, suddenly the growth abated in the June 1999 quarter, with the company adding only as much unearned revenue as it was using.

While several factors probably contributed to this big buildup and then sudden drop in unearned revenue, one allegation at the time was that Microsoft was building reserves to save up for a rainy day. When revenue fell by 6.6 percent sequentially in the September 1999 quarter, investors questioned whether that rainy

Table 8-1. Microsoft’s Unearned Revenue, Quarterly Trend

(\$ millions, except %)	Q1, 9/99	Q4, 6/99	Q3, 3/99	Q2, 12/98	Q1, 9/98	Q4, 6/98	Q3, 3/98
Unearned revenue (beginning balance)	4,239	4,195	3,552	3,133	2,888	2,463	2,038
Additions	1,253	1,738	1,768	1,361	1,010	1,129	885
Usage	(1,363)	(1,694)	(1,125)	(942)	(765)	(704)	(460)
Unearned revenue (ending balance)	4,129	4,239	4,195	3,552	3,133	2,888	2,463
Net addition (subtraction)	(110)	44	643	419	245	425	425
% change sequentially	(2.6%)	1.0%	18.1%	13.4%	8.5%	17.3%	20.9%

day had arrived. Another factor contributing to the decline in deferred revenue was a June 1999 change in revenue recognition policy that caused Microsoft to recognize more revenue up front on certain software sales. In adopting a new rule (SOP 98-9), Microsoft decided to adjust its estimates to increase the amount of revenue it would recognize upon shipment of the software and reduce the amount it would treat as unearned. (See Microsoft's disclosure.) Regardless of the legitimacy of this policy change, the impact was to release some of Microsoft's "pent-up" deferred revenue.

**EXCERPTS FROM MICROSOFT'S REVENUE  
RECOGNITION DISCLOSURE, 1999 10-K**

Upon adoption of SOP 98-9 during the fourth quarter of fiscal 1999, the Company was required to change the methodology of attributing the fair value to undelivered elements. The percentages of undelivered elements in relation to the total arrangement decreased, reducing the amount of Windows and Office revenue treated as unearned, and increasing the amount of revenue recognized upon shipment. *The percentage of revenue recognized ratably decreased from a range of 20% to 35% to a range of approximately 15% to 25% of Windows desktop operating systems. For desktop applications, the percentage decreased from approximately 20% to a range of approximately 10% to 20%.* The ranges depend on the terms and conditions of the license and prices of the elements. The impact on fiscal 1999 was to increase reported revenue \$170 million. [Italics added for emphasis.]

**Stretching Out Unexpected Gains over Several Years**

In reality, few companies have the sort of solid sustained growth that would allow them to confidently squirrel away billions of dollars in revenue earned for a later period and still meet Wall Street targets. More commonly, however, companies use EM Shenanigan No. 6 when they are the recipients of a windfall gain.

**Shifting Windfall Gains to Future Periods.** Consider the Florida-based chemical company W. R. Grace. In the early 1990s, Grace's health-care subsidiary experienced a significant and unanticipated



increase in revenue as a result of changes in Medicare reimbursements. Management deferred some of the unanticipated income by increasing or establishing reserves. These reserves ballooned to more than \$50 million by the end of 1992. By creating these reserves and then releasing some of them, the subsidiary reported steady earnings growth of from 23 to 37 percent between 1991 and 1995. The actual growth rates ranged from *minus 8 percent to plus 61 percent*. When Grace sold this subsidiary in 1995, it released the entire excess reserve into income, labeling it a “change in accounting estimate.” Alert investors should have considered that earnings boost unsustainable.

**Shifting Huge Trading Gains to the Future.** Enron’s infamous manipulation of the California energy markets in 2000–2001 earned the company huge windfall profits in its trading division. The profits were so large that management decided to save some for future quarters, which, according to the SEC, was done in order to *mask the extent and volatility of its windfall trading profits*. Compared to the rest of Enron’s shenanigans, this scheme was fairly straightforward: simply defer some of the trading gain by storing it in a reserve on the Balance Sheet. These reserves came in handy and helped Enron avoid reporting large losses during difficult periods. By early 2001, Enron’s undisclosed reserve accounts had ballooned to over \$1 billion. The company then improperly released hundreds of millions of dollars of these reserves to ensure that Wall Street’s expectations were met. Ironically, there would be no future quarters in which to release unused reserves, as Enron imploded in October 2001 and probably needed to show all the revenue that it had held back for the “rainy day.” That rainy day surely had arrived in October 2001—a *Category Five hurricane for investors, with no survivors!*

**Using Reserves to Smooth Income Is a Serious Transgression.** Smoothing of income is not an uncommon strategy for management to engage in, as Wall Street rewards solid and predictable profit growth. However, the use of reserves to shift income to a later period can be as serious an income manipulation ploy as recording revenue too soon (EM Shenanigan No. 1). In both cases, the effect is misleading financial results. When revenue is recorded too early, future income is recorded in the current period; conversely, with income smoothing, current income is shifted to a future period.

2. Improperly Accounting for Derivatives in Order to Smooth Income

Companies with healthy businesses can engage in income-smoothing shenanigans to give the illusion of nice, steady, predictable results. Consider mortgage giant Federal Home Loan Mortgage Corporation (Freddie Mac or Freddie) and its desire to portray very smooth earnings despite a period of volatile interest-rate movements. Freddie’s attempts to smooth earnings went to the extreme and led to an over \$5 billion fraud.

**Volatile Interest-Rate Market Makes “Steady Freddie” Much Less Predictable.** Freddie’s earnings manipulation was related largely to its incorrect accounting for derivative instruments, loan origination costs, and reserves for losses. When the corrected numbers were released, we learned a fascinating thing about the scandal: the company actually wound up understating its profits. From 2000 to 2002, Freddie Mac underreported net income by nearly \$4.5 billion. As shown in Table 8-2, Freddie’s smoothing techniques allowed it to report earnings growth of 63 and 39 percent in 2001 and 2002, when in reality, earnings growth was a much more volatile *negative* 14 percent in 2001 and *positive* 220 percent in 2002.

What could have led Freddie to embark on this course? Well, Wall Street had come to expect steady and predictable earnings from the company. A challenge arose in 2000 with the implementation of a new accounting rule that created enormous volatility in the company’s investment activities involving derivatives (SFAS No. 133). It quickly became clear to management that the change in accounting would create huge windfall gains for the company.

Table 8-2. Freddie Mac Restatements for Errors

(\$ millions, except %)	2002	2001	2000	Total
Reported net income	5,764	4,147	2,547	<b>12,458</b>
Restated net income	<u>10,090</u>	<u>3,158</u>	<u>3,666</u>	<b><u>16,914</u></b>
Effect of restatement	4,326	(989)	1,119	<b>4,456</b>
Reported net income <i>growth</i>	39%	63%		
Restated net income <i>growth</i>	220%	(14%)		

Initial estimates of the gain were in the hundreds of millions, but they soon ballooned to the billions. For most of us, billions of dollars in windfall gains would be great news. To Freddie Mac, however, this was a problem. The company's rock-solid stock price was largely built on its ability to produce steady and predictable earnings. It certainly earned its nickname "Steady Freddie." So, ever conscious of its reputation for pleasing Wall Street, Freddie schemed to hold back a large part of the windfall gain and release portions of it when needed to smooth earnings.

Unlike the frauds at Enron and WorldCom, the focal point of Freddie's fraud was not to mask a deteriorating business, but rather to maintain its image as a predictable earnings generator. In other words, the ultimate gain was not earnings creation but earnings smoothing. Both types of shenanigans clearly violate accounting rules and misrepresent the economic reality to investors. The biggest difference between companies that create earnings out of thin air and those that smooth is that the latter group is likely to consist of healthy companies that are simply attempting to portray a more predictable earnings stream.

**Fannie Trumps Freddie in Income Manipulation.** Fannie Mae, the larger competitor of Freddie Mac, had a similar desire and incentive to present a steady stream of earnings growth in the volatile and unpredictable mortgage market. According to the Office of Federal Housing Enterprise Oversight (Fannie's regulator), management also had a strong desire to achieve profit targets that would trigger maximum bonuses, which led it down the road of accounting gimmickry.

Like Freddie Mac's, Fannie Mae's business is subject to a substantial amount of interest-rate risk, and the company therefore used derivatives extensively to manage this risk. The largest part of Fannie's accounting fraud involved improper accounting for these derivatives. To better understand how Fannie abused the accounting, let's first discuss some basics of derivatives accounting. (Also see the associated accounting capsule on the next page.)

Companies often use derivatives to hedge their exposure to an asset or liability. For example, if a company has a receivable in a foreign currency, it may use a derivative to hedge its currency exposure, and by doing so, "lock in" the amount of cash that it will

eventually receive. Accounting rules for derivatives (SFAS 133) provide a framework for categorizing hedges into groups based on different attributes, such as their purpose and effectiveness. The categorization is important because it determines whether or not fluctuations in the derivative will affect earnings. For example, all quarterly gains or losses from the change in value (i.e., the mark-to-market adjustment) on a hedge that is deemed to be “ineffective” should be recognized as current-period income. Yet for certain types of “effective” hedges, the change in value does not affect earnings at all. As you might imagine, the categorization of hedges is a very sensitive and important decision. (We know that this can get a bit complicated, and maybe Fannie also got a bit confused—or simply ignored the rules.)

Fannie got into trouble for disregarding hedge accounting rules by valuing and categorizing its hedges inappropriately. In a nutshell, Fannie did not record declines in the value of its derivatives appropriately; it classified some hedges as effective (no impact on earnings) when they should have been treated as ineffective (impact on earnings). This trick allowed Fannie to continue its smooth earnings by giving management the discretion to take gains and losses on derivatives in whatever period it saw fit. Most of Fannie Mae’s \$6.3 billion aggregate restatement was the result of its improper hedge accounting. In fact, Fannie’s unreported derivative losses totaled \$7.9 billion.

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Accounting Capsule: Accounting for Derivatives  
under SFAS No. 133

Derivatives are financial instruments whose value is *derived* from changes in some economic variable. For example, a stock option on Wal-Mart gives the owner the option to buy a share of Wal-Mart at a fixed price. The value of that stock option is derived from changes in the value of Wal-Mart’s stock price. In addition to options, many different types of derivatives exist, including futures contracts, forwards, swaps, and collateralized debt obligations, to name a few. Innovative financial engineers (some would call them “Dr. Frankensteins”) continue to churn out complicated new derivative instruments to this day.

Accounting rules (SFAS 133) require that derivatives be marked to market each quarter. The mark-to-market adjustment (i.e., the change in fair value) is generally reported as earnings (or loss) in the current period, unless the derivative is being used as an *effective* cash flow hedge on a future transaction. If a derivative is being used to hedge an asset or a liability effectively, the value of the hedge will move in the opposite direction from the value of the asset or liability. As a result, quarterly fluctuations in fair value on certain types of effective hedges do not affect earnings.

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**GE Abuses Derivative Accounting to Keep Its Earnings Streak Alive.** Like many large companies, General Electric (GE) issues commercial paper, a form of very short-term debt with variable interest rates. To hedge against exposure to changing interest rates, GE entered into derivatives called interest-rate swaps (so called because GE is “swapping” its variable interest-payment obligation for a fixed payment obligation). If they are done appropriately, interest-rate swaps on commercial paper qualify as effective hedges under SFAS 133 (as discussed previously), which means that earnings would be unaffected by volatility in the value of these derivatives.

A problem arose in late 2002 when GE seemed to have “overhedged,” or entered into more swaps than it needed to hedge its commercial paper interest-rate risk. Naturally, the amount that GE overhedged should be considered ineffective under SFAS 133, which means that the quarterly changes in value should affect earnings. (These hedges were ineffective because they did not offset anything.) GE quickly realized that it would be required to record a pretax charge of \$200 million as a result of these ineffective hedges.

Throughout the December 2002 quarter, GE scrambled to find a way to avoid recording this \$200 million charge. In early January 2003, after the quarter closed and just days before the company reported earnings, GE created an entirely new accounting approach for these hedges that provided the desired results. The auditors signed off, and GE kept its streak of meeting Wall Street estimates

alive. One not-so-small matter remained: the new approach was in violation of GAAP. Several years later, the SEC busted GE for accounting fraud.

**Watch for Large Gains from Ineffective Hedging.** Investors should be cautious when a company reports large gains from hedging activities, as these ineffective (sometimes called economic) “hedges” may really be unreliable speculative trading activities that could just as easily produce large losses in future periods. In addition, investors should look out for ineffective hedges that produce gains well in excess of the loss in the underlying asset or liability. Consider Washington Mutual Inc., with its history of presenting large gains on activities that it characterized as hedging. In 2004, the company reported \$1.6 billion in gains that were classified as “economic hedges” against a \$500 million loss from its unhedged MSR (mortgage servicing rights) asset. In other words, Washington Mutual’s hedging activities resulted in gains that were three times the size of the underlying loss. Investors should also be wary of “hedges” that move in the same direction as the underlying asset or liability, as this may signal that management is using derivatives to *speculate*, not to hedge.

### **3. Creating Reserves in Conjunction with an Acquisition and Releasing Them into Income in a Later Period**

As we have pointed out previously, acquisitive companies create some of the biggest challenges for investors. For one thing, the combined companies immediately become more difficult to analyze on an apples-to-apples basis. Second, as we explore in Part 3, “Cash Flow Shenanigans,” acquisition accounting rules create distortions in the presentation of cash flow from operations. And finally, companies that are making acquisitions might be tempted to have the target company hold back some revenue that was earned before the deal closes so that the acquirer can record it in the later period. That is where our next story begins.

### **How to Make a New Friend Very Happy**

Imagine that you recently signed an agreement to sell your business, with the closing to be in two months. You also receive

instructions to refrain from recording any more revenue until the merger is consummated. Somewhat baffled, you comply and record no more revenue. In so doing, you have made a friend for life, as the two months of revenue you held back will be released by the acquiring company.

Inflating revenue right after closing on an acquisition is a pretty simple trick: once the merger is announced, instruct the target company to hold back revenue until after the merger closes. As a result, the revenue reported by the newly merged company improperly includes revenue that was earned by the target before the merger.

Consider the 1997 merger of 3Com with U.S. Robotics. Because the two companies had different fiscal year-ends, a two-month “stub period” was created just before the closing. Apparently, U.S. Robotics held back an enormous amount of revenue so that it would be available to 3Com after the merger closed. It appeared that 3Com included in its August 1997 quarter revenue that U.S. Robotics had deferred during the stub period. Here’s the “smoking gun”: U.S. Robotics reported a minuscule \$15.2 million of revenue for the two-month stub period (approximately \$7.6 million per month), a tiny fraction of the \$690.2 million in revenue that the company had reported during the preceding quarter (approximately \$230 million per month). Rather than recognizing the revenue during the normal course of business, U.S. Robotics apparently held back well over \$600 million (see Table 8-3).

**Be Alert for Lower Revenue at a Target Company Just Before It Is Acquired**

Remember our friends at Computer Associates who manipulated their numbers to help senior management take home \$1 billion in bonuses? We pointed out some of the many tricks the company

Table 8-3. U.S. Robotics’ Revenue Plummets During Its Preacquisition Stub Period

(\$ millions)	Two Months, 4/97 and 5/97	Q2, 3/97	Q1, 12/96	Q4, 9/96	Q3, 6/96
Revenue	15.2	690.2	645.4	611.4	546.8

Table 8-4. Platinum Technologies’ Revenue Falls Immediately Before Being Acquired by Computer Associates

(\$ millions)	Q1, 3/99	Q4, 12/98	Q3, 9/98	Q2, 6/98	Q1, 3/98	Q4, 12/97	Q3, 9/97	Q2, 6/97
Revenue	170.1	314.7	250.3	217.4	193.4	242.7	190.8	164.2

used to accomplish this feat, including the “35-day” month and immediate revenue recognition on 10-year installment sale contracts. Well, like 3Com, Computer Associates may have also benefited from revenue that was held back before an acquisition.

Consider, for example, Computer Associates’ 1999 purchase of Platinum Technologies. During the March 1999 quarter, the last one before the deal closed, Platinum’s revenue plunged to its lowest level in seven quarters, falling by more than \$144 million sequentially and by more than \$23 million from the year-ago period (see Table 8-4). Platinum attributed the sharp decline to delays in closing customer contracts as a result of its proposed acquisition by Computer Associates. Whatever the real reasons, however, Platinum’s failure to close these sales provided its new owner with an artificial revenue boost. Taking the analysis one step further, even if Platinum’s revenue drop-off was not the result of holding back revenue, investors should still be concerned that Computer Associates was buying a business with rapidly shrinking revenue.

**4. Recording Current-Period Sales in a Later Period**

This final section could be considered a close cousin of the previous one: holding back revenue until a later period. The previous section explored this game in the context of acquisitions. In this section, we discuss a simple trick that is less fancy: management simply decides to record the sale after the period closes, thereby holding back revenue until the later period.

Assume that late in a very strong period, management has achieved all the earnings targets needed to reach its maximum bonuses for the period. Sales continue at a brisk pace, and management has an idea that will ensure high bonus payments for the next period as well—stop recording any more sales and shift them to the



next quarter. It is simple to do, it is unlikely that the auditors will even know about this trick, and your customers certainly won't object, since they will get billed later than they expected. Nonetheless, this practice is dishonest and misleading to investors, as it portrays higher sales in the later period. More important, however, it shows that management makes business decisions that are based not on sound business practices, but on dressing up its financial reports for investors.

## Looking Back

### **Warning Signs: Shifting Current Income to a Later Period**

- Creating reserves and releasing them into income in a later period
- Stretching out windfall gains over several years
- Improperly accounting for derivatives in order to smooth income
- Holding back revenue just before an acquisition closes
- Creating acquisition-related reserves and releasing them into income in a later period
- Recording current-period sales in a later period
- Sudden and unexplained declines in deferred revenue
- Changes in revenue recognition policy
- Unexpectedly consistent earnings during a volatile time
- Signs of revenue being held back by the target just before an acquisition closes

## Looking Ahead

Chapter 8 showed what management might do to hold back legitimate revenue in order to recognize it in a later and apparently

more desirable period. If the goal is to shortchange the present period and benefit future-period income, accelerating expenses to earlier periods should also do the job. Chapter 9 describes a number of techniques used to accelerate expenses, making the current period seem like a disaster in order to show beautiful profits tomorrow.

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# 9

## EARNINGS MANIPULATION SHENANIGAN No. 7: SHIFTING FUTURE EXPENSES TO AN EARLIER PERIOD

Remember the fun children's game called opposite day? For the kids playing the game, the object is to do things the opposite way from how they normally do them. In this chapter, let us adults have a bit of fun playing the opposite game with expenses. You recall that the whole point of Earnings Manipulation Shenanigans No. 4 and 5 was to either push expenses to a later period or simply make them disappear forever. Now, let's get a bit creative with our accounting, in the spirit of opposite day.

First, here are the two basic rules: (1) rather than keeping costs on the Balance Sheet too long (i.e., EM Shenanigan No. 4), rush them to the trash bin of expenses immediately, and (2) instead of trying to hide expenses by failing to record invoices (i.e., EM Shenanigan No. 5), record them all now (the earlier the better) and then

some—even if you literally make up expenses just for the heck of it. Sounds crazy, no? Stay tuned, and soon you will fully understand how management benefits from playing this game—and companies play it more frequently than you would imagine.

This chapter highlights two general techniques that management uses to shift future-period expenses into earlier periods.

**Techniques to Shift Future Expenses to an Earlier Period**

1. Improperly Writing Off Assets in the Current Period to Avoid Expenses in a Future Period
  2. Improperly Recording Charges to Establish Reserves Used to Reduce Future Expenses

**1. Improperly Writing Off Assets in the Current Period to Avoid Expenses in a Future Period**

Let’s briefly return to our Texas two-step dance for assets to expenses. When it is done right, step 1 requires placing costs on the Balance Sheet as assets, since they represent future long-term benefits. Step 2 involves shifting those costs to the proverbial trash bin (known as expenses) when the benefits are received. Chapter 6, “EM Shenanigan No. 4,” showed the first way to bungle the two-step—by shifting from step 1 to step 2 far too *slowly*, or perhaps not at all. This chapter shows another inappropriate way to dance the two-step that is actually the opposite of the dance discussed in Chapter 6—simply shift costs from step 1 to step 2 *immediately*. In other words, write off assets by recording expenses *much earlier* than is warranted.

**Typical Costs under the “Two-Step Process”**

Step 1 Asset	Step 2 Expense
Deferred marketing	Marketing expense
Inventory	Cost of goods sold
Plant and equipment	Depreciation expense
Intangibles	Amortization expense

**Improperly Writing Off Deferred Marketing Costs**

You may recall that when we last saw our friends at AOL in Chapter 6, they were struggling to show a profit and had begun capitalizing marketing and solicitation costs in order to push the company into the black. We roundly criticized them for inflating profits by capitalizing normal expenses on the Balance Sheet. We then censured them for stretching out the amortization period for these costs from one to two years; this further muted the expenses and inflated profits. So, where we left the story a few chapters ago, AOL had accumulated more than \$314 million in the asset account labeled *deferred subscriber acquisition costs (DSAC)*. (See Table 9-1.) But the company still had a big problem: those costs represented tomorrow’s expense, and they would need to be amortized over the next eight quarters—a \$40 million hit to earnings each quarter. Considering AOL’s modest earnings level (\$65.2 million in operating income in fiscal 1996), a recurring \$40 million quarterly charge would be, to put it mildly, quite unwelcome.

So, three months later, when its DSAC asset had ballooned to \$385 million, AOL shifted to Plan B and started playing its version of the *opposite game*. Rather than continuing with the two-step dance and amortizing the marketing costs over the next eight quarters, AOL switched gears and announced “a one-time charge” to write off the entire amount in one fell swoop. Of course, it had to come up with a justification to convince the auditors that this asset account had suddenly become “impaired” and would provide no future benefit. So AOL stated that the write-off was necessary to reflect changes in its evolving business model, including reduced reliance on subscribers’ fees as the company developed other revenue sources. To say that we were skeptical of this explanation would be an understatement.

Table 9-1. AOL’s Deferred Subscriber Acquisition Costs

(\$ millions)	1996	1995	1994	1993
Revenue	1,093.9	394.3	115.7	52.0
Operating income	65.2	(21.4)	4.2	1.7
Net income	29.8	(35.8)	2.2	1.4
Total assets	958.8	405.4	155.2	39.3
<b>Deferred subscriber acquisition costs</b>	<b>314.2</b>	<b>77.2</b>	<b>26.0</b>	—

Just to be clear about the brazenness and extent of the company's scheme, let's recap. First, AOL decided to push normal solicitation costs onto the Balance Sheet to give investors the impression of being a profitable company, when in reality the company was very unprofitable and was burning through a ton of cash. Second, it stretched out the one-year amortization period to two years, further inflating profits by cutting the amortization expense recorded each quarter in half. Of course, at this point, the company knew that it still had a very big challenge. By using aggressive accounting practices, it had successfully pushed more than \$300 million of expenses into the future; however, it had failed to make these expenses disappear forever. But not to worry, the AOL magicians still had one more trick up their sleeve—the grand finale. In an illusion for the ages, management used a \$385 million charge to eliminate all these looming expenses and downplayed the significance by simply calling it a “change in accounting estimate.” Surely you agree that these actions are the product of major *chutzpah*.

### **Improperly Writing Off Inventory as Being Obsolete**

Unlike the solicitation costs that AOL had improperly capitalized for years (before it started playing the opposite game), inventory costs most certainly should be capitalized and then later expensed either when the product is sold (most of the time) or when it is written off as obsolete (less frequently). The most common shenanigans with inventory accounting involve failing to shift costs from the asset account to expense in a timely manner. This trick naturally would understate expenses and inflate profits. Since we are playing the opposite game here, though, let's assume that management decides to write off the inventory cost as an expense long before any sale takes place.

**Cisco Systems Writes Off Billions in Inventory.** During the technology bust in 2000, many companies properly wrote off impaired assets, including inventory, plant and equipment, and intangibles. Cisco System Inc.'s \$2.25 billion inventory write-off in April 2001, however, stood out from the pack as unusual. This inventory charge seemed massive in isolation, but upon closer inspection and compared with the most recent quarter's cost of goods sold, we really understood the magnitude of that number: the amount written off

represented more than 100 percent of that entire quarter's inventory sales. Wow!

Why are we getting so excited? Turn the clock ahead a quarter or two to when the economy started to improve and Cisco's revenue returned to normal levels. Assuming that Cisco chose not to throw all of those written-off routers in the trash when taking the one-time charge (probably a pretty safe assumption), the company then would have reported sales with an *inflated profit margin*. To illustrate, here are some simple numbers: Cisco spends \$100 to manufacture inventory, and then sells it for \$150, producing a \$50 gross profit (33.3 percent margin). If, during that earlier period, the \$100 unit had been written off to zero and subsequently sold for \$150, Cisco would recognize a \$150 profit (100 percent margin). Or even if it had just written down the inventory to \$75, Cisco would recognize a \$75 profit (50 percent margin). There is no clear-cut evidence that Cisco ever sold and reported huge profit margins on units that had been written off or even partially written down. There is reason to be suspicious, however, given (1) company comments on its earnings call suggesting that it would not be scrapping all of the written-off inventory and (2) the rapid expansion in gross margin in subsequent periods.

**Too Many Toys.** Toys 'R' Us accumulated excess inventory that it failed to sell. The company announced that it would take a \$396.6 million (pretax) restructuring charge to cover the cost of a "strategic inventory repositioning" (interpretation: it simply moved slow-selling inventory off of its shelves), as well as the closing of stores and distribution centers. In a report to investors at the time, the Center for Financial Research and Analysis (CFRA) warned that Toys 'R' Us might have bundled into the charge normal operating costs that would otherwise have been included as operating expenses in future periods. The portion of the charge related to repositioning of inventory amounted to \$184 million. The company explained that the inventory was removed from the stores and sold at lower prices through alternative distribution channels. Normally, the inventory would be written down to its net realizable value and the difference charged as an operating expense.

Whether we are considering AOL's acceleration of deferred marketing costs, Cisco's writing off of inventory that it did not throw



away, or Toys ‘R’ Us’ taking large one-time charges, each seemingly had the same ultimate result: accelerating future-period expense into the current period and, moreover, categorizing the write-off as being unrelated to normal activities and showing it below the line. Such actions inflate future-period profits with no detriment to current-period operating results.

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Accounting Capsule: Restructuring Charges Create  
Interperiod and Intraperiod Benefits

EM Shenanigan No. 7 creates both *interperiod* and *intraperiod* benefits for management. First, future-period expenses are accelerated to an earlier period, leaving fewer expenses to burden the later one. Second, the accelerated expenses are often classified as “restructuring” or “one-time charges” and presented below the line, creating a win-win situation for the company: operating income (above the line) in the period of the charge is unaffected, since the impact is felt below the line; and operating income in the later period is inflated, as some normal expenses have been pulled out and included in the earlier-period charge.

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**Improperly Writing Off Plant and Equipment Considered Impaired**

When we introduced shenanigans involving plant and equipment in Chapter 6, we cautioned about management reporting inflated profits by depreciating these assets over too long a period or failing to write them off completely if their value becomes permanently impaired. As we continue the opposite game, let’s shift gears and think how management can accelerate current-period expenses by curtailing the depreciation period and announcing impairment charges for certain pieces of plant and equipment, even though they may be perfectly fine. Investors should be particularly alert to this type of shenanigan when it corresponds to the hiring of a new CEO with tantalizing stock options or if management uses this ploy with uncommon regularity.

**Lesson One for New CEOs.** Do you ever wonder how a person prepares to take the reins as CEO of a public company? Surely, seminars abound, along with books and other training material. No

doubt, one of the lessons taught would be what to do in the first 90 days on the job. Considering how often such a scenario plays out, we would not be surprised if the following strategy was found as Lesson One in the “New CEO Playbook.”

During your first few weeks on the job, announce some bold initiatives to clean up the mess left by your predecessor and try to look like a strong, decisive leader with a solid grip on the details. Oh, and be sure to announce a streamlining of operations and a large write-down of assets (often called a “big bath”)—the larger the write-down, the better. Investors will be impressed, and, of course, it makes showing earnings growth in future periods infinitely easier; you just lowered the bar by shifting those future expenses into today’s charge. Include in your announcement the need to write off bloated inventory and plant assets. Investors won’t even penalize the company for the near-term loss, since it will all be packaged below the line. When tomorrow comes, you will report much improved profits, since many of tomorrow’s costs have already been written off as part of the special charge.

**The Saga of “Chainsaw Al” Dunlap.** That’s how Sunbeam’s infamous “Chainsaw Al” Dunlap managed to look so smart—at least for a while. When Dunlap arrived in July 1996, Sunbeam was a struggling company. Dunlap had a reputation as a turnaround artist.

During his prior 18-month gig leading the Scott Paper Company, Dunlap’s shenanigans had helped to drive up the stock price by 225 percent, increasing the company’s market value by \$6.3 billion. The company was then sold to Kimberly-Clark for \$9.4 billion, with Dunlap pocketing \$100 million as a going-away present. During his short stay at Scott, Dunlap fired 11,000 employees, slashed expenditures on plant improvements and research, and then sold the company to a major rival. Wall Street cheered as Scott became the sixth company sold or dismembered by Dunlap since 1983.

So, not surprisingly, the day Sunbeam announced that Dunlap would become its new CEO, its share price jumped 60 percent—the largest one-day jump in the company’s history. By the following year, the apparent turnaround had begun to impress investors. The stock, which had been \$12.50 the day before Dunlap’s hiring was announced, peaked at \$53 in early 1998. Dunlap was given a new contract, doubling his base salary.

Then the truth became known. On April 3, 1998, the stock plunged 25 percent when the company disclosed a loss for the quarter. Two months later, negative statements in the press about the company's aggressive sales practices prompted Sunbeam's board to begin an internal investigation. The investigation uncovered numerous accounting improprieties and resulted in the termination of both Dunlap and the CFO and extensive restatement of earnings from the fourth quarter of 1996 through the first quarter of 1998. The restatement wiped out nearly two-thirds of Sunbeam's reported 1997 net income, and the company eventually filed for bankruptcy.

**Improperly Writing Off Intangible Assets.** In a manner similar to the accounting treatment of plant and equipment, most intangible assets (with goodwill as a notable exception) will be amortized over a set period established by management. Under EM Shenanigan No. 4, stretching out the time horizon provides an artificial boost to income by lowering the quarterly amortization expense. And, of course, curtailing the time horizon serves to mute profits. Since this is the precise objective of EM Shenanigan No. 7, investors should be mindful of such a shortened useful life on intangible assets.

**Watch for Restructuring Charges Just Before an Acquisition Closes.** Remember from the previous chapter that U.S. Robotics gave its new friend 3Com a gift by holding back hundreds of millions in revenue to be released by 3Com after the merger closed? Well, U.S. Robotics had a second wonderful welcoming gift that was just as simple to create by using one of the techniques under EM Shenanigan No. 7. Just before the merger, U.S. Robotics took a \$426 million "merger-related" charge, which prevented 3Com from having to record those costs as part of normal operations after the merger. Of the total charge, \$92 million was related to the write-off of fixed assets, goodwill, and purchased technology. Naturally, writing off these assets would reduce future-period depreciation and amortization expense and increase net income. What a great way to make a new friend smile!

**Be Wary When Restructurings Occur with Uncommon Regularity.** Restructuring costs for streamlining operations and cost containment programs often are warranted during tough economic times.

However, restructuring events should not become an every year occurrence. As we discussed in Chapter 5, “EM Shenanigan No. 3: Boosting Income Using One-Time or Unsustainable Activities,” some companies abuse the ability to present charges below the line by recording charges for “restructuring costs” or “one-time items” in every single period. A case in point was Alcatel and its restructuring charges in just about every quarter for years on end. After a while, investors must question whether companies actually know the difference between nonrecurring and recurring. If a company incurs a certain type of cost every year, it should be shown with all the other recurring operating items.

## **2. Improperly Recording Charges to Establish Reserves Used to Reduce Future Expenses**

In the first section of this chapter, we discussed how companies record an expense today in order to prevent *past expenditures* (which remain as assets on the Balance Sheet) from becoming future expenses. In this section, we highlight a similar trick in which companies record an expense today in order to keep *future expenditures* from being reported as expenses. With this trick, management loads up the current period with expenses, both taking some from future periods and even making some up. In so doing, when the future period arrives, (1) operating expenses will be underreported, and (2) bogus expenses and the related bogus liabilities will be reversed, resulting in underreported operating expenses and inflated profits. Let’s examine those two results in more detail.

### **Using Restructuring Charges Today to Inflate Operating Income Tomorrow**

Just as AOL was anxious to remove the \$385 million in deferred marketing costs from future periods’ amortization expense, any company that is taking a restructuring charge (such as laying off workers) might consider padding the total dollars written off in order to lower future-period operating expenses. Thus, salary expense to employees who are laid off today will decline in future periods, as any future severance payments received will be bundled into today’s one-time charge. The result: future periods’ above-the-line operating expense disappears, and the current period’s below-

the-line restructuring charge increases by that same amount. But remember, investors generally ignore restructuring charges, so the more a company throws into the charge-off, the better. More below-the-line expense and less above-the-line is viewed as a win-win situation.

**Watch for Dramatic Improvement in the Numbers Right After the Restructuring Period.** Let’s return to Sunbeam to see the huge impact on future earnings from a prior restructuring charge. As shown in Table 9-2, Sunbeam’s operating income surged to \$132.6 million in the nine months following the restructuring charge, from \$4.0 million in the prior-year period. Consider the impact of Sunbeam’s accounting policy changes shortly after Dunlap took the reins. During the December 1996 quarter, Sunbeam recorded a special charge of \$337.6 million for restructuring and another \$12 million charge for a media advertising campaign and “one-time expenditures for market research.” According to the SEC lawsuit, the 1996 *restructuring charge was inflated* by at least \$35 million, and Sunbeam also improperly created a \$12 million litigation reserve.

**Watch for “Big Bath” Charges During Difficult Times.** Perhaps there is no better time to record huge charges than when the market is in a downturn. Since during these times investors are more focused on how companies will emerge from the downturn, large charges are rarely frowned upon; indeed, they are often seen as a positive. Amazingly, during the 2002 market slump, 40 of the 54 largest U.S. utility companies (74 percent) recorded “unusual” charges (according to a survey by CFRA). As we discussed earlier, it is not difficult

Table 9-2. Sunbeam’s Operational Performance

(\$ millions)	9 months 9/97	9 months 9/96	% Change
Revenue	830.1	715.4	16%
Gross profit	231.1	124.1	86%
Operating income	132.6	4.0	NM
Receivables	309.1	194.6	59%
Inventory	290.9	330.2	(12%)
Cash flow from operations	(60.8)	(18.8)	(223%)

for management to use these charges to inappropriately write off productive assets or establish bogus reserves.

**Creating a Larger-Than-Needed Restructuring Reserve and Inflating Future Earnings by Releasing the Reserve**

The previous chapter explained how companies tend to obsess over reporting smooth and predictable earnings. Remember the example of Freddie Mac reserving so much that it got caught before it was ever able to release more than \$4 billion that it had squirreled away? This technique of creating and releasing reserves, as needed, works great for management playing the opposite game.

**Using a Restructuring Reserve to Smooth Earnings.** When a company takes an appropriately sized restructuring charge (e.g., when it plans to lay off 100 people and takes a charge for only those 100), salary expense will be shifted to the earlier period and classified as below the line. That intraperiod movement to below the line works fine for most, but some managements become too greedy and use a second (and unethical) trick. When it is planning to lay off employees, management instead takes an inappropriately large restructuring charge (e.g., it plans to lay off 100 people but announces and takes a charge for 200). By announcing a 200-person layoff when 100 would be sufficient, management doubles the restructuring expense and liability. Let's assume that management provides a \$25,000 severance package for each person who is laid off. That works out to \$2.5 million if management acts ethically; alternatively, by doubling the 100 employees to 200, it takes a \$5 million charge, as shown in the following entry:

Restructuring expense	\$5,000,000	
Liability for severance		\$5,000,000

The company then pays out the promised \$25,000 to each of the 100 folks who are now out of work and makes the following accounting entry:

Liability for severance	\$2,500,000	
Cash		\$2,500,000

Of course, another \$2.5 million still remains in the liability, with no more expected severance obligations. So, management takes the plunge and releases the bogus reserve in the liability account, reducing compensation expense. This sure seems like an enticing trick for an unethical company that needs a few more pennies to beat Wall Street’s estimates. We call this “the gift that keeps on giving.”

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Liability for severance	\$2,500,000	
Compensation expense		\$2,500,000

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**Lucent Fills the Cookie Jar.** Consider Lucent’s focus on using reserves with restructuring charges in the late 1990s. It put aside far more than it needed to cover the restructuring expenses, and the excess reserves then helped the company to smooth out choppy earnings. Over three years, Lucent allegedly lowered its expenses and pumped up earnings by releasing \$442 million from reserve accounts.

**Watch for Companies That Create Reserves at the Time of an Acquisition.** In December 2000, Symbol Technologies recorded \$185.9 million in charges in connection with its purchase of competitor Telxon Corporation. At the time, Symbol justified these charges as being necessary for restructuring of operations, impairment of assets (including inventory), and merger integration costs. It turns out that the charges improperly included fictitious costs that were used to create cookie jar reserves to help inflate earnings in future periods. The charges also overstated inventory write-offs that would provide a boost to future gross margins as the related inventory was sold.

Similarly, in June 1997, Xerox purchased the 20 percent stake in its own European subsidiary that had been owned by the U.K.-based Rank Group. In connection with this purchase, Xerox improperly established a \$100 million reserve for “unknown risks” arising out of the transaction. In establishing the reserve, Xerox violated generally accepted accounting principles by recording a reserve for an unknown and unquantifiable risk. Nonetheless, Xerox began using this reserve as a type of piggy bank, releasing funds from it into income whenever the company’s results fell short of Wall Street’s es-

timates. It continued to draw on the reserve each quarter for things that were completely unrelated to the acquisition until it was fully depleted at the end of 1999. Using this same trick, Xerox fraudulently released into income approximately 20 other excess reserves totaling \$396 million to improve earnings from 1997 through 2000.

**Building Up Your Reserve During Times of Plenty.** The Bible tells the story of Joseph's unique ability to decipher Pharaoh's unsettling dream. After hearing details of the dream, Joseph warned Pharaoh that a famine was coming; devastating shortages would follow seven years of plenty. Joseph became Pharaoh's chief steward and immediately began a program to set aside a reserve of food and supplies. Seven years later the famine hit, but Pharaoh and all of Egypt were ready.

Companies also look into the future and can reasonably predict normal business cycles and, less reasonably well, those occasional sudden jolts to the economy. Smart management today understands what Joseph and Pharaoh learned—lean years invariably follow the good ones. In that context, if a company has already met its income projections for the current period, it may attempt to shift next year's expenses into this earlier period. H.J. Heinz Company had a premonition that one of the lean years was fast approaching and shifted some costs to the earlier period by prepaying expenses to boost the following year's profit. One of its subsidiaries engaged in other ploys as well, such as misstating its cost of sales, improperly soliciting bills from vendors for advertising, and expensing invoices for services that had not yet been received.

## Looking Back

### Warning Signs: Shifting Future Expenses to an Earlier Period

- Improperly writing off assets in the current period to avoid expenses in a future period
- Improperly recording charges to establish reserves used to reduce future expenses
- Large write-offs accompanying the arrival of a new CEO



- Restructuring charges just before an acquisition closes
- Gross margin expansion shortly after an inventory write-off
- Repeated restructuring charges that serve to convert ordinary expenses to a one-time expense
- Unusually smooth earnings during volatile times

## Looking Ahead

Chapters 8 and 9 illustrated games that management might play in order to (1) smooth earnings, (2) shift income from a particularly strong period to a weaker one, or (3) clear the decks of troublesome expenses to produce future-period earnings that will dazzle investors.

These two chapters complete Part 2 and our discussion of the seven Earnings Manipulation Shenanigans. As EM Shenanigans No. 1 through 5 illustrated, management has a large arsenal of techniques that can trick investors into believing that a company has generated more profit than it really has. And if management instead desires to make tomorrow look fantastic, EM Shenanigans No. 6 and 7 will get the job done.

If you were reading the 2002 edition of *Financial Shenanigans*, your lessons would now be over. At that time, we believed that the extent of management trickery in financial reporting consisted of misrepresenting its earnings. While today management still spends far too much time coming up with tricks to manipulate earnings, it has expanded the playing field of deception far beyond Earnings Manipulation Shenanigans. Therefore, as management strategy and tactics for financial misrepresentations have evolved, investors must learn new lessons about such tricks.

Part 3 begins teaching these new lessons by focusing on misrepresenting cash flow from operations (CFFO). We call this category of tricks *Cash Flow Shenanigans*. Let's get started, as we now know that management gallops ahead in finding new tricks, and investors need to work even harder just to keep pace and have a reasonable chance of knowing what lies behind the numbers.

# PART THREE

## CASH FLOW

### SHENANIGANS

With so many recent financial frauds going undetected, investors are increasingly questioning the value of the accrual-based figures shown on the Statement of Income. Time and time again, companies have duped investors by recording revenue too soon or hiding expenses. Some sophisticated investors claim that they realize that earnings can be manipulated and therefore put more faith in the “purer” cash flow from operations.

While that’s certainly a step in the right direction, be extra careful to look both ways as you cross the proverbial street from accrual-based earnings to the cash flow numbers. The reasons for exercising this caution will become abundantly clear as you read through this part of the book.

In Part 3, we showcase four specific types of Cash Flow (CF) Shenanigans, discussing techniques that management employs to inflate reported cash flow from operations (CFFO), a particularly important metric that investors rely upon to assess both a company’s ability to generate cash and its “quality of earnings.” We also present strategies for detecting Cash Flow Shenanigans quickly and offer tips on how to adjust the reported numbers to calculate a more sustainable cash flow metric.

## Four Cash Flow Shenanigans

Chapter 10	CF No. 1: Shifting Financing Cash Inflows to the Operating Section
Chapter 11	CF No. 2: Shifting Normal Operating Cash Outflows to the Investing Section
Chapter 12	CF No. 3: Inflating Operating Cash Flow Using Acquisitions or Disposals
Chapter 13	CF No. 4: Boosting Operating Cash Flow Using Unsustainable Activities

### Accrual versus Cash-Based Accounting

Before digging into the specific techniques, it is important to have a firm grasp of accrual versus cash-based accounting as well as the structure of the Statement of Cash Flows (SCF). Accounting rules mandate that a company report its earnings performance using the accrual basis. For all you nonaccountants, that simply means that you report revenue when it is earned (rather than when cash comes in) and charge expenses when the benefit has been received (rather than when payment occurs). In other words, cash inflows and outflows play a secondary role under accrual-based accounting. Fortunately for investors, companies must also provide a separate SCF highlighting inflows and outflows from three main sources: Operating, Investing, and Financing activities. The information included in the Operating section can be used as an *alternative performance measure* to the accrual-based net income.

As discussed in previous chapters, savvy investors often compare net income with CFFO and become concerned when CFFO lags behind net income. Indeed, high net income along with low CFFO often signals the presence of some Earnings Manipulation Shenanigans.

Let's compare the form and structure of a typical Statement of Income with the Operating section of the Statement of Cash Flows. Under accounting rules (SFAS 95), companies can use either the "direct" or the "indirect" method to present CFFO. The direct method simply shows major sources of cash inflows (i.e.,

from customers) and outflows (i.e., to vendors and employees). The indirect method, in contrast, starts with accrual-based net income and reconciles it to CFFO. The direct method certainly seems more intuitive for investors, and rule makers specifically expressed their preference for companies to use that approach. However, this urging by rule makers has failed to convince companies to go along, as the vast majority present only the indirect method. (However, as we write this book, standard setters are in advanced stages of establishing a new rule that would require companies to present cash flows using the direct method.) Here we present the Statement of Income (Accrual-Based), Cash Flow from Operations (Direct Method), and Cash Flow from Operations (Indirect Method).

#### Statement of Income: Accrual-Based

Sales revenue	1,000,000
Less: Operating expenses	<u>(850,000)</u>
Operating income	150,000
Less: Nonoperating expenses	<u>(50,000)</u>
Pretax income	100,000
Less: Income tax @35%	<u>(35,000)</u>
<b>Net income</b>	<b>65,000</b>

#### Cash Flow from Operations: Direct Method

Customer collections	750,000
Less:	
Vendor payments	(550,000)
Employee salaries	(600,000)
Tax payments	(35,000)
Interest payments	<u>(40,000)</u>
<b>Cash flow from operations</b>	<b>(475,000)</b>

## Cash Flow from Operations: Indirect Method

Net income	65,000
<i>Adjustments to reconcile to net cash</i>	
Depreciation and amortization	40,000
Provision for doubtful accounts	10,000
<i>Changes in working capital</i>	
Accounts receivable	(820,000)
Inventory	(80,000)
Prepaid expenses	50,000
Accounts payable and deferred revenue	260,000
<b>Cash flow from operations</b>	<b>(475,000)</b>

Although net income and CFFO represent slightly different but equally valid measures of a company's performance, investors generally should expect them to move in the same direction. That is, if a company reports growing net income to shareholders, it would be discomfoting if cash flow from operations is shrinking. Notice that in the illustration just given, CFFO lagged behind net income by a whopping \$540,000 (negative \$475,000 less a positive \$65,000). As we discussed earlier, such an outcome may have investors worried that the company is employing Earnings Manipulation Shenanigans.

## Performance Measures—From Earnings to Cash Flow

Management certainly understands that its investors cherish a high "quality of earnings." They know that investors test earnings quality by benchmarking it against CFFO, as we did in the previous example. They also know that many investors consider CFFO to be the most important measure of company performance; some have even completely turned away from earnings and instead focus primarily on analyzing a company's ability to generate cash. Management is fully aware that investors are lulled by the old wives' tale that cash flow cannot be manipulated.

It should therefore come as no surprise that companies have become cleverer in their financial reporting and disclosure practices. Many have found new ways to mislead investors, using deceptive

practices that may go undetected in traditional quality of earnings analysis. As you will learn in Part 3, many of these tricks involve shenanigans involving the manipulation of cash flow from operations.

**Cash Flow from Operations: The Favored Son**

Before diving into these Cash Flow Shenanigans, it is important to understand the basic structure of the Statement of Cash Flows. The SCF shows how a company’s cash balance changed over the period. It presents all inflows and outflows of cash, reconciling the beginning to the ending balance. All cash movements can be grouped into one of three categories: Operating, Investing, and Financing activities. Figure P3-1 illustrates the typical inflows and outflows within each section of the SCF.

Investors do not consider the three sections of the Statement of Cash Flows equally important. Rather, they regard the Operating section as the “favored son” because it presents cash generated from a company’s actual business operations (i.e., cash flow from operations). Many investors are less concerned with a company’s investments or capital structure, and some even go to the extreme and completely ignore the other sections. After all, the Operating section should fully convey a company’s operating activities, right?

Well, not really. Companies can exert a great deal of discretion when presenting cash flows. Many popular Cash Flow Shenanigans can be labeled *intraperson geography games*—a liberal company

	Operating Activities	Investing Activities	Financing Activities
Inflows	Customer collections Interest collections Dividend collections	Investment sales Plant/equipment sales Business disposals	Bank borrowings Other borrowings Stock issuance
Outflows	Vendor payments Employee salaries Tax payments Interest payments	Capital expenditures Investment purchases Property purchases Business acquisitions	Loan repayments Stock repurchases Dividend payments

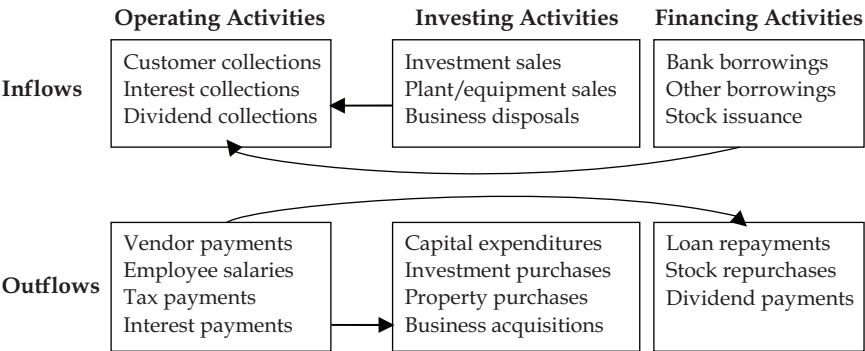
**Figure P3-1. The Statement of Cash Flows Is Organized into Three Sections: Operating, Investing, and Financing Activities.**

interpretation of “what goes where” on the Statement of Cash Flows. For example, should an outflow be shown in the Operating or the Investing section? Clearly, management’s answer would have a profound effect on the reported CFFO and on an investor’s assessment of the company’s performance. Other shenanigans involve subjective management decisions that influence the timing of cash flows in order to portray an overly rosy economic picture.

**Robin Hood Tricks**

Think of these intraperiod geography games as “Robin Hood” tricks: stealing from the rich section of the Statement of Cash Flows and giving to the poor one. In most cases, the “poor” section will be the Operating section, which investors follow much more closely, and the “rich” sections will be the Investing and Financing sections, which investors tend to ignore.

As you will see, these Robin Hood tricks are actually quite simple and more common than you might imagine. It is not that difficult for companies to concoct a reason to move the good stuff (cash inflows) to the most important Operating section, and send the bad stuff (cash outflows) to the less important Investing and Financing sections. Figure P3-2 illustrates some of these tricks, such as improperly moving inflows that really came from bank borrowings to the Operating section or shifting those unwanted outflows out of Operating and labeling them capital expenditures.



**Figure P3-2. Cash Flow Shenanigans: Robin Hood Tricks.**

## Where Is the Sheriff of Nottingham?

Just as the Sheriff of Nottingham could not prevent Robin Hood from stealing from the rich and giving to the poor, the current accounting rules often seem inadequate to prevent companies from engaging in such cash flow shenanigans. This is because the rule makers failed to adequately address many key issues when they wrote the accounting rules for the Statement of Cash Flows. Indeed, when addressing “what goes where” on the Statement of Cash Flows, the accounting rules are quite vague, providing management with a great deal of discretion.

In fact, occasionally the accounting rules can be considered as “accomplices” in the Robin Hood tricks because, as applied, in some cases they fail to capture the true economics of transactions. As a result, even when companies follow the rules, they may still present a CFFO figure that measures the organic growth of the business poorly. Of course, companies that follow the rules should not be accused of chicanery. Nonetheless, playing by the rules does not always result in financial reporting that accurately reflects the underlying economic reality.

## Good News and Bad News (but Mostly Good News)

Now it's time for some good news and some bad news. The *bad news* is that many techniques exist that allow companies to portray misleading cash flow. Moreover, many aspects of the rules surrounding the Statement of Cash Flows create confusion about the sustainability of the CFFO reported to investors.

However, the *good news* is that you realize this—indeed, you are reading this book. You are about to learn how to detect these tricks quickly and gain the knowledge and tools necessary to successfully go toe-to-toe with companies whose management attempts to mislead you with Cash Flow Shenanigans.

The next four chapters offer a guided tour of four Cash Flow Shenanigans, including techniques used by management to shift undesirable outflows away from the Operating section and push desirable inflows into that section. Naturally, we share our secrets on how to detect signs of these shenanigans. Chapter 10 starts off with shifting the cherished inflows from financing arrangements to the Operating section.



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# 10

## CASH FLOW SHENANIGAN No. 1: SHIFTING FINANCING CASH INFLOWS TO THE OPERATING SECTION

Arnold Schwarzenegger and Danny DeVito were an unlikely pair in the 1988 hit comedy *Twins*. They were born in a genetics lab as the result of a secret experiment to create the perfect child. Doctors manipulated the fertility process to funnel all of the desirable traits to one child while sending the “genetic trash” to the other. They were able to create an intelligent Adonis (Schwarzenegger), but in order to do so, the doctors also had to create his gnomish, conniving twin brother (DeVito).

That very same year, new cash flow reporting standards (SFAS 95) took effect, officially formalizing the Statement of Cash Flows and its three sections (Operating, Investing, and Financing). It seems that some corporate executives were reviewing the new rules at the same time that they were watching the fertility manipulation in *Twins*.

This may be where they got the crazy idea of manipulating the Statement of Cash Flows by sending all of the desirable cash inflows to the most important section (Operating) and all of the unwanted cash outflows to the other sections (Investing and Financing).

In recent years, many companies have seemingly been operating their own *Twins* genetics labs. But rather than attempting to create the perfect child, they are attempting to create the perfect Statement of Cash Flows. In this chapter, we expose one of the most important secret procedures being performed inside those labs: shifting the desirable inflows from a financing transaction to the Operating section.

Techniques to Shift Financing Cash Inflows to the Operating Section

1. Recording Bogus CFFO from a Normal Bank Borrowing
  2. Boosting CFFO by Selling Receivables Before the Collection Date
  3. Inflating CFFO by Faking the Sale of Receivables

These three techniques all represent ways in which companies inflate cash flow from operations (CFFO) by shifting net cash inflows from financing arrangements to the Operating section, as illustrated in our handy cash flow map in Figure 10-1.

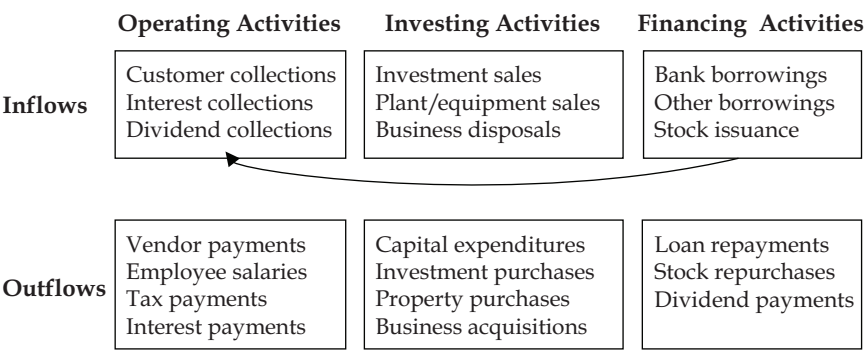


Figure 10-1.

## **1. Recording Bogus CFFO from a Normal Bank Borrowing**

### **Sham Sales of Inventory to a Bank**

At the end of 2000, Delphi Corporation found itself in a bind. It had been spun out from General Motors (GM) a year earlier, and management was intent on showing the company to be a strong and viable stand-alone operation. However, despite management's ambitions, all was not well at the auto parts supplier. Since the spin-off, Delphi had cooked up many schemes to inflate its results. The auto industry was reeling, and the economy was getting worse.

Delphi's operations continued to deteriorate in the fourth quarter of 2000, and the company was facing the prospect of having to tell investors that cash flow from operations had turned severely negative for the quarter. This would have been a devastating blow, as Delphi often highlighted its cash flow in the headline of its earnings releases as a key indicator of the company's performance and its (purported) strength.

So, already knee-deep in lies, Delphi concocted another scheme to save the quarter. In the last weeks of December 2000, Delphi went to its bank (Bank One) and offered to sell it \$200 million in precious metals inventory. Not surprisingly, Bank One had no interest in buying inventory. Remember, we are talking about a bank, not an auto parts manufacturer. Delphi understood this and crafted the agreement in such a way that Bank One would be able to "sell" the inventory back to Delphi a few weeks later (after year-end). In exchange for the bank's "ownership" of the inventory for a few weeks, Delphi would buy it back at a small premium to the original sale price.

Let's step back and think about what really happened here. The economics of this transaction should be clear to you: Delphi took out a short-term loan from Bank One. As is the case with many bank loans, Bank One required Delphi to put up collateral (in this case, the precious metals inventory) that could be seized in case Delphi decided not to pay back the loan. Delphi should have recorded the \$200 million received from Bank One as a borrowing (an increase in cash flow from financing activities). As a plain vanilla loan, this transaction should have increased cash and a liability (loan payable) on Delphi's Balance Sheet. Clearly, borrowing and later repaying the loan produces no revenue.

Rather than recording the transaction in a manner consistent with the economics and intent of the parties, as a loan, Delphi brazenly recorded it as the sale of \$200 million in inventory. In so doing, Delphi inflated revenue and earnings, as discussed in EM Shenanigan No. 2. Moreover, it also overstated CFFO by the \$200 million that Delphi claimed to have received in exchange for the “sale” of inventory. As shown in Table 10-1, without this \$200 million, Delphi would have recorded only \$68 million in CFFO for the whole year (rather than the \$268 million reported), including a dismal *negative* \$158 million in the fourth quarter.

**Remember That Bogus Revenue May Also Mean Bogus CFFO.** In EM Shenanigan No. 2, we discussed techniques that companies use to record bogus revenue, including engaging in transactions that lack economic substance or that lack a reasonable arm’s-length process. Some investors become so disillusioned when they read about bogus revenue and other earnings manipulation tricks that they decide to completely ignore accrual-based numbers and, instead, blindly rely exclusively on the Statement of Cash Flows. We consider that decision unwise. Investors should understand that *bogus revenue might also signal bogus CFFO*. This was clearly the case in the Delphi example discussed here, as well as in many other so-called *boomerang* transactions. Thus, as a rule, signs of bogus revenue may also portend inflated CFFO as well.

**Tip:** If you suspect a company of recording bogus revenue, you must also consider that it may also have recorded bogus operating cash flow.

Table 10-1. Delphi’s Cash Flow from Operations (CFFO), Removing Impact of Sham Loan

(\$ millions)	FY 2000
Cash flow from operations	268
Less: Borrowed cash improperly recorded as CFFO	(200)
Normalized CFFO	68

**Be Wary Around Pro Forma CFFO Metrics.** Delphi steered investors away from its reported CFFO, and instead highlighted a cash flow measure that it defined itself and confusingly labeled “Operating Cash Flow.” Normally investors use the terms *CFFO* and *operating cash flow* interchangeably; however, Delphi defined them very differently. (More on this in Part 4, “Key Metrics Shenanigans.”)

In FY 2000, Delphi reported \$268 million in CFFO on its Statement of Cash Flows; however, its self-defined “Operating Cash Flow” (reported in the earnings release) was \$1.636 billion. No, we’re not kidding—a differential of an amazing \$1.4 billion! Careful investors would have noticed this shenanigan and immediately become skeptical about the company, as the level of trickery was astounding and inexcusable. (Stay tuned for more on this \$1.4 billion differential in Chapter 14.) Of course, even the \$268 million in reported CFFO was inflated, as it included the sham sale of inventory to the bank discussed previously. The Securities and Exchange Commission (SEC) must have had a field day when it sorted through all of Delphi’s schemes and charged the company with fraud.

Not only did Delphi create a misleading substitute for CFFO, but it routinely highlighted the strength of this number to investors in the title of its quarterly earnings reports. Investors should be cautious whenever management places such an intense focus on a company-created cash flow metric that covertly redefines the very important CFFO. Of course, management’s creative use of metrics may not always be indicative of fraud; however, investors should nonetheless ratchet up their normal level of skepticism.

### **Complicated Off-Balance-Sheet Structures Raise the Risk of Inflated CFFO**

We have already outlined several ruses perpetrated by Enron, particularly its use of off-balance-sheet vehicles such as special-purpose entities. Some of the schemes that Enron concocted helped it present a misleadingly stronger CFFO. For example, Enron would create such a vehicle and then help it borrow money by co-signing its loans. The Enron-controlled vehicle then used the cash received to “purchase” commodities from Enron. Enron recorded the cash received as an Operating section inflow (CFFO) from the “sale” of the commodities.

The structure of these transactions may seem complicated, but the economics were quite simple: Enron entered into arrangements to sell commodities to itself. The problem was that it recorded only half of the transaction—the part that reflected the cash inflows. Specifically, Enron recorded the “sale” of the commodities as an Operating inflow, but ignored the offsetting outflow from the vehicle’s “purchase” of these commodities. If Enron had recorded this transaction in line with its economics, the cash inflow would have been deemed a loan and hence recorded as a Financing inflow. This trick allowed Enron to embellish its CFFO by billions of dollars, to the detriment of its Financing cash flow—and, of course, of its investors.

## **2. Boosting CFFO by Selling Receivables Before the Collection Date**

In the previous section, we discussed how Delphi and Enron created a dangerous scheme in their *Twins* genetics labs that allowed them to record completely bogus cash flow from operations. In this section, we discuss how companies might boost CFFO with a transaction that is considered completely appropriate and is actually quite popular: selling accounts receivable. However, the way management presents these transactions on its financial statements often leads to a great deal of confusion for investors.

### **Turning Receivables into Cash Even Though the Customer Has Yet to Pay**

Companies often sell accounts receivable as a useful cash-management strategy. These transactions are actually quite simple: a company wishes to collect on its receivables before they come due. The company finds a willing investor (often a bank) and transfers the ownership of some receivables to it. In return, the company pockets a cash payment for the total amount of receivables, less a fee.

Let’s think about the underlying transaction, its purpose, and the other party’s interest. Does this arrangement sound like a financing transaction or an operating one? Many people would agree that an arrangement in which a bank simply cuts you a check looks strikingly similar to an old-fashioned loan—nothing more than a form of financing, particularly since management determines the timing and the amount of cash received. They therefore expect that this

transaction will not affect CFFO. However, the rules state otherwise. The appropriate place to record cash received from the sale of receivables would be as an Operating, not a Financing inflow. Why Operating? Because the cash received could be viewed as representing collections from past sales. Indeed, this is one of many “gray areas” that cause confusion among even the savviest investors.

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### Accounting Capsule: Selling Accounts Receivable

It is important to recognize when a company is selling its receivables, as these transactions are recorded as CFFO inflows. There are different ways in which companies can sell their receivables, including factoring transactions and securitizations. Keep an eye out for these key words in financial statements.

- *Factoring*: The simple sale of receivables to a third party, often a bank or a special-purpose entity.
- *Securitization*: The sale of receivables to a third party (often a special-purpose entity) for the purposes of creating new financial instruments (“securities”) by repackaging the receivable inflows.

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### Selling Accounts Receivable: An Unsustainable Driver of Cash Flow Growth

In 2004, pharmaceutical distributor Cardinal Health needed to generate a lot more cash. So, management decided to sell accounts receivable to help the company raise a substantial amount of cash very quickly. By the end of the second quarter (December 2004), Cardinal Health had sold \$800 million in customer receivables. This transaction was the primary driver of the company’s robust \$971 million in CFFO growth in December 2004 over the prior-year period.

While Cardinal Health certainly was entitled to any cash received in exchange for its accounts receivable, investors should have realized that this was an *unsustainable* source of CFFO growth. Cardinal Health essentially collected on receivables (from a third party, rather than from its customers) that would normally have been collected in future quarters. By collecting the cash earlier than anticipated, the company essentially shifted future-period cash inflows into the current quarter, leaving a “hole” in future-periods’ cash flow. The



transfer of cash flow to an earlier period is likely to result in disappointing future CFFO— unless, of course, management finds another CF Shenanigan to plug the hole. (Companies never stop looking for and finding new tricks, which is why a fourth edition of *Financial Shenanigans* will surely be needed in the not-too-distant future.)

**Watch for Sudden Swings on the Statement of Cash Flows.** Even novice investors could have identified that something important had changed in Cardinal Health’s accounts receivable, and that CFFO growth was largely driven by this change. Look at the company’s Statement of Cash Flows in Table 10-2. Notice that the \$971 million increase (from \$548 million to \$1.5 billion) in CFFO had been driven primarily by a \$1.1 billion “swing” in the impact of receivables. Specifically, in the six months ending December 2004, the change in accounts receivable represented a cash inflow of \$622 million, while in the previous year, the change in accounts receivable had contributed a cash *outflow* of \$488 million. Without doubt, the massive receivable sale, not an improvement in Cardinal Health’s core business, produced the impressive CFFO improvement. To emphasize, investors should focus not only on *how much* CFFO grew, but also on *how* it grew—a very big difference.

Table 10-2. Cardinal Health’s Cash Flow from Operations, as Reported

(\$ millions)	Six Months Ended	
	12/31/04	12/31/03
<b>Earnings from continuing operations</b>	<b>421.6</b>	<b>697.1</b>
Depreciation and amortization	198.2	143.2
Asset impairments	155.8	4.8
Provision for bad debts	0.8	(2.7)
<b>Decrease/(increase) in trade receivables</b>	<b>622.3</b>	<b>(488.3)</b>
Increase in inventories	(707.5)	(841.4)
Decrease/(increase) in sales-type leases	(95.3)	22.0
Increase in accounts payable	794.1	964.3
Other accrued liabilities and operating items, net	129.2	49.4
<b>Net cash provided by operating activities</b>	<b>1,519.2</b>	<b>548.4</b>

Sudden “swings” like that at Cardinal Health signal the need to explore more deeply. In this case, you would have found that the company began selling more accounts receivable. This was fairly easy to find, and the company clearly did nothing improper. In fact, the company was very forthcoming, disclosing the accounts receivable sales clearly in its earnings release as well as in the 10-Q filing (although disclosing it on the Statement of Cash Flows would be preferred). While perhaps casual or lazy investors were too easily impressed with Cardinal Health’s ability to grow its CFFO, savvy investors would certainly have realized that the growth came from a nonrecurring source.

**Stealth Sales of Receivables**

Unlike Cardinal Health, which was relatively forthcoming with its disclosure, some companies try hard to keep investors in the dark when their CFFO benefits from the sale of receivables. Take, for instance, the case of a certain electronics manufacturer. Sanmina-SCI Corporation reported its fourth-quarter results for September 2005 in early November. In the earnings release, Sanmina decided to prominently display its strong CFFO as one of its fourth-quarter “highlights.” Accounts receivable had decreased, and Sanmina also proudly pointed out the decline in receivables near the top of the release.

But the earnings release didn’t tell the whole story. Nearly two months later, deep in the 10-K filed on December 29, 2005, while many investors were on holiday, Sanmina disclosed what had really happened: *the primary driver of CFFO in Q4 was the sale of receivables*. Sanmina reported that \$224 million in receivables that it had sold were still subject to recourse at the end of the quarter, according to a report by RiskMetrics Group. This was quite an increase from the \$84 million reported in the previous quarter. Sanmina had been quietly selling receivables for the past couple of quarters, but never in this magnitude. As shown in Table 10-3, without this increase

Table 10-3. Sanmina-SCI’s CFFO in Q4, 9/05, Adjusted to Remove the Impact of Sold Receivables

(\$ millions)	Q4, 9/05
Cash flow from operations	175
Quarterly change in sold receivables	139
Normalized CFFO	36

in receivables sold, Sanmina's CFFO would have been \$139 million lower, falling to \$36 million instead of the reported \$175 million.

**Tip:** When normalizing CFFO to exclude the impact of sold receivables, use the *change* in sold receivables *outstanding at the end of the quarter*. This way, you account for the receivables that were outstanding last quarter, but collected during this one.

**Read the Quarterly Filings to Know What to Anticipate.** Certainly, a full reading of the 10-K (which, by now, you should know to do) would have revealed that sales of receivables drove CFFO. But could you have suspected that this was the case before the 10-K was even filed? Indeed, the answer would be yes. Astute investors would have read the previous quarter's 10-Q and noticed that Sanmina discussed the sale of receivables no fewer than four times. They also would have noted that the company had mentioned the arrangement in passing on its earnings conference call two quarters earlier. These A-plus investors would have known that they should be wary in the fourth quarter when the CFFO suddenly surged as a result of a significant decline in receivables. They certainly would have been able to connect the dots.

**Shun Opacity.** It is clearly inappropriate for companies to be opaque when reporting sensitive and impactful structured arrangements such as selling receivables. Be wary if companies fail to provide investors with details. Question their reasons for not being transparent about how they monetize their receivables. Perhaps management's objective was simply to window-dress its Statement of Cash Flows. The worst-case scenario would be that the company is trying to hide a real cash crunch from investors. Such a cover-up clearly goes far beyond simple window dressing and points to a company camouflaging a material deterioration in its business. Dot-com high-flyer Global Crossing sold \$183 million in receivables just six months before it filed for bankruptcy in 2002. Similarly, Xerox raised the ire of the SEC by silently selling \$288 million in receivables at the end of 1999 in order to report a positive year-end cash balance of \$126 million.

### 3. Inflating CFFO by Faking the Sale of Receivables

In the previous section, we discussed the implications of normal receivable sales for CFFO. We pointed out that in many cases, selling receivables may be not only appropriate, but also a prudent business decision. However, investors also need to understand that the cash flow that was expected in a future period has now been collected, and that this inflow should be viewed as unsustainable. In this section, we take a step into more nefarious territory. We will encounter another top-secret procedure being performed in the companies' *Twins* labs: faking the sale of receivables.

#### Sham Sales of Receivables—The Watergate of Shenanigans

President Nixon resigned in disgrace as a result of trying to cover up the break-in at the Watergate Hotel. The smoking-gun evidence apparently was included on an 18 ½-minute section of a White House recording that was conveniently erased to cover up the crime. Similarly, Peregrine Systems used a convenient cover-up to hide its accounting fraud. As we discussed in Chapter 4 ("EM Shenanigan No. 2: Recording Bogus Revenue"), Peregrine embellished its revenue in the years leading up to its 2002 bankruptcy, using deceptive practices such as recording bogus revenue and entering into reciprocal transactions. All of this fake revenue resulted in bloated receivables on the Balance Sheet that would never be collected. Peregrine became concerned that these bloated receivables would become the smoking gun of its bogus revenue. So, the cover-up began in earnest with *fake sales of accounts receivable*.

In this cover-up, Peregrine transferred its receivables to a bank in exchange for cash; however, the risk of collection loss remained with Peregrine. That collection risk was huge, of course, because *there were no customers*—many of the related sales were bogus. Since the risk of loss had not been transferred, Peregrine remained on the hook to return the cash to the bank when the receivables inevitably were not collected.

Since the receivables had never actually been transferred, the economics of this transaction would be more akin to a collateralized loan, just as we saw with Delphi earlier in this chapter. Peregrine borrowed money from the bank and used receivables as collateral. On the Statement of Cash Flows, this should be presented as a

*Financing* inflow. Peregrine, however, ignored the economic reality of the situation. Instead, it recorded the transaction as the sale of receivables, and shamelessly reported the cash received as an *Operating* inflow.

**Watch Carefully for Disclosure Changes in the Risk Factors.** Many investors overlook the “Risk Factor” section of corporate filings because it seems like legal boilerplate. *Warning to investors:* ignore the risk factors at your own peril. While most of the text may be similar from quarter to quarter, investors should carefully try to identify *changes* in the verbiage. If new risks have been added or previously listed ones have been changed, then the change is deemed worthy of disclosure by the company or its auditors, and you need to know about it.

For instance, in 2001, the year before Peregrine imploded in fraud, the company inserted an important new risk factor disclosure that should have awakened investors from their slumber. Peregrine actually changed its risk factor disclosure twice, first in June 2001 and then again in December 2001. The new disclosure in June 2001 informed readers that Peregrine was engaging in new customer financing arrangements, including loan financing and leasing solutions. It also reported that some customers were failing to meet their obligations. The mere fact that this disclosure found its way into the risk factors tells you that it must have been significant.

#### PEREGRINE'S NEW RISK FACTOR DISCLOSURE IN JUNE 2001

In addition, other factors, including indirect factors resulting from the macroeconomic climate, could have an adverse effect on our operating results in a given quarter or over several quarterly periods. For example, in the current economic environment, we have experienced increased demand from some customers for customer financing, including loan financing, and leasing solutions. We expect this demand for customer financing to continue, and we have engaged in customer financing where we believe it is a competitive factor in obtaining business. Although we have programs in place to monitor and mitigate the associated risks, there can be no

assurance that such programs will be effective in reducing related credit risk. We have experienced losses due to customers failing to meet their obligations. Future losses, if incurred, could harm our business and have a material adverse effect on our operating results and financial condition.

Then, in December 2001, Peregrine added one small sentence to the end of the new disclosure from the June period. While it was only 12 words, it read like a five-alarm fire:

**PEREGRINE'S NEW RISK FACTOR DISCLOSURE  
IN DECEMBER 2001**

The Company may at times market certain client receivable balances without recourse.

Peregrine was doing more than just finding new ways to provide its customers with financing; it was also trying to sell its accounts receivable. The cryptic nature of this new sentence, together with the hush-hush disclosure in the risk factors with no mention of it elsewhere, is extremely concerning. Peregrine was clearly hiding something big from investors and trying to comply with the minimal level of disclosure requirements.

**Tip:** It is well worth your time to look for changes in disclosure each quarter, particularly in the most important sections of the filings. Most research platforms and word processing software have “word compare” or “blackline” functionality. Reviewing both filings side by side is also not as cumbersome as it sounds.

**Computer Associates Makes an Accounting “Decision”**

Computer Associates’s FY 2000 10-K revealed that one of its primary sources of operating cash flow that year had come from its recent fourth quarter “decision” to assign accounts receivable to a third party. No other details were provided. Investors were given

no insight into the details of the arrangement, the mechanics of the “assignment,” or the magnitude of the impact.

**COMPUTER ASSOCIATES ACCOUNTS RECEIVABLE  
DISCLOSURE IN ITS FY 2000 10-K**

The primary source of cash for the year was higher net income adjusted for non-cash charges. Other sources of cash included strong collections of outstanding accounts receivable and *the Company's decision, in the fourth quarter, to assign selected existing installment accounts receivable to a third party.* The Company may continue to explore the use of financing companies as a means of expediting debt reduction, mitigating interest rate risk, and reducing installment accounts receivable balances. [Italics added for emphasis.]

**RED FLAG!** A company overtly stating that it made an accounting “decision.”

Recall from Chapter 3, “EM Shenanigan No. 1: Recording Revenue Too Soon,” that the SEC charged Computer Associates with prematurely recognizing more than \$3.3 billion in revenue from 1998 to 2000. Well, like Peregrine, Computer Associates needed a cover-up to conceal this bogus revenue. It found one by offloading receivables, and it certainly tried to keep that news under wraps. Whenever companies disclose that a mysterious new arrangement is a driver of CFFO (or of any important metric, for that matter), investors should seek to understand the mechanics of the arrangement. Only significant changes would require new disclosure, so when you notice something new, consider it a big deal. At the benign end of the spectrum, it may simply be a nonrecurring benefit that might be important to your analysis. However, on the other end of the spectrum (think Computer Associates), it may be a red flag signaling a major impropriety.

**Tip:** New disclosures should provide more answers, not more questions. Avoid companies in which the reverse is true.

## **Vitesse Semiconductor Emulated Its Friends at Peregrine and Computer Associates**

Vitesse Semiconductor also admitted to classifying cash that it received from a bank as the sale of accounts receivable rather than as borrowing. The alleged scheme involved Vitesse “selling” accounts receivable (many of which related to uncollectible or fraudulent revenue) to Silicon Valley Bank at the end of each quarter, to make it seem that Vitesse’s accounts receivable had remained relatively stable. Vitesse never really offloaded the risk of loss from these receivables, however, as the bank retained the right to demand that Vitesse repurchase these receivables.

The scheme came to light only serendipitously when a special committee of the company’s board was given the task of investigating Vitesse’s stock option backdating practices. As the cockroach theory (“where there is one, there are many”) would have it, the committee found many more problems than options backdating tricks. It found damning evidence of accounting improprieties and provided a startling list of transgressions, two of which involved manipulating cash flow, including (1) “improper accounting for certain transactions as sales of accounts receivable rather than borrowings” and (2) “failure to disclose practices to increase reported cash balances, which balances were not representative of operating cash balances throughout the reporting period.”

## **Looking Back**

### **Warning Signs: Shifting Financing Cash Inflows to the Operating Section**

- Recording bogus CFFO from a normal bank borrowing
- Boosting CFFO by selling receivables before the collection date
- Disclosures about selling receivables with recourse
- Inflating CFFO by faking the sale of receivables
- Changes in the wording of key disclosure items in the financial reports
- Providing less disclosure than in the prior period
- Big margin expansion shortly after an inventory write-off



## Looking Ahead

A second clever way in which management may inflate operating cash flows is by pushing some of the “bad stuff” (i.e., the outflows) from the Operating section to another place on the Statement of Cash Flows. The next chapter shows just how easy it is to move these outflows to the less-scrutinized Investing section.

# 11

## CASH FLOW SHENANIGAN No. 2: SHIFTING NORMAL OPERATING CASH OUTFLOWS TO THE INVESTING SECTION

Jimmy Hoffa, corrupt boss of the Teamsters Union, left a Detroit restaurant on July 30, 1975, and vanished without a trace. It is widely believed that he was “whacked” in a mob hit, yet despite having searched for the past 35 years, the FBI has been unable to locate his remains. Urban legends run rampant, providing many different accounts of his final resting place, including a New Jersey landfill, a Michigan sanitation plant, the Florida Everglades, and even (the old) Giants Stadium. Only one thing is for certain: whoever buried Jimmy Hoffa did not want him to be found.

Like Hoffa’s handlers, many companies have a secret dumping ground for pesky cash outflows that they don’t want anyone to find. It’s called the Investing section of the Statement of Cash Flows (SCF). Companies have found numerous clever ways to dump

normal operating cash outflows into the Investing section, hoping that they will vanish forever. And most investors, like the FBI in its hunt for Jimmy Hoffa, seem to have very few clues as to where to look.

While unfortunately we can be of no help to the FBI in its search for Hoffa, we certainly can help investors find clues to the whereabouts of hidden cash outflows. Chapter 11 shows you exactly where to look. We'll show you how to find these outflows that management loves to bury in the Investing section, even though they seem more like operating-related outflows. And we'll discuss the following three primary techniques that companies use to shift these operating cash outflows to the Investing section.

Techniques to Shift Normal Operating Cash Outflows to the Investing Section

1. Inflating CFFO with Boomerang Transactions

2. Improperly Capitalizing Normal Operating Costs

3. Recording the Purchase of Inventory as an Investing Outflow

All three methods are examples of those used by companies that inflate cash flow from operations (CFFO) by dumping normal operating costs into the Investing section, as shown in Figure 11-1.

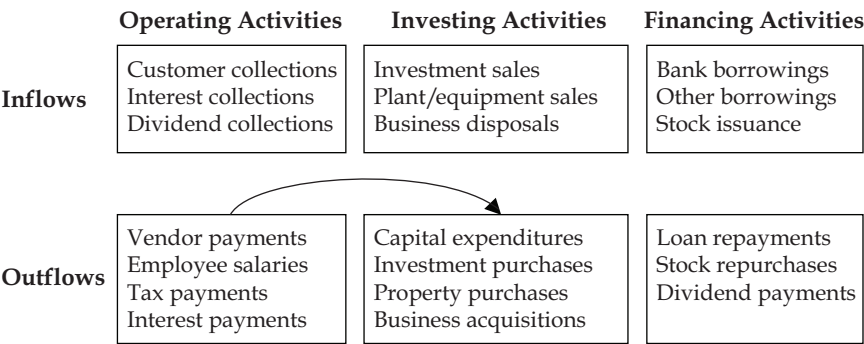


Figure 11-1.

1. Inflating CFFO with Boomerang Transactions

Global Crossing was one of the highest-flying technology companies during the 1990s dot-com bubble. It was building an undersea fiber-optic cable network that would connect more than 200 cities across four continents, and investors appeared to be absolutely giddy over its prospects. However, as the project neared completion in 2000 and early 2001, critics began to wonder whether Global Crossing would ever sell enough network capacity to recoup the extensive costs of the project and pay down its massive debt.

When questioned, Global Crossing always seemed to have a great rebuttal for these naysayers: “Look at all the cash we are generating.” Global Crossing had entered into many substantial contracts in which it sold future capacity and received cash from customers up front—and it had the CFFO to prove it. In 2000, despite a *negative* \$1.7 billion in earnings, the company reported to investors a *positive* \$911 million in operating cash flow. (See Table 11-1.)

Normally, investors would be overjoyed about a company that generates substantially more CFFO than net income. Indeed, some of the differential was legitimately explained by these advances received from customers. However, a sizable portion related to a boomerang scheme to manipulate its CFFO.

As the technology industry was facing a slowdown, Global Crossing and other telecom players came up with a plan to effectively sell products to each other and, in so doing, boost revenue. From a purely economic standpoint, it was like taking money out of your right pocket and putting it into your left: nothing really changed.

Here’s how it worked: Global Crossing sold large blocks of future network capacity to telecom customers. At the same time, the company purchased a similar dollar amount of capacity from these same customers. In other words, Global Crossing would sell capacity

Table 11-1. Global Crossing’s Cash Flow from Operations versus Net Income

(\$ millions)	H1, 6/01	FY 2000	FY 1999	FY 1998
Cash flow from operations (CFFO)	677	911	732	349
Net income (loss) (NI)	(1,246)	(1,667)	(111)	(88)
CFFO – NI	1,923	2,578	843	437

to a customer and *simultaneously buy a similar amount of capacity* on a different network. This was a classic *boomerang* transaction. You can almost picture some Global Crossing executive telling the company's customers, "You scratch my back, and I'll scratch yours."

So, what does this have to do with cash flow? Well, Global Crossing recorded these boomerang transactions in a way that artificially inflated CFFO. The company recorded the cash that it received from its customers in these transactions as an Operating inflow; however, the cash that it paid to the same customers was recorded as an Investing outflow. Essentially, Global Crossing inflated cash flow from operating activities by depressing cash flow from investing activities. This allowed the company to show strong CFFO that clearly was well in excess of the economic reality of the transaction. It mattered little that the overstated CFFO was offset by understated cash from investing activities, because *CFFO was the key cash flow metric on which investors were focused*. Did we mention the word *chutzpah* before?

**Be on the Lookout for Boomerang Transactions.** These are very sneaky transactions that make you wonder about the economic substance of the arrangements. Diligent investors should be able to detect these transactions most of the time; look for disclosure of them in 10-Q and 10-K filings, but don't expect that companies will use the term *boomerang*. Of course, companies will make investors work to find them and certainly will not present them on a silver platter. However there are often plenty of details about these transactions, particularly when they are substantial in size. Consider Global Crossing's disclosure of its boomerang transactions in its March 2001 10-Q filing:

#### DISCLOSURE OF BOOMERANG TRANSACTIONS IN GLOBAL CROSSING'S MARCH 2001 10-Q FILING

Page 11: For the March quarter, \$375 *in consideration*, which is included in the \$441 of Recurring Adjusted EBITDA below and in the \$1,613 of cash revenue above, *was received from significant Carrier customers who signed contracts during the quarter to purchase \$500 of capacity on the Global Crossing Network, and to whom the Company made substantial capital commitments during the quarter.* [Italics added for emphasis.]

Page 16: During the quarter, *the Company also entered into several agreements with various Carrier customers for the purchase of capacity and co-location space.* These transactions were implemented in order to acquire cost-effective local network expansions; to provide for cost-effective alternatives to new construction in certain markets in which the Company anticipates shortages of capacity; and to provide additional levels of physical diversity in the network as the Company implements its global mesh architecture. *These new capital commitments total an estimated \$625,* including the cost of the possible construction of the Caribbean system previously mentioned. [Italics added for emphasis.]

This disclosure alone should have spooked investors. On page 11, Global Crossing discloses that \$375 million of its \$441 million in EBITDA (earnings before interest, taxes, depreciation, and amortization) came from sales to customers “to whom the Company made substantial capital commitments during the quarter.” Page 16 reminds readers that Global Crossing purchased capacity from customers and states that “new capital commitments total an estimated \$625 million.”

**Raise Your Antennae When You See a Boomerang Transaction.** Once you identify a boomerang transaction, it is imperative that you dig around and understand the true economics of the arrangement. Look for further disclosure. Call the company and have it explain the arrangement to you. Assess the economics of the transaction and understand how it contributes to the company’s results. Consider whether the company has been deliberately avoiding or complicating the disclosure—it may not want you to understand how its boomerang transactions work. If you cannot get comfortable with a boomerang transaction, steer clear of the company.

**Key Metrics Shenanigans.** You may be wondering about the odd metrics that Global Crossing highlighted in the excerpts shown: “cash revenue” and “recurring adjusted EBITDA.” The company used these metrics in its communications with investors and advertised them as being better performance measures than GAAP (generally accepted accounting principles) revenue and earnings.

As you might imagine, these metrics were defined in such a way as to circumvent GAAP. The definitions allowed Global Crossing to take credit for cash received in these boomerang transactions that could not legitimately be recognized as revenue until far in the future. The whole concept of management's deliberately sidestepping GAAP to mislead investors is quite alarming and very important to understand. We will pick up on this topic and discuss it much more thoroughly in Part 4, "Key Metrics Shenanigans."

## 2. Improperly Capitalizing Normal Operating Costs

Recording normal operating costs as an asset rather than as an expense sounds simple, and frankly, it is quite easy to do. However, it is one of the scariest and most lethal shenanigans out there. Why? Because it is a simple sleight of hand that does more than just embellish earnings—it inflates operating cash flow as well.

**Tip:** If you suspect a company of receiving an earnings benefit from improper capitalization, don't forget that there may be a boost to operating cash flow as well.

It certainly is no coincidence that WorldCom, the perpetrator of one of the largest and most shocking accounting frauds in history, was a purveyor of this particular brand of snake oil. By classifying billions of dollars of normal operating costs as capital equipment purchases, WorldCom not only artificially inflated its profits, but it also overstated its CFFO.

### Recording Normal Operating Costs as a Capital Asset Rather Than as an Expense

Recall our discussion of how WorldCom improperly inflated its earnings by recording its line costs (a clear operating expense) as an asset rather than as an expense? This simple tactic helped the company portray itself as a profitable company rather than tell investors that trouble was stirring.

This move also allowed WorldCom to present strong operating cash flow. Purchases of capital assets (called "capital expenditures") are classified on the Statement of Cash Flows as Investing activities.

By classifying line costs as a capital asset, WorldCom shifted a very large cash outflow from the Operating to the Investing section.

This line cost scheme artificially inflated WorldCom’s CFFO by nearly \$5 billion in 2000 and 2001, according to the company’s restatement. Together with other improperly capitalized costs and CFFO boosts, WorldCom’s operating cash flow was overstated by a whopping \$8.588 billion over these two years (as shown in Table 11-2, the difference between \$15.660 reported and the \$7.072 restated).

In EM Shenanigan No. 4, we discussed several ways to identify companies that are engaging in aggressive capitalization. Dishonest company executives may find ways to improperly capitalize any normal operating cost; however, the most common ones are generally those related to long-term arrangements, such as research and development, labor and overhead related to a long-term project, software development, and costs to win contracts or customers. Monitor these accounts for the best chance of spotting aggressive capitalization.

**Tip:** Rapidly growing fixed asset accounts or “soft” asset accounts (e.g., “other assets”) may be a sign of aggressive capitalization. Create a quarterly common-size Balance Sheet (i.e., calculate all assets and liabilities as a percentage of total assets) to help you quickly identify assets that are growing faster than the rest of the Balance Sheet.

**Pay Attention to Free Cash Flow as Well.** When a company improperly records costs as an asset instead of an expense, CFFO will be

Table 11-2. WorldCom’s CFFO, Reported versus Restated, 2000–2001

(\$ millions)	FY, 2001	FY, 2000	Total
<i>Reported</i> cash flow from operations (CFFO)	7,994	7,666	15,660
Improperly capitalized line costs	(2,933)	(1,827)	(4,760)
Other CFFO boosts	(2,216)	(1,612)	(3,828)
<i>Restated</i> CFFO	2,845	4,227	7,072



Table 11-3. WorldCom’s Free Cash Flow

(\$ millions)	2000	1999
Reported cash flow from operations	7,666	11,005
Subtract: Capital expenditures (capex)	(11,484)	(8,716)
Free cash flow	(3,818)	2,289

overstated. However, as we discussed in Chapter 1, free cash flow may not be affected because it is a measure of cash flow *after* capital expenditures. As shown in Table 11-3, calculating free cash flow at WorldCom reveals the extent of the company’s problems: a \$6.1 billion deterioration from 1999 to 2000.

Accounting Capsule: Free Cash Flow

Free cash flow measures the cash generated by a company, including the impact of cash paid to maintain or expand its asset base (i.e., purchases of capital equipment). Free cash flow typically would be calculated as follows:

Cash flow from operations *minus* capital expenditures

3. Recording the Purchase of Inventory as an Investing Outflow

“Cost of goods sold” (COGS) is a very apt name for the direct expenses that companies incur to acquire or produce inventory sold to customers. On the Statement of Income, COGS is subtracted from revenue to yield a company’s gross profit, an important measure of the profitability of the company’s products.

The Statement of Cash Flows is sometimes not as straightforward. The economics of purchasing goods to be sold to customers suggests that these purchases should be classified as an Operating activity on the Statement of Cash Flows. Normally, this would be the case. Curiously, some companies treat these purchases as an Investing outflow.

Purchase of DVDs: Operating or Investing?

Consider the case of Netflix Inc., the online movie rental company. As you might imagine, one of the company’s largest expenditures is purchasing the DVDs that it rents out to customers. DVDs are

essentially Netflix's inventory, and therefore the company records its DVD library as an asset on its Balance Sheet. This asset is then amortized (over a period of one year for new releases and three years for back catalog), and, as you would expect, the amortization cost is presented on the Statement of Income as a cost of goods sold. In 2007, Netflix's amortization of its DVD library amounted to \$203 million on revenue of \$1.2 billion.

While Netflix's Statement of Income appropriately reflects the economics of its DVD costs, its Statement of Cash Flows does not. You would think that the purchase of DVDs should be presented on the SCF as an Operating outflow just like the purchase of any inventory (particularly the purchase of the new releases that are amortized for only one year). However, Netflix does not see it that way. Instead, it considers the purchase of DVDs to be the purchase of a capital asset, and therefore the cash outflows are presented in the Investing section. This treatment effectively moves a big cash outflow (payment for DVDs) from the Operating to the Investing section, thereby inflating CFFO.

Interestingly, Netflix's competitor Blockbuster Inc., a company that is not known for accounting conservatism, changed its accounting for DVD acquisitions at the end of 2005. Previously, Blockbuster had presented DVD purchases as an Investing outflow, just like Netflix. However, after consultation with the regulators at the Securities and Exchange Commission, Blockbuster began classifying DVD purchases as an Operating outflow and restated its historical numbers.

**Consider Differences in Accounting Policies When Comparing Competitors.** Since Netflix puts DVD purchases in the Investing section and Blockbuster puts them in the Operating section, investors have little ability to compare the CFFO of the two companies without making an adjustment. As shown in Table 11-4, Netflix's cash flow from operations was much stronger than that of Blockbuster in 2007; however, the difference is much less pronounced after adjusting for the DVD purchases.

**Question Any Investing Outflow That Sounds Like a Normal Cost of Operations.** While many analysts claim that reading the Statement of Cash Flows is an integral part of their analysis, many of them

Table 11-4. CFFO for Netflix and Blockbuster (FY 2007), as Reported and as Adjusted to Remove DVD Purchases from Netflix’s CFFO

(FY 2007, \$ millions)	Netflix	Blockbuster
Cash flow from operations (CFFO), as reported	291.8	(56.2)
SCF treatment of acquiring DVD library	Investing outflow	Operating outflow
Acquisitions of DVD library	(223.4)	(709.3)
Apples-to-apples (Blockbuster’s treatment)	68.4	(56.2)

Source: RiskMetrics Group.

fail to read carefully below the Operating section. Simply scanning Netflix’s Investing section would have revealed that the company classified “Acquisitions of DVD library” as an Investing activity. Even investors with only a basic knowledge of Netflix’s business would know enough to realize that acquisition of DVDs represents a normal cost of operations for Netflix.

**Tip:** Keep an eye out for this cash flow trick at companies that purchase goods and then lease or rent those goods to customers.

**Purchasing Patents and Newly Developed Technologies**

Some professional sports franchises fill their team rosters with players whom they scouted, drafted, and developed within their own organizations. Others rely on the “free agent” market to sign proven players (albeit normally at a much higher price). In the same way, some companies rely on their own internal research and development projects to grow their businesses organically, while others choose to grow inorganically by acquiring development-stage technologies, patents, and licenses. While these different business strategies are both means to the same end, the expenditures are often treated differently on the Statement of Cash Flows. Specifically, cash paid to employees and vendors for internal research and development would be reported as an Operating outflow. However,

some companies report cash paid to acquire already researched and developed products as an Investing outflow.

In certain industries, acquiring development-stage technologies is considered commonplace. For example, small biotechnology research companies often develop new drugs and then sell the rights to those drugs to a larger pharmaceutical company once FDA approval is near. The pharmaceutical company then, as owner of the drug, reaps all of the profits. When analyzing the pharmaceutical company’s business, you certainly should be considering the cash paid to acquire the drug rights. However, since the payment will be classified in the Investing section, many investors will have no idea that it even exists.

**Tip:** Keep an eye out for this treatment at companies where individual patents or rights agreements have a significant impact on the business, such as pharmaceutical and technology companies.

Consider the case of biopharmaceutical company Cephalon. Looking to continue its rapid pace of growth, Cephalon went on a \$1 billion shopping spree in 2004 and 2005, snapping up patents, rights, and licenses related to several newly developed drugs. Cephalon presented these cash payments as “acquisitions” and dumped them into the Investing section of the Statement of Cash Flows. Had they been classified as Operating, CFFO instead would have been severely negative in both years. (See Table 11-5.)

**I’ll Gladly Pay You Tuesday for a Hamburger Today**

In an interesting twist, Biovail Corporation, Canada’s largest pharmaceutical company, gained ownership of certain drugs by purchasing

Table 11-5. Cephalon’s Cash Flow from Operations (Adjusted to Subtract Drug Purchases)

(\$ millions)	2005	2004	2003
Cash flow from operations, as reported	185.7	178.6	200.2
“Acquisition” of drug patents, rights, and licenses	(599.7)	(528.3)	—
Cash flow from operations, as adjusted	(414.0)	(349.7)	200.2

the rights through *noncash* transactions. Instead of paying cash at the time of the sale, Biovail compensated the sellers by issuing a note—essentially, a long-term IOU under which the company would pay cash in the future. Since no cash changed hands at the time of the sale, there was no impact on the Statement of Cash Flows. And as Biovail paid down the notes over time, the cash payments were presented on the SCF as the repayment of debt—a Financing outflow.

Biovail's noncash purchases of product rights can be thought of in the same light as Cephalon's patent purchases and Netflix's DVD purchases. The economics suggest that these purchases relate to normal business operations, yet they are reflected in a very different way on the Statement of Cash Flows. When analyzing Biovail's ability to generate cash, these purchases should certainly not be ignored.

**Look for “Supplemental Cash Flow Information.”** Companies frequently provide information about noncash activities in disclosures in the financial reports called “Supplemental Cash Flow Information.” This disclosure is sometimes found immediately after the Statement of Cash Flows; however, occasionally companies will bury this disclosure deep in the footnotes. For example, Biovail provided the disclosure about its noncash purchases in a supplemental cash flow footnote that came 30 pages after the Statement of Cash Flows:

#### **BIOVAIL'S SUPPLEMENTAL CASH FLOW DISCLOSURE**

In 2003, *non-cash investing and financing activities* included the long-term obligation of \$17,497,000 related to the acquisition of Ativan® and Isordil®, and the subscription to \$8,929,000 Series D Preferred Units of Reliant in repayment of a portion of the loan receivable from Reliant. In 2002, non-cash investing and financing activities included long-term obligations of \$99,620,000 and \$69,961,000 related to the acquisitions of Vasotec® and Vaseretic®, and Wellbutrin® and Zyban®, respectively, as well as a long-term obligation of \$80,656,000 related to the amendments to the Zovirax distribution agreement. [Italics added for emphasis.]

## Looking Back

### **Warning Signs: Shifting Normal Operating Cash Outflows to the Investing Section**

- Inflating operating cash flow with boomerang transactions
- Improperly capitalizing normal operating costs
- New or unusual asset accounts
- Jump in soft assets relative to sales
- Unexpected increase in capital expenditures
- Recording purchase of inventory as an investing outflow
- Investing outflows that sound like a normal cost of business
- Purchasing patents, contracts, and development-stage technologies

## Looking Ahead

As Chapter 11 showed, shifting operating cash outflows to the Investing section can be quite enticing for managements that hope to impress investors with stronger cash flow. Well, it seems that management cannot get enough of a good thing. Chapter 12 shows how, just by a quirk in acquisition accounting, management can shift a boatload of working capital that normally depresses operating cash flows to the Investing section.

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# 12

## CASH FLOW SHENANIGAN No. 3: INFLATING OPERATING CASH FLOW USING ACQUISITIONS OR DISPOSALS

The Friday after Thanksgiving is generally considered the unofficial start of the holiday shopping season. Traditionally, it is one of the biggest shopping days of the year, if not *the* biggest. The day has long been called “Black Friday,” since many people are hopeful that it will be the day when retailers move “into the black” (slang for “turning a profit”) for the year. Every time Black Friday approaches, retailers are quick to remind us of all the holiday shopping that we need to do. They offer huge sales and fill the airwaves and newsprint with “Shop ‘Til You Drop” advertisements trying to lure us into their stores.



Tyco and WorldCom seemed to adhere to the “Shop ‘Til You Drop” mantra quite literally; however, they were buying entire businesses, and their holiday season ran all year long for many years. In the late 1990s and early 2000s, both companies went on lavish shopping sprees, acquiring business after business in order to fuel impressive performance. Organic growth at Tyco and WorldCom was much weaker than investors realized, though, as they hid their problems by acquiring oodles of companies and futzing with the accounting to show impressive results. They shopped and shopped—until the exposure of their massive accounting frauds caused them to drop like a ton of bricks.

Throughout their shopping sprees, both companies satiated investors and quashed red flags by consistently reporting strong cash flow from operations. However, in reality, this cash flow was not a sign of operational strength at all. Rather, it came mainly from a liberal use of Cash Flow Shenanigan No. 3: Inflating Operating Cash Flow Using Acquisitions or Disposals.

In this chapter, we will discuss three techniques by which Tyco, WorldCom, and other such companies use acquisitions and disposals to enhance and flatter cash flow from operations (CFFO).

## **Techniques to Inflate Operating Cash Flow Using Acquisitions or Disposals**

1. Inheriting Operating Inflows in a Normal Business Acquisition
2. Acquiring Contracts or Customers Rather Than Developing Them Internally
3. Boosting CFFO by Creatively Structuring the Sale of a Business

### **1. Inheriting Operating Inflows in a Normal Business Acquisition**

The cash flow shifting tricks in this chapter have many similarities to the ones we discussed in the previous chapter; they represent shifts between the Operating and the Investing sections. However,

in this chapter, we focus solely on shifts that are related specifically to acquisitions and disposals. The first two techniques in this chapter involve shifting Operating cash outflows to the Investing section, as shown in Figure 12-1.

Rabidly acquisitive companies such as Tyco and WorldCom routinely reported impressive CFFO quarter after quarter. Faced with the opacity that is inherent whenever multiple sets of financial statements are suddenly combined, investors in these companies began to rely more heavily on CFFO generation as a sign of business strength and earnings quality. Unfortunately, heavy reliance on CFFO for acquisitive companies is ill advised because of a deep, dark secret that companies don't want investors to know.

This secret concerns an accounting quirk (read loophole) that enables acquisitive companies to show strong CFFO every quarter *simply because they are acquiring other businesses*. In other words, the mere act of acquiring a company provides a benefit to CFFO. How can this be true? Well, it's a peculiar side effect from the accounting rules that segregate cash flows into three sections. The quirk is actually quite simple and easy to understand.

Imagine you are a company that is getting ready to make a business acquisition. When you pay for the acquisition, you do so without affecting CFFO. If you buy the company with cash, the payment is recorded as an *Investing outflow*. If you offer stock instead, there is, of course, no cash outflow.

As soon as you gain control of the company, all of the ins and outs of the acquired business become a part of the combined

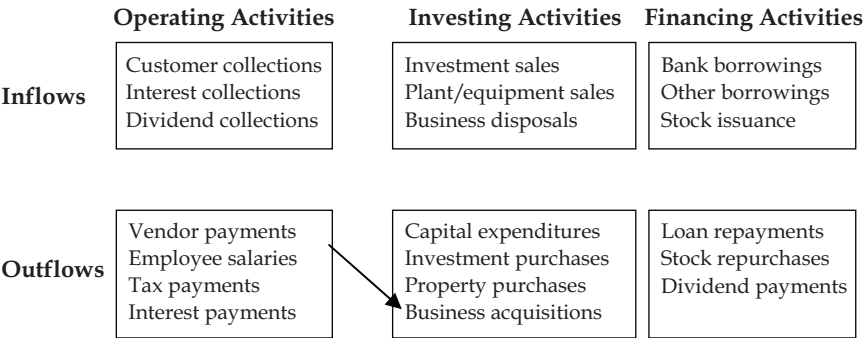


Figure 12-1.

company's operations. For example, when the newly acquired company makes a sale, you naturally record that on your Statement of Income as revenue. Similarly, when the newly acquired company collects cash from a customer, you record that collection on your Statement of Cash Flows as an Operating inflow. Think about the cash flow implications of this situation. For one, you were able to generate a new cash flow stream (the acquired business) without any initial CFFO outflow. In contrast, companies that seek to grow their business *organically* would generally first incur CFFO outflows in order to build the new business.

Additionally, now that you inherited the receivables and inventory of the acquired business, you can generate an unsustainable CFFO benefit by rapidly liquidating these assets (that is, by collecting the receivables and selling the inventory). Normally, accounts receivable result from past cash expenditures (e.g., cash paid to purchase or manufacture the inventory sold). In other words, a cash inflow from collecting a receivable comes only after you have had a cash outflow to generate that receivable. When you acquire a company, however, and inherit its accounts receivable, the cash outflows involved in generating those receivables were recorded on the acquired company's books prior to the acquisition. This means that when you collect those receivables, you will be receiving an *Operating* cash inflow without ever having recorded a corresponding *Operating* cash outflow. The same is true with inventory. The proceeds received from selling inventory inherited in an acquisition will be recorded as an Operating inflow even though no Operating outflow ever occurred.

Think of it this way: cash spent to purchase inventory and other costs related to the sale *occurred before the acquisition*, and when you close on the deal, you obviously must pay the seller for inventory, receivables, and so on, but those outflows are reflected in the Investing section. Then, after the deal closes, you collect all that delicious cash from customers and show it as inflows in the Operating section. By liquidating and not replenishing these assets (e.g., keeping the acquired business's inventories at a lower level), you can show an unsustainable benefit to cash flow. Brilliant! In an acquisition context, cash outflows never hit the Operating section, yet all the inflows do.

To be fair, when companies inherit working capital liabilities (like accounts payable), then the acquirer will be on the hook for

paying off the seller's vendors and the cash paid will be an Operating cash outflow. However, most acquisitions involve companies that *have positive net working capital* (more receivables and inventory than accounts payable).

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### Accounting Capsule: The Impact of Acquisition Accounting on CFFO

A quirk in the accounting rules gives many companies a benefit to CFFO just for making an acquisition. A company that is growing organically will incur CFFO outflows (payments for creating and marketing products) in order to create CFFO inflows (receipts from customers). However, a company that is growing by acquiring other businesses generates growth without the stigma of those initial CFFO outflows.

To understand why, realize that cash spent to acquire another business runs through the Investing section of the Statement of Cash Flows (SCF) (of course, stock issued for an acquisition does not impact the SCF at all). As a result, when buying another business, companies inherit a brand new stream of cash flows without having to incur a CFFO outflow. Moreover, by liquidating the working capital of the acquired business, a company can provide itself with an unsustainable CFFO boost. These accounting nuances are why companies that grow through acquisitions often appear to have stronger CFFO than companies that grow organically.

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It is important to realize that because this CFFO boost is considered perfectly permissible, even the most honest companies will benefit from inflated CFFO after making an acquisition. Moreover, this boost may cause "quality of earnings" measures (such as CFFO minus net income) to improve, particularly if a company does not engage in any Earnings Manipulation Shenanigans at the time of the acquisition.

### **Serial Acquirers Receive This CFFO Boost Repeatedly**

So far, we have established that by their very nature, acquisitions serve to boost CFFO. Consider the impact at companies that make numerous acquisitions every year, serial acquirers like our friends at Tyco and WorldCom. Many investors criticize serial acquirers

for being able to produce revenue and earnings growth only inorganically by “rolling up” acquisitions.

These “roll-ups” often reject this criticism and point to their CFFO as proof that they are running the acquired businesses well and exploiting synergies. Many investors believe this hype because they fail to understand the lesson that you just learned: stronger reported CFFO is merely an accounting side effect from acquiring numerous companies each year. Don’t misunderstand; we love companies that generate strong operating cash flows. What we don’t love are companies that make numerous acquisitions of mediocre companies and brag to investors about the strength of their underlying business, pointing to the exploding CFFO. They know the real story: the cash flow boost had virtually nothing to do with the performance of their business. They took advantage of the loopholes in acquisition accounting rules.

### **Putting the “Con” in Conglomerate**

For some companies, these pure boosts to cash flow are just not enough. They want to squeeze even more juice out of these acquisitions. Consider the following scenario, based on allegations in legal proceedings of Tyco’s behavior during the acquisition process.

Imagine that you work in the accounting department of a company that just announced that it was being bought by a serial acquirer. The acquisition has not officially happened yet, but it is a friendly takeover with lucrative terms, and the deal is likely to close before the end of the month. The new owners want to start coordinating operations.

In walks one of the finance executives from the acquirer. He calls a meeting with the team and discusses some logistics that he says will help the transition go more smoothly.

He points to a pile of checks—payments from customers that you had planned to deposit later that day. “You see all those checks? I know you normally deposit them at the end of the day, but let’s hold off on that for now. Put them in this drawer, and we’ll deposit them in a few weeks. And let’s call up our biggest customers and tell them that they can hold off on paying us for a few weeks. I know that sounds odd, but this will score us some points and ensure that they stay loyal through the transition.

“And you see that pile of bills? I know you normally wait until the deadline approaches to pay them; however, let’s pay them

down ASAP. In fact, see if you can prepay any vendors or suppliers—I'm sure those folks would be willing to take our money and perhaps even give us a discount. We certainly have enough cash in the bank; let's put it to good use."

The day after the acquisition closes, the executive returns. "Now that we are one company, it's time to go back to normal business procedure. Deposit those checks immediately and start collecting from customers. And stop paying those bills early—let's wait until we get closer to the deadline."

Think about the cash flow implications of this scenario. The target company's CFFO was abnormally low in the weeks leading up to the acquisition as a result of abandoning collection efforts and paying down bills rapidly. However, once the acquisition closed, there were an unusually large number of receivables to collect and an unusually small number of bills to pay. This causes CFFO for your division to be abnormally high in the period immediately after the acquisition.

The finance executive had a trick up his sleeve. His reasons for abandoning collection efforts and prepaying vendors had little to do with engendering goodwill. He concocted this scheme in order to boost the CFFO of the combined company in the first quarter after the acquisition. Granted, the effect of this benefit would be short-lived; however, the executive knew that the scheme could continue as long as the company kept rolling up more and more acquisitions each quarter.

### **Tyco: The Mother of All Roll-Ups**

This scenario is similar to allegations of what happened behind the scenes when Tyco made its acquisitions. And Tyco made *a lot* of acquisitions. From 1999 to 2002, Tyco bought more than 700 companies (that's not a typo) for a total of approximately \$29 billion. Some of these acquisitions were large companies; however, most of the businesses acquired were small enough that Tyco considered them "immaterial" and chose to disclose nothing at all about them. Imagine the impact that this game could have with 700 companies worth a combined \$29 billion! It should come as no surprise, then, that Tyco was able to generate strong CFFO over these years, as shown in Table 12-1. But it certainly was not from a booming business!

Table 12-1. Tyco's Cash Flow from Operations (from Continuing Operations)

(\$ millions)	FY 2002	FY 2001	FY 2000	FY 1999
Cash flow from operations	5,696	6,926	5,275	3,550

**Treat CFFO Differently for Acquisitive Companies.** Since acquisitions create an unsustainable boost to CFFO, investors should not blindly rely on CFFO as a barometer of performance. Use free cash flow after acquisitions to assess cash generation at acquisitive companies. Table 12-2 shows that Tyco recorded negative free cash flow after acquisitions each year, despite reporting positive CFFO; this was a warning that operating cash flow was not what it appeared to be.

**Tip:** "Free cash flow after acquisitions" is a useful measure of cash flow when analyzing serial acquirers. This metric can easily be calculated from the Statement of Cash Flows: CFFO *minus* capital expenditures *minus* cash paid for acquisitions.

**Review the Balance Sheets of Acquired Companies.** If these documents are available, then by all means review them. Doing so should help you gauge the potential inherent working capital benefits. It

Table 12-2. Tyco's Free Cash Flow After Acquisitions (from Continuing Operations)

(\$ millions)	2002	2001	2000	1999
<b>Reported cash flow from operations</b>	<b>5,696</b>	<b>6,926</b>	<b>5,275</b>	<b>3,550</b>
Subtract: Capital expenditures	(1,709)	(1,798)	(1,704)	(1,632)
Subtract: Construction in Progress	(1,146)	(2,248)	(111)	—
<b>Free cash flow</b>	<b>2,841</b>	<b>2,880</b>	<b>3,460</b>	<b>1,918</b>
Subtract: Acquisitions	(3,709)	(11,851)	(4,791)	(5,135)
<b>Free cash flow after acquisitions</b>	<b>(868)</b>	<b>(8,971)</b>	<b>(1,331)</b>	<b>(3,217)</b>

may be difficult to be precise in this analysis; however, you often will be able to make an assessment that is within the “ballpark” of the potential benefit. Companies often disclose the Balance Sheets of larger acquisitions and sometimes an aggregate Balance Sheet for smaller ones in their footnotes. If the acquired company had publicly traded stock or bonds, you can probably obtain a Balance Sheet from public records.

## **2. Acquiring Contracts or Customers Rather Than Developing Them Internally**

In the previous section, we discussed how acquisitions, by their very nature, provide a boost to CFFO. This benefit results not from illegitimate accounting maneuvers, but rather from quirky accounting rules. We witnessed Tyco abusing the rules by quietly snapping up hundreds of small companies and finding ways to squeeze even more CFFO out of these acquisitions.

In this section, we take a step into more nefarious terrain and explore how companies use the acquisition accounting loophole for nonacquisition situations to shift normal operating cash flows to the Investing section.

Witness Tyco (again) and its electronic security monitoring business. Home security monitoring was a fast-growing business in the 1990s, and Tyco’s ADT division proved to be among the most popular brand names. Tyco generated new security systems contracts in two ways: through its own direct sales force and through an external network of dealerships. The dealers allowed Tyco to outsource a portion of its sales force. They were not on Tyco’s payroll, but they sold security contracts, and Tyco paid them about \$800 for every new customer.

Oddly, Tyco executives did not view these \$800 payments to dealers to be normal customer solicitation costs, as the economics would suggest. Instead, they deemed these payments to be a purchase price for the “acquisition” of contracts. Thus, after the dealer presented Tyco with a number of contracts and received payment, Tyco curiously accounted for these “contract acquisitions” in the same way that it accounted for normal business acquisitions: as Investing outflows.

Given how deeply the acquisition mentality was engrained in Tyco’s culture and DNA, you can almost picture confusion among



its executives. Almost. These customer solicitation costs resemble normal operating expenditures much more closely than they resemble business acquisitions. As a result, it makes more sense for them to be recorded on the Statement of Cash Flows in the same way that Tyco's internal sales force commissions are recorded: as Operating outflows. By classifying these operating outflows in the "acquisitions" line in the Investing section, Tyco found a convenient way to overstate CFFO. *And the company didn't stop there!*

### **From Aggressive Accounting to Fraud**

By turning the Investing section into a hidden dumping ground for customer solicitation costs, Tyco aggressively and creatively twisted the accounting rules. But the company still wanted more. So it concocted a new scheme to inflate CFFO (and earnings) even further, and in so doing, crossed the line from aggressive accounting to fraud. The SEC charged that from 1998 to 2002, Tyco used a "Dealer Connection Fee Sham Transaction" to fraudulently generate \$719 million in CFFO. Here's how it worked.

For every contract Tyco purchased from a dealer, the dealer would be required to pay an up-front \$200 "dealer connection fee." Of course, the dealers would not be happy about this new fee, so Tyco raised the price at which it would purchase new contracts by the same \$200—from \$800 to \$1,000. The net result caused no change in the economics of the transaction—Tyco was still paying a net of \$800 to purchase these contracts from dealers.

However, Tyco did not see it that way. After all, the company would not have created the ruse if it didn't think that it would prove to be beneficial in the end. Tyco now recorded a \$1,000 Investing outflow for the purchase of these contracts, and an offsetting \$200 as an Operating inflow. Essentially, Tyco created a bogus \$200 CFFO inflow by depressing its Investing cash flow. (See Table 12-3.) Over the course of five years and hundreds of thousands of contracts, this was quite a contribution to CFFO!

### **3. Boosting CFFO by Creatively Structuring the Sale of a Business**

In the previous two sections, we showed how companies use acquisitions to shift cash *outflows* from the Operating section to the

Table 12-3. Tyco’s Creative Classification of Net Payments to Dealers

	Original	Sham	Tyco’s SCF
Tyco purchases contract from dealer	\$800	\$1,000	Investing outflow
Dealer pays “connection fee” to Tyco	—	(\$200)	Operating inflow
Net payment by Tyco to dealer	\$800	\$800	—

Investing section of the SCF. In this next section, we discuss the flip side of that coin: how companies use disposals to shift cash *inflows* from the Investing section to the Operating section, as shown in Figure 12-2.

**Recording CFFO for Proceeds from the Sale of a Business**

In 2005, Softbank structured an interesting two-way arrangement with a fellow Japanese telecom company, Gemini BB. Softbank sold its modem rental business to Gemini, and simultaneously, the companies entered into a “service agreement” in which Gemini would pay Softbank royalties based on the modem rental business’s future revenue. At the time of the sale, Softbank received ¥85 million in cash from Gemini, but it did not consider the entire amount to be related to the sale price of the business, according to a report by RiskMetrics Group. Instead, Softbank decided to split the cash

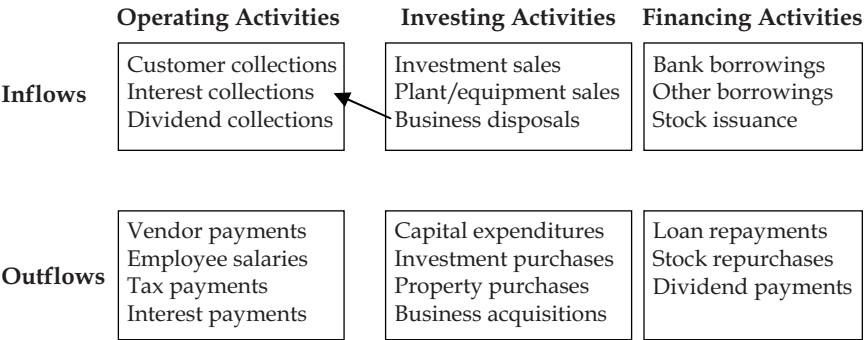


Figure 12-2.

received into two categories: ¥45 million was allocated to the sale of the business, and ¥40 million was deemed to be an “advance” on the future royalty revenue stream. (You may recall the earnings boost that this transaction provided, as discussed in EM Shenanigan No. 3.)

The economic reality of this situation seems to be that Softbank sold its modem rental business for ¥85 million. However, the way it structured the transaction seemingly allowed Softbank to exercise discretion in its presentation of cash flow. Rather than recording an ¥85 million *Investing* inflow from the sale of the business, Softbank recorded (1) a ¥45 million *Investing* inflow from the sale of the business and (2) a ¥40 million *Operating* inflow from the “advance” on future revenue. This ¥40 million boost to CFFO represented 69 percent of Softbank’s ¥57.8 million in CFFO for the full year.

**Watch for New Categories on the Statement of Cash Flows.** Investors could easily have spotted Softbank’s CFFO boost just by looking at the Statement of Cash Flows. Take a look at Table 12-4, and note that a new line item surfaced in 2006—a ¥40 million “increase in deferred revenue.” This Statement of Cash Flows disclosure, together with the magnitude of its impact on CFFO, would be reason enough for astute investors to dig deeper.

**Sell the Business, but Keep Some of the Good Stuff**

Tenet Healthcare is a company that owns and operates hospitals and medical centers. In recent years, Tenet has been selling some

Table 12-4. Softbank’s Statement of Cash Flows, 2005–2006

(¥ millions)	2006	2005
<b>Pretax earnings</b>	129,484	(9,549)
Depreciation and amortization	80,418	66,417
Other noncash gains, net	(136,455)	(115,659)
Increase in trade receivables	(23,333)	(15,854)
Increase in trade payables	4,331	2,373
<b>Increase in deferred revenue</b>	<b>40,000</b>	<b>—</b>
Increase in other receivables	(9,865)	(70,813)
Increase (decrease) in other payables	(26,774)	97,096
Cash flow from operating activities	57,806	(45,989)

of its hospitals in order to improve its liquidity and profitability. It often plays a neat little CFFO-enhancing trick when structuring the sale of these hospitals—it sells *everything but the receivables*.

Let's discuss how this works. Think of each hospital as being its own little business, with revenue, expenses, cash, receivables, payables, and so on, just like any other company. Before putting a hospital up for sale, Tenet strips the receivables out of the business. In other words, if a hospital has, say, \$10 million in receivables, Tenet keeps the rights to those receivables and puts the rest of the business up for sale. This, of course, lowers the eventual sale price of the hospital by about \$10 million, but Tenet couldn't care less, as it recoups that amount when it collects the receivables.

What are the implications with regard to cash flow? Well, normally all proceeds from selling a hospital would be recorded as an Investing inflow (just like the sale of any business or fixed assets). However, by stripping out the receivables prior to the sale, Tenet lowers the sale price (and the Investing inflow) by \$10 million. However, the company will soon collect the \$10 million from its former customers, and here's the nice part: all the proceeds will be reported as an Operating inflow, since it is related to the collection of receivables. This trick allowed Tenet to shift the \$10 million inflow from the Investing to the Operating section.

This game was easily recognizable by those diligent investors that read Tenet's financial reports. As presented in the box, the company clearly disclosed in its March 2004 10-Q that it planned to keep \$394 million in receivables in connection with the sale of 27 hospitals. Careful investors were not misled into thinking that this gimmick actually produced sustainable CFFO.

#### TENET'S DISCLOSURE ABOUT THE SALE OF HOSPITALS, 3/04 10-Q

Because *we do not intend to sell the accounts receivable* of the asset group, except for one hospital, these receivables, less the related allowance for doubtful accounts, have been included in our consolidated net accounts receivable in the accompanying condensed consolidated Balance Sheets. At March 31, 2004, *the net accounts receivable for the hospitals to be divested aggregated \$394 million.* [Italics added for emphasis.]

## Looking Back

### **Warning Signs: Inflating Operating Cash Flow Using Acquisitions or Disposals**

- Inheriting Operating cash inflows in a normal business acquisition
- Companies that make numerous acquisitions
- Declining free cash flow while CFFO appears to be strong
- Acquiring contracts or customers rather than developing them internally
- Boosting CFFO by creatively structuring the sale of a business
- New categories appearing on the Statement of Cash Flows
- Selling a business, but keeping the related receivables

## Looking Ahead

The next chapter completes our discussion of shenanigans that companies use to inflate operating cash flow. Unlike the first three Cash Flow Shenanigans, which all involved shifting the “bad stuff” out and pushing the “good stuff” in, the fourth one discusses one-time unsustainable boosts to operating cash flow—not shifting or pushing from one section to another, but just plain old one-time boosts that investors should not expect to see in future periods.

# 13

## CASH FLOW SHENANIGAN No. 4: BOOSTING OPERATING CASH FLOW USING UNSUSTAINABLE ACTIVITIES

With local versions in more than 100 countries, the hit game show *Who Wants to Be a Millionaire?* is one of the most internationally successful television franchises of all time. The game is alluringly simple: contestants are asked up to 15 trivia questions. Answering all questions correctly will win the grand prize; however, if the contestant gives one wrong answer, he or she goes home.

If a contestant is struggling with a question, the rules allow for the use of a “lifeline.” For example, one lifeline allows the contestant to ask an expert for help, and another polls the studio audience for its opinion. These lifelines can prove very valuable and often keep struggling contestants afloat. However, they must be used

judiciously, since there are just three of them, and once they're gone, they're gone.

Similarly, struggling companies often use valuable "lifelines" to help them keep their cash flow afloat. Just as in the game show, it is often wise and certainly legitimate for companies to use these lifelines. Unlike in the game show, however, companies may fail to disclose the use of these nonrecurring cash flow lifelines. It is up to you to spot them, because once they're gone, they're gone.

In Chapter 13 we discuss four unsustainable lifelines that companies use to boost their cash flow from operations (CFFO).

## **Techniques to Boost Operating Cash Flow Using Unsustainable Activities**

1. Boosting CFFO by Paying Vendors More Slowly
2. Boosting CFFO by Collecting from Customers More Quickly
3. Boosting CFFO by Purchasing Less Inventory
4. Boosting CFFO with One-Time Benefits

### **1. Boosting CFFO by Paying Vendors More Slowly**

Want to save a little more cash this year? Use your "delay payments" lifeline: wait until the beginning of January to pay your December bills. If you push your payments out a month, your end-of-year bank balance will be higher, and it will cosmetically seem as if you generated more cash this year. However, you certainly would not be under the delusion that you had found a recurring way to grow your cash flow each year; rather, you would realize that this was a one-time benefit. To grow your cash flow again next year, you would have to push two months' worth of payments into the following January.

Your "delay payments" lifeline may be a helpful cash-management strategy, and there is certainly nothing wrong with holding your money a month longer. In the same way, it is completely appropriate for a company to take longer to pay back its vendors and reap the immediate cash-management benefits. However, just like you, companies cannot continue to delay payments into eternity.

The cash inflow from pushing out payments (i.e., an increase in payables) should be considered a one-time activity, not a sign that the company has found a lasting way to generate more cash. While this may seem like common sense, you would be surprised at how many companies tout their CFFO strength and forget to mention their little secret: that they increased CFFO by stringing out vendors and not paying them in a timely fashion.

### **Home Depot Squeezes Its Vendors**

Just days after losing an internal management succession battle to replace the legendary Jack Welch at GE, Bob Nardelli's consolation prize was the top job at The Home Depot Inc. Appointed in December 2000, Nardelli immediately was hailed as the master operating executive that the unruly home improvement retail chain desperately needed. The board loved his GE pedigree and rewarded him right off the bat with an extremely generous compensation package. And Nardelli definitely knew how to please. In his first year on the job, he more than doubled CFFO—from \$2.8 billion to nearly \$6 billion. Investors who were not too worried about the details were thrilled.

This cash flow growth, however, would prove to be unsustainable and unrelated to increasing sales at the business. In that first year, Nardelli did a masterful job of redefining the way Home Depot did business with its vendors. Specifically, the company started treating them very badly by paying them much more slowly. By the end of fiscal 2001, Home Depot had successfully stretched out accounts payable to 34 days from 22 the year earlier. The company's Statement of Cash Flows (SCF) (Table 13-1) reveals that this seemingly small change in accounts payable was the primary driver of the company's impressive cash flow growth. Another large component of CFFO growth was a decrease in the amount of inventory at each store (as we discuss later in this chapter).

Okay, mission accomplished for 2001. The next year, Home Depot was faced with the challenge of improving upon an incredible 2001. In order to grow CFFO again, however, the company first would have to replicate the 2001 boost that it would no longer receive in 2002. The company was able to stretch payables again in 2002, but not to the extent of the prior year (as payables reached 41 days from 34 days). CFFO for 2002 fell to \$4.8 billion from \$6.0 billion in 2001.



Table 13-1. Home Depot Statement of Cash Flows, 2000–2002

(\$ millions)	Fiscal Year		
	2002	2001	2000
<b>Net earnings</b>	<b>3,664</b>	<b>3,044</b>	<b>2,581</b>
Depreciation and amortization	903	764	601
Increase in receivables, net	(38)	(119)	(246)
<b>Increase in merchandise inventories</b>	<b>(1,592)</b>	<b>(166)</b>	<b>(1,075)</b>
<b>Increase in accounts payable and accrued liabilities</b>	<b>1,394</b>	<b>1,878</b>	<b>268</b>
Increase in deferred revenue	147	200	486
Increase in income taxes payable	83	272	151
Increase (decrease) in deferred income taxes	173	(6)	108
Other	68	96	(78)
<b>Net cash provided by operations</b>	<b>4,802</b>	<b>5,963</b>	<b>2,796</b>

#### Accounting Capsule: Days' Sales of Payables (DSP)

Days' sales of payables (DSP) is generally calculated as follows:

Accounts payable/cost of goods sold × number of days in the period (for quarterly periods, 91.25 days is a normal approximation)

Investors should analyze payables in terms of days' sales, in much the same way that they analyze receivables (days' sales outstanding, or DSO) and inventory (days' sales of inventory, or DSI). An increase in DSP means that the company is paying off its payables over a longer period of time. A decrease in DSP means that the company is paying its bills more quickly.

Investors should note that Nardelli's cash-management techniques certainly were not inappropriate and seemed beneficial to the company's operations. The takeaway here, however, is that the \$3 billion increase in CFFO during 2001 should have been viewed as nonrecurring. Alert investors would have correctly anticipated that CFFO would shrink in 2002.

**Watch for an Increase in Payables.** An increase in payables relative to cost of goods sold (COGS) tells you that the company has prob-

ably stretched out its payments to vendors. Assess the extent to which CFFO growth is derived from stretching out payments to vendors and consider that amount an unsustainable boost that is unrelated to improved business activities.

**Look for Large Positive Swings on the Statement of Cash Flows.** A quick review of Home Depot's CFFO in 2001 shows that improvements in accounts payable and inventory were the primary drivers of CFFO growth. (See Table 13-1.) In the following year, it is evident that Home Depot's inability to sustain that improvement was the primary source of CFFO deterioration.

**Be Alert When Companies Use Accounts Payable "Financing."** Auto parts retailers Advance Auto Parts, AutoZone, and Pep Boys all used bank loans to pay their vendors in 2004 (think of these arrangements as accounts payable "financing"). While the arrangements were essentially identical at all three companies, interestingly, each company recorded the cash flow impact differently. According to a report by the Center for Financial Research and Analysis (CFRA), Advanced Auto Parts recorded its loans as a Financing activity, AutoZone recorded them as Operating, and Pep Boys used a curious hybrid approach—inflows as Operating, but outflows as Financing. We believe that Advanced Auto Parts' approach makes the most economic sense, since these arrangements are essentially financing activities.

This anecdote shows the enormous management discretion available in classifying a fairly straightforward transaction on the Statement of Cash Flows. In order to properly compare cash flow generation at these competitors, investors must adjust for this difference in policy. Each company provided sufficient disclosure to understand its SCF classification. Diligent investors would have used those disclosures to reflect both sides of the loan transaction (inflows and outflows) as Financing, not Operating.

**Tip:** Accounts payable is a relatively straightforward account. If you see a discussion of accounts payable that is longer than a couple of sentences, there is probably something in there that you want to know (for example, accounts payable financing arrangements).

**Watch for Swings in Other Payables Accounts.** Accounts payable is not the only obligation that companies can use to manage their cash flow. CFFO can be influenced by the timing of payments on many liability accounts, including tax payments, payroll or bonus payments, and pension plan contributions. Consider how Callaway Golf Company's tax situation resulted in unsustainably strong CFFO in 2005.

Callaway spent the off-season working on its long game. The dedication seemed to pay off. In 2005, Callaway drove its CFFO up to \$70.3 million—quite an improvement from the \$8.5 million duff in 2004. A quick check of the Statement of Cash Flows reveals that CFFO growth came from an improved swing—that is, a \$55.8 million “swing” in the impact of tax payables and receivables (apparently as a result of net tax refunds and settlements). It should not have been too rough for investors to spot this tax swing on the Statement of Cash Flows and deduce that Callaway's strong CFFO growth would not recur.

## **2. Boosting CFFO by Collecting from Customers More Quickly**

Another way in which companies can generate a nonrecurring CFFO boost would be to convince customers to pay them more quickly. This certainly would not be considered a bad thing, and it may even speak well of a company's significant leverage over its customers. However, as in our discussion about stretching out payables, companies cannot continue to collect at a faster and faster rate every quarter in perpetuity. As a result, the growth in CFFO that results from accelerated collections should be deemed unsustainable.

Take, for example, technology services provider EDS (now part of Hewlett-Packard). In 2002, EDS renegotiated a contract with an existing customer and received up front a \$200 million prepayment for services that the company was scheduled to provide over the next two years. Clearly, prepayments from customers are not a bad thing; in fact, most companies would love to be in this position. However, EDS failed to level with investors and tell them that this inflow should be considered just an accelerated payment and was unsustainable in nature. It should have explained that the boost in CFFO was ephemeral and that this unprecedented transaction was

the primary driver of its cash flow growth. Indeed, the \$200 million prepayment accounted for 26 percent of CFFO in the first half of 2002 and more than all of its growth over the prior year. (See Table 13-2.) Given how closely investors followed EDS’s cash flow, the SEC found the company’s disclosure to be inadequate.

**Watch for New Disclosure about Prepayments.** EDS did give investors a hint that it was receiving more prepayments when discussing cash flow growth in its June 2002 10-Q. However, the disclosure was very limited (shown in the following box), so much so that the SEC deemed it inadequate given the magnitude of the prepayment.

**EDS’S 10-Q DISCLOSURE WAS SPARSE**

This increase of receivables was more than offset by an increase in deferred revenue due to an *increase in customer prepayments* as well as lower payments on current liabilities. [Italics added for emphasis.]

**Watch for Elaborate Strategies to Influence the Timing of Cash Flow.** Warning signs about accelerated collections could certainly have been spotted at Silicon Graphics several quarters before its May 2006 bankruptcy. The company was burdened with debt and did everything in its power to portray to investors a stronger liquidity position. Unlike companies that may use a position of power with customers to accelerate collections, Silicon Graphics’ diminished health compelled it to offer discounts to induce early payments. Consider the disclosure shown here from the company’s September 2005 10-Q. Also, notice other cash management tricks that Silicon Graphics was playing (holding vendor payments and

Table 13-2. EDS’s CFFO, Adjusted to Remove Unusual Prepayment from Customer

(\$ millions)	H1, 6/02	H1, 6/01
Cash flow from operations	759	581
Subtract: Unusual customer prepayment	(200)	—
CFFO excluding prepayment	559	581

buying inventory at the end of the quarter) to show cash on its Balance Sheet at its highest point on the last day of the quarter. Diligent investors would have noticed these issues and known that disaster was not far away.

#### SILICON GRAPHICS INC. SEPTEMBER 2005 10-Q

During the first quarter of fiscal 2006, we maintained our focus on customer cash collections and *offered certain customers discounted terms for early payment*. As a result, our days' sales outstanding were 37 days at September 30, 2005, down from 49 days at June 24, 2005 and 39 days at September 24, 2004. We expect that days' sales outstanding will be more in line with historical levels in the second quarter of fiscal 2006. . . .

. . . We also experience significant intra-quarter fluctuations in our cash levels, with the result that *our cash balances are generally at their highest point at the end of each quarter and significantly lower at other times*. These intra-quarter fluctuations reflect our business cycle, with significant requirements for inventory purchases in the early part of the quarter and most sales closing in the last few weeks of the quarter. *To maintain adequate levels of unrestricted cash within each quarter, we offer certain customers discounted terms for early payment and hold certain vendor payments to the beginning of the following quarter.* [Italics added for emphasis.]

**Be Wary of Dramatic Improvements in CFFO.** Telecom equipment manufacturer UTStarcom reported markedly improved CFFO in early 2008. After a dismal 2007, in which it logged four consecutive quarters of negative CFFO (for a total cash burn of \$218 million), UTStarcom suddenly reported positive cash flow of \$97 million in March 2008. Investors could have readily noticed that the cash flow turnaround resulted from a number of particularly aggressive working capital actions. A quick peek at the Balance Sheet revealed a \$65 million drop in accounts receivable and a \$66 million increase in accounts payable. The 10-Q gave more insight and mentioned one of those “management decisions” we warned you about in CF Shenanigan No. 1 with the infamous Computer Associates. (See the accompanying disclosure from UTStarcom’s March 2008 10-Q.)

### UTSTARCOM'S 10-Q DISCLOSURE TOLD THE STORY

The decrease in accounts receivable was primarily due to strong customer collections in our PCD business segment. The increase in accounts payable was due to the high level of inventory purchasing activity late into the first quarter of 2008, as well as a *management decision to forgo early payment discounts with a significant vendor.* [Italics added for emphasis.]

UTStarcom proceeded to report negative operating cash flow throughout the rest of 2008. Despite the \$97 million in positive CFFO during the first quarter, the company ended the year in a hole, having burned through \$55 million in operating cash flow.

**Tip:** While many investors are pleased when management says that it is “aggressively managing working capital,” you should take this as a warning sign that recent CFFO growth may not be sustainable.

### 3. Boosting CFFO by Purchasing Less Inventory

Home Depot, as you recall, received an unsustainable CFFO boost in 2001 from stretching out payments to vendors. Well, the company had another CFFO-improving trick up its sleeve: purchasing less inventory.

Earlier in this chapter, we discussed how Bob Nardelli doubled Home Depot’s operating cash flow in his first year on the job by stretching out vendor payables and reducing the amount of inventory at each store. Home Depot lowered its inventory levels simply by not restocking shelves after goods had been sold. In other words, the company just did not purchase as much inventory from vendors as in previous years.

If you recall from our earlier discussion of Home Depot, stretching out vendor payments produced a large positive “swing” on the Statement of Cash Flows. In the same way, failing to restock inventory levels would also provide an unsustainable boost to CFFO. Let’s revisit Home Depot’s Statement of Cash Flows in Table 13-1 to see the inventory swing from an outflow of \$1.1 billion in 2000 to an

outflow of only \$166 million in 2001 (and then back to an outflow of \$1.6 billion in 2002 as the benefit reversed).

To be fair, Home Depot was very clear in its disclosure under the “Liquidity and Capital Resources” section of its 10-K filing, stating that CFFO growth primarily had been driven by an extension of payables and a decrease in inventory per store (see the disclosure in the accompanying box). Investors would be well served by reading through the entire document because such important nuggets of information can be found deep inside the filing.

#### HOME DEPOT 2/2002 10-K

For fiscal 2001, cash provided by operations increased to \$6.0 billion from \$2.8 billion in fiscal 2000. The increase was primarily due to significant growth in days payable outstanding from 23 days at the end of fiscal 2000 to 34 days at the end of fiscal 2001, a 12.7% decrease in average inventory per store as of the end of fiscal 2001 and increased operating income.

In the next year, Home Depot did not benefit from a decrease in inventory. However, it provided a good spin on this in the “Liquidity and Capital Resources” section, suggesting that it had pared back inventory too much in the previous year:

#### HOME DEPOT 2/2003 10-K

For fiscal 2002, cash provided by operations decreased to \$4.8 billion from \$6.0 billion in fiscal 2001. The decrease was primarily due to a 7.9% *increase in average inventory per store resulting from our focus on improving our in-stock position in fiscal 2002*. [Italics added for emphasis.]

**Tip:** Buried in the 10-Qs and 10-Ks is some extra insight about the drivers of cash flow. It is one of the most important sections of the filing, but many investors don’t know it exists. To find it, turn to the Management Discussion & Analysis (MD&A)—near the back is a section often called “Liquidity and Capital Resources.” This section is a “must-read” for every company you analyze.

**Watch for Disclosure about Timing of Inventory Purchases within Each Quarter.** Silicon Graphics purchased inventory at the very beginning of each quarter and then worked it down as much as possible by the end of the period, only to purchase more once the quarter closed. (See the 10-Q disclosure in our earlier discussion on Silicon Graphics.) As with its receivables and payables management schemes, the company used this strategy to manipulate investor perceptions that its liquidity was adequate when, in reality, it was teetering on the brink of bankruptcy.

#### 4. Boosting CFFO with One-Time Benefits

Microsoft Corp. doled out billions of dollars to settle antitrust litigation in recent years. One of the largest recipients, Sun Microsystems, pocketed nearly \$2 billion from Microsoft in 2004 (\$1.6 billion of which was immediately recognized as income). Sun presented this large one-time item in plain view on its Statement of Income, listing it separately as “settlement income.” Sun’s disclosure made it very easy for investors to understand that the income from this settlement was nonrecurring and unrelated to its normal operations; it was reported “below the line” as nonoperating income.

Sun’s Statement of Cash Flows, however, was less clear. The company recorded the \$2 billion in cash as an Operating inflow (as is appropriate under the indirect method), but it was not listed separately on the SCF; rather, it was simply bundled with net income. As you would imagine, a \$2 billion settlement was quite material to Sun’s results—CFFO for all of 2004 was \$2.2 billion, up from \$1.0 billion in 2003. Diligent investors would have noticed this settlement reflected on the Statement of Income and should have immediately realized that it was an unsustainable source of CFFO.

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#### Accounting Capsule: The Meaning of “Operating”

The term *operating* means different things when it comes to “operating cash flow” and “operating income.” For example, taxes, interest, and large one-time events are considered to be a part of operating cash flow but not of operating income.

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**Tip:** Nonrecurring boosts to CFFO are often not plainly disclosed on the Statement of Cash Flows. Whenever you spot any kind of one-time earnings benefit, ask yourself: “How does this boost affect the Statement of Cash Flows?”

## Looking Back

### **Warning Signs: Boosting Operating Cash Flow Using Unsustainable Activities**

- Boosting CFFO by paying vendors more slowly
- Accounts payable increasing faster than cost of goods sold
- Increases in other payables accounts
- Large positive swings on the Statement of Cash Flows
- Evidence of accounts payable financing
- New disclosure about prepayments
- Offering customers incentives to pay invoices early
- Boosting CFFO by purchasing less inventory
- Disclosure about the timing of inventory purchases
- Dramatic improvements in CFFO
- CFFO benefit from one-time items

## Looking Ahead

Chapter 13 completes our unit on Cash Flow Shenanigans—techniques to inflate operating cash flows. In aggregate, Parts 2 and 3 focused on gimmicks to produce results that will impress investors with either higher reported earnings or higher operating cash flows. Well, if those doctored-up results still have not dazzled investors, some eager-to-please companies have developed a new group of tricks that involve the use of *Key Metrics*. We will share some of those deep dark secrets in Part 4.

# PART FOUR

## KEY METRICS SHENANIGANS

We have climbed the first two mountains in our quest to conquer financial shenanigans, with one big climb still to come. Until now, we have focused on assessing the performance of companies using two separate metrics: earnings and cash flow.

Part 2, “Earnings Manipulation Shenanigans,” discussed techniques for manipulating accrual-based performance numbers by playing around with revenue and expenses or shifting them to the wrong section or the wrong financial statement entirely. We pointed out the limitations of accrual-based performance metrics like net income, and suggested that investors should expand their analysis to evaluate cash flow performance metrics, such as cash flow from operations and free cash flow.

Part 3, “Cash Flow Shenanigans,” addressed a relatively new and troubling phenomenon: management’s propensity to use Cash Flow Shenanigans to give a company the misleading appearance of having strong operating and free cash flow. We also presented strategies that investors can use to detect Cash Flow Shenanigans and to adjust the reported numbers to remove these unsustainable boosts.

At this point, you can take a deep breath and feel good about your ability to evaluate a company’s “economic” performance through accrual-based (Statement of Income) and cash-based (Statement of Cash Flows) models, even when management employs shenanigans to hide the true story from investors. You have also learned how to uncover dozens of tricks used by management.

However, your quest is not yet over. In Part 4, “Key Metrics Shenanigans,” we discuss the importance of using other “key metrics” to evaluate a company’s performance and economic health, and we expose tricks that companies could use to cloud the picture and mislead investors.

## Two Key Metrics Shenanigans

Chapter 14	KM No. 1: Showcasing Misleading Metrics That Overstate Performance
Chapter 15	KM No. 2: Distorting Balance Sheet Metrics to Avoid Showing Deterioration

Successful investing requires a rigorous analysis of a broad array of financial performance and economic health metrics for a company. Some pertinent information can be found fairly easily by reading the Statement of Income, Statement of Cash Flows, and Balance Sheet. Other equally important information may be gleaned from supplementary documents (i.e., company press releases, earnings announcements, footnotes, and Management Discussion and Analysis included with the financial reports). In addition, investors should study the financial reporting of competitors, not only to compare performance and health measures, but also to assess the application of accounting standards and disclosure.

Now you have reams of data to read and analyze. Great, but before digging in, remember to ask these two important questions.

1. What are the *best metrics of that specific company’s performance*, and does management highlight, ignore, distort, or even make up its own version of these metrics?
2. What are the *best metrics that would reveal a specific company’s deteriorating economic health*, and does management highlight, ignore, distort, or even make up its own version of these metrics?

Investors are increasingly evaluating companies using both performance- and economic health-related metrics. Not surprisingly, with so much riding on pleasing investors, management is providing much more information, but it often tries to camouflage any

deterioration in the business. We label this group of tricks Key Metrics (KM) Shenanigans. They can be grouped as (1) performance metrics and (2) economic health metrics.

Evaluation of Financial Performance and Economic Health Metrics

For a given industry or company, start out by learning the very best metrics for evaluating economic performance and health—both past and expected in the near-term. (Longer-term performance predictions tend to be woefully inaccurate and provide little value for investors.) When evaluating metrics, create your own grading chart similar to the one shown in Table P4-1.

Let’s consider a subscription-based business, an industry that we know quite well. Start with the traditional performance metrics reported on the Statement of Income (revenue, operating earnings, net income, and earnings per share [EPS]) and on the Statement of Cash Flows (cash flow from operations and free cash flow). Nothing would be wrong with any of these—assuming that *no* Earnings Manipulation or Cash Flow Shenanigans exist. But this list would lack at least one enormously important piece of information—the most recent trends in the business. Have recent subscriber counts been falling? Has the amount of revenue earned from each subscriber declined over the last few quarters? Since both accrual-based revenue and cash flow-based CFFO focus on *past, not expected, revenue or cash flows*, investors should be keen on receiving and evaluating subscriber-based metrics. This information would be extraordinarily valuable. *Grade A* for its benefit for investors.

In general, most revelations provided in the supplementary information would fit into the middle categories, ranging from useful (B

Table P4-1. Metric Grading Chart

Grade	Reason
A	Essential and properly used by management
B	Useful addition
C	Neutral—no real value
D	Correct metric, but misused by management
F	Misleading metric created by management

grade) to of little additional value (C grade). Only those metrics in the two lowest grade categories can be categorized as shenanigans: a grade of D is given to an otherwise-appropriate metric chosen by management that is being used out of context, and a grade of F is given to a misleading metric that was made up in order to dress up results.

### Categories of Performance Metrics

Think of our traditional financial performance metrics (e.g., revenue, net income, and cash flow) as being similar to the *box score* of yesterday's baseball game. While the information reflects past performance, it can often provide very relevant indicators about the strength of the team and in many cases can shed light on what to expect tomorrow. However, other supplementary pieces of information exist or can be derived that are excluded from the box score, yet would be essential for an analysis of the team. As baseball historian Bill James realized when he pioneered a new form of baseball statistical analysis (and as Michael Lewis illustrated beautifully in *Moneyball*), many unconventional baseball statistics can be more revealing than the traditional metrics listed in the box score.

The best supplementary financial performance metrics should provide additional insight into a company's recent operational performance (good or bad) to go with that conveyed by traditional financial statement metrics based on generally accepted accounting principles (GAAP). We highlight ways in which management presents (1) surrogates for revenue, (2) surrogates for earnings, and (3) surrogates for cash flow.

**Surrogates for Revenue.** Management often tries to clarify and expand its disclosures on customer sales and provide insight into future demand and pricing power. A broadcast cable operator, for example, may disclose its subscriber count, an airline its "load factor" (the percentage of total seats filled), an Internet portal its number of "paid clicks," and a hotel operator its "revenue per available room." Industries and companies often produce their own unique metrics to help investors get a better grasp of a company's performance. Some common metrics that would be considered revenue surrogates include same-store sales, backlog, bookings, subscriber count, average revenue per customer, and organic revenue growth.

**Surrogates for Earnings.** Management sometimes tries to present a “cleaner” version of earnings in order to convey the true operating performance of the business. A chemical manufacturer, for example, may remove a large one-time gain from selling real estate when presenting earnings in order to convey its performance in a way that is comparable with that used in past and future periods. Companies often have similar names for these non-GAAP earnings surrogates, even though each company may define them differently. Some common metrics used include pro forma earnings, EBITDA (earnings before interest, taxes, depreciation, and amortization), non-GAAP earnings, constant-currency earnings, and organic earnings growth.

**Surrogates for Cash Flow.** As with earnings surrogates, management may also try to present a “cleaner” version of its cash flow, although this may be a bit trickier and is often more controversial. For example, a retail chain may present cash flow excluding a substantial one-time cash payment for a legal settlement. Some common metrics used include pro forma operating cash flow, non-GAAP operating cash flow, free cash flow, cash earnings, cash revenue, and funds from operations.

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#### Accounting Capsule: Pro Forma Numbers—“Apples-to-Apples” Comparison

Whenever management makes significant accounting or classification changes or even makes an acquisition, comparisons with earlier period results may become difficult, if not impossible, for investors to make. Thus, to provide an apples-to-apples comparison for investors, companies include pro forma (as if) adjusted financial statements as supplementary information. For example, let’s assume that a company changes its revenue recognition policy. The GAAP-based numbers would naturally show current-period results with the new accounting policy but would still report alongside them the earlier-period results using the old accounting policy, no doubt creating confusion. To help investors make a sensible comparison, a pro forma presentation would include the results of both periods under the new revenue recognition policy.

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## Categories of Economic Health Metrics

Continuing our baseball analogy, if analyzing performance metrics can be considered akin to reviewing yesterday's *box score*, then analyzing economic health metrics would be similar to reviewing today's baseball *standings* that show a team's cumulative performance (wins and losses for the season). The Balance Sheet can be thought of as a company's present, up-to-the-minute record that reflects its cumulative performance since its inception. (For some long-standing companies, that could be a very long "season.") While the Balance Sheet reflects the accumulation of all past performance, it can shed light on what to expect tomorrow. A baseball team that is at the top of the win-loss standings and is leading the league in runs scored for the season can normally be considered to be in excellent health. On the opposite side of the spectrum, a team that is near the bottom of the standings, has a miserable cumulative batting average, and is letting through more runs than any other team can be considered to be in poor health and relatively unstable.

As with the approach described for performance, for a given industry, start out by learning the very best metrics for evaluating economic health and stability—both past and expected in the near term. And, as with performance evaluation, when evaluating economic health metrics, use the grading chart shown in Table P4-1. The best supplementary economic health metrics should provide added insight into the strength of a company's Balance Sheet, including how well the company (1) manages customer collections, (2) maintains prudent inventory levels, (3) maintains financial assets at their appropriate value, and (4) keeps liquidity and solvency risks in check to prevent a devastating cash crunch.

**Evaluation of Accounts Receivable Management.** Investors worry if collection of customer receivables begins stretching out. Analysts use a days' sales outstanding (DSO) metric to catch signs of collection problems. Higher DSO (as discussed earlier) typically suggests that customers have been paying more slowly. Or worse, perhaps management has used Earnings Manipulation Shenanigans to inflate revenue and profits. Now, if management wants to hide these problems from investors, it may distort the true accounts receivable balance. Investors should evaluate accounts receivable to gauge whether the

DSO metric provided by management fairly presents the underlying economics of the business. Remember, distorting accounts receivable metrics could indeed be an attempt to hide revenue problems.

**Evaluation of Inventory Management.** A healthy and prudent level of inventory is essential for a well-run business. Holding too much of an undesirable product leads to write-downs, and not having enough of a hot one will lead to missed sales opportunities. Naturally, investors monitor inventory level closely and use a metric called days' sales of inventory (DSI, as introduced in Chapter 6). Management may create misleading inventory metrics to hide profitability problems. Or it may simply classify inventory incorrectly on the Balance Sheet to trick investors into using the wrong input when computing DSI.

**Evaluation of Asset Impairments for Financial Companies.** Financial institutions provide metrics that give investors insight into the quality or strength of their financial assets. Companies may disclose, for example, delinquency rates on mortgage loans or the fair value of their investments. Investors must monitor these supplementary data to ensure that proper reserves and impairments are being recorded. With the recent financial crisis, investors who were unable to spot lax impairment decisions took an undue hit.

**Evaluation of Liquidity and Solvency Risks.** Investors can face devastating losses, often with little warning, if they fail to monitor imminent threats of a massive cash crunch. Enron's demise came very rapidly when credit rating agencies swiftly downgraded its bonds to "junk" status and the company's liquidity sources immediately dried up. In a similar way, any company with debt outstanding could face equally serious consequences if it were to fall out of compliance with the conditions of its debt covenants. If a company fails to provide data on such threats (or worse, if it intentionally covers up those threats), investors will be in serious jeopardy.

The next two chapters walk you through the two Key Metrics Shenanigans. Investors should generally be delighted if management provides additional useful information to help them better assess the company's performance and economic health. Unfortunately for investors, management provides information on a fairly



regular basis that not only adds nothing of value, but involves metrics that could be deemed downright misleading. Chapter 14 highlights metrics that either camouflage revenue, earnings, or cash flow problems from investors or simply put an overly positive spin on modest achievements. Chapter 15 describes misleading economic health metrics that hide problems.

# 14

## KEY METRICS SHENANIGAN No. 1: SHOWCASING MISLEADING METRICS THAT OVERSTATE PERFORMANCE

*Above all, do no harm.*

—HIPPOCRATES, the father of Western medicine

Newly minted doctors are required to take the Hippocratic oath and pledge their commitment to practice medicine ethically. This oath is widely attributed to Hippocrates, the father of Western medicine, in the fourth century BC, and the gist of it can be boiled down to “above all, do no harm.”

Perhaps corporate managers should be made to study this solemn oath taken by physicians and apply it in earnest when they communicate with investors. In so doing, they would pledge to never knowingly harm investors and always refrain from showcasing metrics that misrepresent performance. Based on what you

already have seen in this book, that day seems way off in the horizon. Well, we can only dream that such a day will eventually come! Until it arrives, however, investors must be alert to the following three techniques that management can use to obfuscate company performance.

## **Techniques to Showcase Misleading Metrics That Overstate Performance**

1. Highlighting a Misleading Metric as a Surrogate for Revenue
2. Highlighting a Misleading Metric as a Surrogate for Earnings
3. Highlighting a Misleading Metric as a Surrogate for Cash Flow

### **1. Highlighting a Misleading Metric as a Surrogate for Revenue**

Many people consider revenue growth to be an important and straightforward measure of the overall growth of a business. Companies also frequently provide additional data points to supplement revenue, providing investors with more insight into product demand and pricing power. As discussed in the previous chapter, investors should welcome this additional information and analyze these supplemental non-GAAP (generally accepted accounting principles) revenue metrics to better assess the sustainable business performance. However, sometimes these revenue surrogates provided by management can be misleading and can harm investors if they have not put appropriate safeguards in place. In this first section, we highlight ways in which companies can be less than honest using fairly common revenue surrogates and how careful investors can protect themselves.

#### **Same-Store Sales**

Revenue growth at retailers and restaurants is often fueled by the opening of additional stores. Logically, companies that are in

the middle of a rapid store expansion show tremendous revenue growth, since they have many more stores this year than they had the prior one. While total company revenue growth may give some perspective on a company's size, it gives little information on whether the individual stores are performing well. Investors should therefore focus more closely on a metric that measures how the company's stores have actually been performing.

To provide investors with that insight, management often reports a metric called "same-store sales" (SSS) or "comparable-store sales." This metric establishes a comparable base of stores (or "comp base" for short) for which to calculate revenue growth, allowing for more relevant analysis of true operating performance. For example, a company may present its revenue growth on stores that have been open for at least one year. Companies often prominently disclose SSS in their earnings releases, and investors use it as a key indicator of company performance. Many consider same-store sales to be the most important metric in analyzing a retailer or restaurant. We agree that if it is reported in a logical and consistent manner, SSS is extremely valuable for investors.

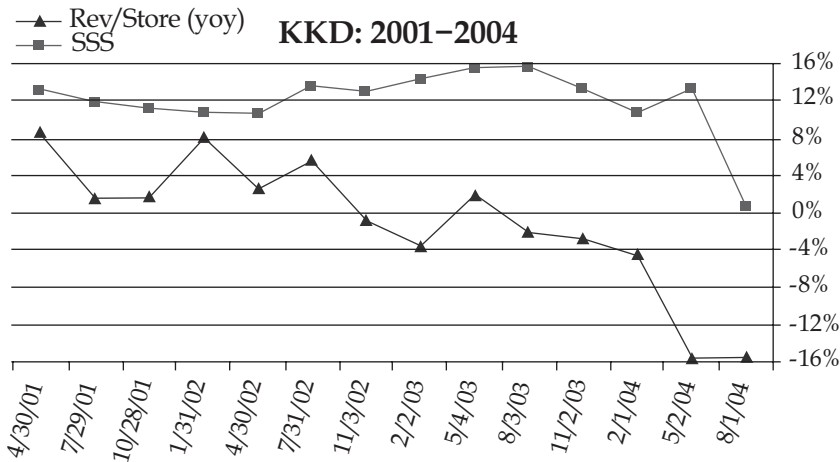
However, because same-store sales (and the other metrics discussed in Part 4) fall outside of GAAP coverage, no universally accepted definition exists, and calculations may vary from company to company. Worse, a company's own calculation of SSS in one quarter may differ from the one used in the previous period. While most companies compute their same-store sales honestly and disclose them consistently, "bad apples" try to dress up their results by routinely adjusting their definition of SSS. Investors, therefore, should always be alert to the presentation of same-store sales to ensure that it fairly represents a company's operating performance.

**Compare Same-Store Sales to the Change in Revenue per Store.** When a company experiences fairly consistent growth, same-store sales should be trending up consistently with the average revenue at each store. By comparing SSS with the change in revenue per store (i.e., total revenue divided by average total stores), investors can quickly spot positive or negative changes in the business. For example, assume that a company's SSS growth has been consistently tracking well with its revenue per store growth. If a material divergence in this trend suddenly appeared, with SSS accelerating

and revenue per store shrinking, investors should be concerned. This divergence indicates one of these two problems: (1) the company’s new stores are beginning to struggle (driving down revenue per store, but not affecting SSS because they are not yet in the comp base), or (2) the company has changed its definition of same-store sales (which affects the SSS calculation but not total revenue per store).

This framework was used by the Center for Financial Research and Analysis (CFRA) to successfully identify problems at Krispy Kreme Doughnuts Inc. in 2004 and Starbucks Corporation in 2007, and to warn investors before these companies unraveled. As shown in Figure 14-1, Krispy Kreme maintained its high SSS level in 2003 and 2004, despite a tremendous drop-off in total revenue per store.

**Watch for Changes in the Definition of Same-Store Sales.** Companies usually disclose how they define same-store sales. Once the definition is disclosed, investors should have little difficulty tracking it from period to period. Companies can manipulate same-store sales by adjusting the comp base in two possible ways. The first involves simply changing the length of time before a store enters the comp base (for example, requiring a store to be open for 18 months, versus 12 months



**Figure 14-1. Krispy Kreme’s Same-Store Sales versus Revenue per Store Growth.**  
*Source: RiskMetrics Group.*

previously). The second trick involves changing the types of stores included in the comp base (for example, excluding certain stores based on geography, size, businesses, remodeling, and so on).

**Watch for Bloated Same-Store Sales Resulting from Company Acquisitions.** The comp base can also be influenced by unrelated company activities, such as acquisitions. For example, from 2004 to 2006, the universe of stores in the comp base of Starbucks kept changing each quarter as the company continuously bought up its regional licensees and put them into the comp base. As a result, Starbucks calculated same-store sales using a slightly different universe each quarter—hardly a comparable metric. If Starbucks had been purchasing its strongest licensees, this acquisition activity would have had a positive impact on SSS performance, thereby misleading investors about the company's underlying sales growth.

Like Krispy Kreme's, Starbucks's 2006 same-store sales trend began diverging from its revenue per store trend. The gap widened in 2007, and in September 2007, Starbucks reported that U.S. traffic had fallen for the first time ever. When same-store sales in the United States turned negative in December, Starbucks announced that it would no longer disclose SSS, stating that it will "not be an effective indicator of the Company's performance."

**Be Wary When a Company Stops Disclosing an Important Metric.** Just as Starbucks stopped disclosing same-store sales when business went sour, Gateway stopped disclosing the number of computers sold when times were tough in late 2000. This metric had been an important data point provided to investors, and Gateway's change in disclosure led the SEC to censure the company and label its actions "materially misleading" because it obscured the softening consumer demand for computers.

**Tip:** Sound the alarm if a key metric goes missing.

**Look for Strange Definitions of Organic Growth.** Affiliated Computer Systems (ACS) had an odd way of presenting its organic growth, or what it called "internal growth." Rather than simply excluding all revenue from acquired businesses when calculating

internal growth, ACS calculated a fixed amount to remove based on the acquired business's revenue for the previous year. (See ACS's disclosure in the accompanying box.) This meant that ACS was able to include in its own internal growth any large deals that the acquired company booked just before the acquisition.

### ACS'S INTERNAL REVENUE GROWTH DEFINITION

#### MARCH 2005 EARNINGS RELEASE

Internal revenue growth is measured as total revenue growth less acquired revenue from acquisitions and revenues from divested operations. Acquired revenue from acquisitions *is based on pre-acquisition normalized revenue of acquired companies.* [Italics added for emphasis.]

To illustrate, let's hypothetically assume that ACS acquired a company on January 1, 2005. In 2004, that target company had generated \$120 million in revenue (\$30 million per quarter). In the weeks before the acquisition, the target company also closed a large deal that would bring in an additional \$10 million in revenue each quarter beginning in 2005.

Now, assume that in March 2005 (the first quarter after its acquisition by ACS), the target company generates \$40 million in revenue as expected (the normal \$30 million plus \$10 million from the new contract). ACS, when calculating its own March 2005 internal revenue growth, logically should exclude this entire \$40 million because none of it would have been included in ACS's revenue absent the acquisition. However, ACS's calculation allows the company to treat the new \$10 million contract as part of its own internal growth. As a result, ACS's internal revenue growth would improperly benefit from revenue that actually came from the acquired company's business. Clearly, this is not an apples-to-apples comparison.

**Tip:** Scrutinize the organic growth calculation of acquisitive companies as it may include revenue that spilled over from the target company.

### Average Revenue per User

When comparing key non-GAAP metrics across a peer group, it is important to ensure that these metrics are being calculated in the same way. For example, in the broadcast industry, a common metric analyzed is ARPU (average revenue per user), calculated as total subscription revenue divided by average subscribers. Calculating the average revenue per subscriber sounds like it should be simple; however, varying definitions of ARPU abound. Consider, for example, the different definitions at competitors Sirius Satellite Radio Inc. and XM Satellite Radio Holdings Inc. (before they merged in 2008). Sirius's calculation of ARPU included revenue from subscriptions, advertising, and activation fees. XM Radio, on the other hand, calculated ARPU using only revenue from subscriptions; advertising revenue and activation fees were excluded. (See the accompanying box.) In order to compare ARPU at the two companies on an apples-to-apples basis, investors must either adjust Sirius's ARPU calculation to exclude advertising revenue and activation fees or adjust XM's ARPU calculation to include these revenue sources.

#### AVERAGE REVENUE PER USER (ARPU) DIFFERENCES AT SIRIUS AND XM RADIO

**Sirius's ARPU Calculation:** Subscriber (including offset for sales rebates) *activation* and *advertising revenue* divided by the daily weighted average number of subscribers for the period. [Italics added for emphasis.]

**XM Radio's ARPU Calculation:** Total monthly earned subscription revenue net of promotions and rebates divided by monthly weighted average number of subscribers for the period reported.

*Source: "Satellite Radio Industry Analysis" RiskMetrics Group April 2006.*

### Subscriber Additions and Churn

Let's go back to our discussion of subscription-based businesses in the previous chapter. Since these types of companies (e.g., research providers, telephone companies, newspapers, fitness clubs, and so on) rely on new subscribers for growth, it is helpful for



investors to monitor subscriber levels in order to get a sense of the most recent trends in the business. Logically, the number of new subscriber additions each quarter is often a good leading indicator of upcoming revenue. Similarly, the level of cancellations (called “churn”) is important to know when assessing the business. If a company shows a healthy subscriber base with growth in new subscribers and shrinking churn, investors can expect strong revenue growth ahead. That is, unless the company is manipulating these metrics.

Consider AOL Time Warner’s (AOL’s) scheme to inflate the number of subscribers to its online Internet service. One of the ways in which AOL sold subscriptions was to sell “bulk subscriptions” to corporations, which would then distribute these subscriptions to employees as a perk. AOL did not include these bulk subscription sales in its subscriber count because it knew that many of these subscriptions would never actually be activated. When employees did sign up, however, they rightfully entered the subscriber count.

In 2001, AOL was struggling to meet its subscriber targets. So, the company began including the number of bulk subscriber sales in its subscriber count, despite the fact that the majority of these subscriptions were never activated. Moreover, AOL would ship these bulk subscription membership kits to customers immediately before the quarter end in order to meet targets for subscriber count.

Adelphia Communications, the Rigas family business we introduced in Chapter 2 and the sixth largest cable company in the United States at the time, artificially inflated its subscriber counts by including subscribers of unconsolidated affiliates that had not previously been included in the count. For instance, in June 2000, Adelphia suddenly began including 15,000 subscribers of an affiliate in Brazil in its subscriber count. The very next quarter, Adelphia started including 28,000 subscribers of an unconsolidated Venezuelan affiliate.

Adelphia also decided to start including subscribers to other product lines in its count of basic cable subscribers. In June 2001, for example, Adelphia somehow thought it was appropriate to include 27,000 Internet service subscribers in its count of basic cable subscribers. To top it off, the company added 60,000 home security subscribers to its basic cable count in September 2001.

Pegasus Satellite Communications, a satellite television company, also manipulated its subscriber data in the years leading up to its 2004 bankruptcy filing. Normally, Pegasus's subscriber billing system would automatically remove from the subscriber base any customers with bills that were overdue by 54 days. In order to keep the churn level down and inflate subscriber counts, Pegasus employees manually overrode the subscriber billing system, allowing customers to go well beyond the 54-day limit before being removed from the subscriber base.

**Tip:** Subscriber data are often disclosed in both the earnings release and the 10-Q. Look for inconsistencies between the two sources, particularly discrepancies in which subscribers are shifted between categories.

### **Bookings and Backlog**

Many companies disclose their quarterly “bookings” or “orders,” which are supposed to represent the amount of new business *booked during the period*. Companies may also disclose their backlog, which essentially represents their outstanding book of business or, in other words, all past orders that have yet to be filled (and recognized as revenue). “Book-to-bill” is also a common disclosure that compares current-period bookings to current-period revenue and is calculated as bookings divided by revenue.

If they are presented accurately, bookings and backlog are important indicators, as they provide investors with extra insight into upcoming revenue trends. However, since they are non-GAAP metrics, companies have plenty of leeway in how they define and disclose bookings and backlog. You would think that the calculations would be pretty straightforward, but indeed there are plenty of nuances in what should and should not be included. For example, different companies include the following types of orders differently in their presentation of bookings and backlog: cancelable orders, orders in which the quantity purchased is not defined, bookings for longer-term service or construction contracts, contracts with contingencies or extension clauses, bookings on noncore operations, and so on.

The varying definitions of bookings and backlog across companies make it extremely important for investors to understand exactly what the metric represents before putting any faith in it. Moreover, if the metric is a key performance indicator for a company, investors should use extra diligence to ensure that the company does not change its own definition of bookings in a way that flatters the metric.

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#### Accounting Capsule: Bookings and Backlog

The following formula shows the general relationship between bookings, backlog, and revenue (for all revenue streams that run through backlog). This formula is very helpful when analyzing companies, as it can be used to test the veracity or consistency of these non-GAAP metrics. It can also be used to calculate bookings when only backlog is given.

Beginning backlog + net bookings – revenue = ending backlog

(Net bookings is total bookings minus cancellations.)

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## 2. Highlighting a Misleading Metric as a Surrogate for Earnings

Investment guru Warren Buffett (chairman of Berkshire Hathaway) has long poked fun at management teams that create dishonest pro forma metrics. He memorably compared this practice to an archer who shoots an arrow into a blank canvas and *then* draws a bull's-eye around the implanted arrow.

### EBITDA and Its Variations

Consider the bull's-eye drawn by the archers at Global Crossing. The company reported a net loss of \$120 million in the March 2007 quarter. Desperate to show a profit, however, management removed expenses using a pro forma concoction reminiscent of its bad behavior during the dot-com bubble. First, management removed \$97 million in expenses for interest, taxes, depreciation, and some other items to get to a metric it called “adjusted EBITDA” (earnings before interest, taxes, depreciation, and amortization). Then, it removed \$15 million in noncash stock compensation expense, bringing the company to an “adjusted cash EBITDA” of *negative*

\$8 million. Close, but not all the way to profitability, management then removed a host of charges that it deemed one-time in nature, propelling the company to a positive \$4 million in what it called “adjusted cash EBITDA less one-time items.” Bull’s-eye!

It is easy to be skeptical about Global Crossing’s three levels of pro forma, and it is hard not to laugh when looking at some of the “one-time” charges that the company removed. (See Table 14-1.) Last time we checked, expenses for “maintenance” are a normal cost of doing business and therefore should never be excluded from a pro forma calculation. Ditto for customer defaults (bad debts), employee retention bonuses, and routine regulatory charges. Do not be fooled into thinking that these items will not recur just because management decides to present them as one-time in nature.

**Now You See It, Now You Don’t.** On its June 2007 earnings call, flash memory manufacturer Spansion proudly stated that EBITDA grew to \$72 million from \$61 million the quarter before. The following quarter, Spansion reported that EBITDA fell to \$71 million;

Table 14-1. Global Crossing’s “Adjusted Cash EBITDA Less One-Time Items”

(\$ millions)	Q1, 3/07
<b>Net income</b>	<b>(120)</b>
Provision for income taxes	12
Other expense	6
Interest expense	29
Depreciation and amortization	50
<b>“Adjusted EBITDA”</b>	<b>(23)</b>
Noncash stock compensation	15
<b>“Adjusted cash EBITDA”</b>	<b>(8)</b>
One-time item: regulatory charges	5
One-time item: Asian earthquake	1
One-time item: customer defaults	2
One-time item: severance	1
One-time item: cash portion of retention bonus	3
One-time item: utility credit	(2)
One-time item: maintenance charge	2
<b>“Adjusted cash EBITDA less one-time items”</b>	<b>4</b>

Source: RiskMetrics Group.

however, the company soothed concerned investors by claiming that EBITDA actually increased by \$8 million if you exclude a one-time real estate gain received in the previous quarter. Conveniently, this one-time gain was not excluded from EBITDA when earnings were reported the previous quarter. So, Spansion essentially included the one-time gain to help show strong EBITDA growth in June, and then excluded the gain the next quarter in order to show strong EBITDA growth in September. You can't have it both ways!

### **Pro Forma Earnings/Adjusted Earnings/Non-GAAP Earnings**

What's in a name? That which companies call earnings, by any other name would smell as sweet . . . or so management would like you to think. Sometimes management insists that a foul-smelling "pro forma" or "adjusted" earnings metric (or any other earnings metric with a qualifying name) is a sweet and pure measure of earnings.

**Pretending That Recurring Charges Are One-Time in Nature.** Remember our friends at Peregrine Systems who recorded bogus revenue and then tried to cover it up by fraudulently faking the sale of accounts receivable? Well, the company had so many bogus receivables that it also used pro forma tactics to hide the evidence of its chicanery. In addition to pretending to sell these receivables, Peregrine also took charges for these receivables, but inappropriately classified those charges as nonrecurring and related to acquisitions. This classification gave Peregrine the cover to exclude these charges from its pro forma earnings presentation so that investors would not be concerned (or at least those investors that always took the company at its word).

**Pretending That One-Time Gains Are Recurring in Nature.** General Motors (GM) recorded a \$259 million after-tax gain on the sale of an equity interest in a regional homebuilder in June 2006. Normally, GM removes any one-time gains or losses when presenting "adjusted income" in its earnings releases. Indeed, in the very same quarter, GM removed from adjusted income a gain on the sale of a different equity investment. Curiously, GM management decided that the gain on the homebuilder investment (which accounted for more than 20 percent of adjusted income) would not be excluded.

Trump Hotels & Casino Resorts also chose not to remove large nonrecurring gains from its adjusted income. Trump opened an

All Star Café in its Atlantic City Taj Mahal Casino in 1997. All Star Café signed a 20-year lease; however, just two years later, its parent company (Planet Hollywood) went bankrupt. As a result, the lease was terminated, and all of the sports memorabilia and real estate improvements in the All Star Café became the property of Trump. Trump valued this property at \$17 million and, in September 1999, recorded a one-time gain. (Shockingly, Trump put this gain in revenue!) When releasing its earnings results to Wall Street, however, Trump conveniently forgot to tell investors about this one-time benefit and failed to remove it from its pro forma numbers. As shown in Table 14-2, had Trump been more truthful in communicating with its investors and reported an honest measure of pro forma results, the company would have reported declines in both earnings and revenue, in contrast to the reported growth in both metrics.

**Changing the Definition of Adjusted Earnings.** While Openwave Systems was accelerating its revenue recognition by changing its accounting policies (as discussed in Chapter 3), the company also quietly played around with its earnings metric of choice, “non-GAAP net income.” In late 2005, Openwave changed its definition of non-GAAP net income twice in two consecutive quarters. In the September 2005 quarter, Openwave began excluding expenses for restricted stock grants from its non-GAAP net income. According to a CFRA report in November 2005, this change added \$0.04 to Openwave’s earnings, without which the company would have missed Wall Street’s expectations. Then, the very next quarter, Openwave changed the definition again, this time to exclude acquisition-related hedging costs from non-GAAP net income. The

Table 14-2. Trump’s Pro Forma Results for Q3 1999, as Reported and Adjusted to Exclude One-Time Gain

(\$ millions, except EPS)	Q3, 9/99, as Reported	Q3, 9/99, Excluding One-Time Gain	Q3, 9/98
Pro forma revenue	403.1	385.9	397.4
Pro forma net income	14.0	3.0	5.3
Pro forma EPS	\$0.63	\$0.14	\$0.24

two changes combined to add \$0.04 to earnings in the December quarter as well.

### **3. Highlighting a Misleading Metric as a Surrogate for Cash Flow**

Non-GAAP cash flow metrics are less common than non-GAAP revenue and earnings disclosures; however, they do exist. Sometimes companies create a pro forma cash flow metric in order to exclude a nonrecurring activity, such as a large litigation settlement. However, other times, companies may be looking to artificially enhance their cash-generation profile.

#### **“Cash Earnings” and EBITDA Are Not Cash Flow Metrics**

Companies sometimes present metrics like “cash earnings” or “cash EBITDA” (as we just saw with Global Crossing). Do not confuse these metrics with substitutes for cash flow! Many companies and investors alike believe that these metrics (as well as plain old EBITDA) are good surrogates for cash flow simply because the calculation includes the adding back of noncash expenses such as depreciation. As you surely know by now, a company’s cash flow consists of much more than just net income plus noncash expenses. Calculating it in this way is really just an abuse of using the indirect method of developing the Statement of Cash Flows (SCF) (refer back to our discussion of cash flow presentation in the Part 3 introduction). Ignoring working capital changes when calculating cash flow will provide you with a fictional portrait of a company’s cash-generation abilities, in the same way that ignoring accruals for expenses such as bad debts, impairments, and warranty expenses will give you an illusory sense of profitability. In reality, metrics such as EBITDA and cash earnings are poor representations of performance.

Moreover, for capital-intensive businesses, EBITDA is often an illusory measure of performance and profitability because all of the major capital costs run through the Statement of Income as depreciation, and therefore are excluded from EBITDA. Some companies abuse the investment community’s acceptance of EBITDA and use the metric even though it is completely unwarranted. For example, rent-to-own retailer Rent-A-Center, Inc., purchases inventory (such as furniture and home electronics) and then rents the merchandise

to customers for a monthly fee. Rent-A-Center records the rental fees as revenue, and the rental merchandise is depreciated over the rental life and recorded as “cost of rentals” on the Statement of Income (similar to cost of goods sold). However, when presenting its EBITDA, the company excludes the impact of these costs because they can be considered depreciation. We find it completely inappropriate to exclude these costs from any legitimate measure of profitability, since they are indeed the cost of inventory.

### **Non-GAAP Cash Flow Metrics Put There to Confuse**

In Chapter 10, “CF Shenanigan No. 1: Shifting Financing Cash Inflows to the Operating Section,” we discussed how our friends at Delphi Corp. improperly recorded a loan from the bank as the sale of inventory, and in doing so boosted cash flow from operations (CFFO) by \$200 million in 2000. Well, management at Delphi also liked to mislead investors by presenting tricky cash flow metrics. For example, Delphi routinely talked about and headlined its “Operating Cash Flow” in its earnings releases. No doubt, many people thought that Delphi was discussing its CFFO; however, this was not the case. “Operating Cash Flow” was actually Delphi’s deceptively named surrogate for GAAP cash flow from operations. Since the name is so close to its GAAP compadre, you can imagine how many investors were confused into thinking that this pro forma metric was Delphi’s actual CFFO. In truth, this surrogate barely resembled GAAP cash flow from operations. As shown in Table 14-3, it was calculated as net income *plus* depreciation and other noncash charges *minus* capital expenditures *plus* some huge mystery item labeled “other.”

We mentioned earlier that in 2000, Delphi’s actual CFFO (as reported on the SCF) was \$268 million, but its self-defined “Operating Cash Flow” (as presented in the earnings release) was \$1.636 billion—an astonishing differential of almost \$1.4 billion. Since this cash flow surrogate includes the impact of capital expenditures, it may be more relevant to compare it to Delphi’s free cash flow (CFFO less capital expenditures) of *negative* \$1.0 billion—bringing our differential to an outrageous \$2.6 billion. (Oh, by the way, that \$268 million in CFFO reported on the SCF was actually only \$68 million if you exclude the sham sale of inventory that we discussed in Chapter 10.)



Table 14-3. Delphi's GAAP Cash Flow versus Pro Forma Cash Flow, 2000

(\$ millions)	2000
Net income (GAAP)	1,062
One-time charge for in-process R&D	(32)
Depreciation and amortization	936
Capital expenditures	(1,272)
Other, net	878
<b>"Operating Cash Flow" (non-GAAP)</b>	<b>1,636</b>
Cash flow from operations (GAAP)	268
Free cash flow (GAAP CFFO less GAAP capital expenditures)	<b>(1,004)</b>

In 2003, Delphi was still up to the same tricks, but the company was now showing a reconciliation between its "Operating Cash Flow" and CFFO as reported on the Statement of Cash Flows. Delphi's "Operating Cash Flow" was \$1.2 billion in 2003, versus \$737 million in CFFO and *negative* \$268 million in free cash flow. As shown in Table 14-4, the primary differences included routine operating uses of cash flow, including pension plan contributions, payments to employees, and a decline in the sales of accounts receivable.

Any serious investor who looked at this presentation would be aghast at seeing such normal operating expenditures excluded from

Table 14-4. Delphi's GAAP Cash Flow versus Pro Forma Cash Flow, 2003

(\$ millions)	2003
<b>"Operating Cash Flow" (non-GAAP)</b>	<b>1,220</b>
Pension contributions	(990)
Cash paid for employee and product line charges	(229)
Cash paid for lump-sum contract signing bonuses	(125)
Decrease in sales of accounts receivable	(144)
Capital expenditures	1,005
Cash flow from operations (GAAP)	737
Free cash flow (GAAP CFFO less GAAP capital expenditures)	<b>(268)</b>

the calculation of “Operating Cash Flow.” The old adage “where there’s smoke, there’s fire” is very applicable when searching for shenanigans. Delphi’s ridiculous cash flow surrogate deception was the smoke. The fraudulent revenue and cash flow was the fire.

### **Funds from Operations**

The real estate investment trust (REIT) industry uses the funds from operations (FFO) metric as a standard for measuring company performance. While this metric was not promulgated by GAAP, it is widely viewed as a gauge of a REIT’s ability to generate cash flow and is often viewed as being more useful than traditional GAAP earnings or cash flow measures. In order to promote the consistency and legitimacy of this performance metric, the industry’s main trade group, the National Association of Real Estate Investment Trusts (NAREIT), laid out a strict definition of FFO. NAREIT defined FFO to be net income excluding depreciation, gains or losses from the sale of property, and income from unconsolidated joint ventures.

Some companies, however, are not really interested in conforming to voluntary industry standards, especially when they benefit from going rogue. American Financial Realty, for example, shunned the industry standard definition in 2003 and instead used its own more favorable definition, which, of course, inflated performance and helped management reach its bonus targets. As shown in the accompanying box, the primary difference between American Financial Realty’s definition and the industry standard was that the company decided to include its gains from the sale of property, whereas NAREIT explicitly prohibits this. Had American Financial Realty excluded these gains from the calculation as dictated by the industry definition, the company’s 2003 FFO would have been cut by nearly half.

Investors could quite easily adjust American Financial Realty’s FFO to bring it in line with the industry standard, and thus allow for comparisons with other companies. The tricky part, however, would be to know that this needed to be done. By now you should know that any time a company reports an important non-GAAP metric, you need to read and monitor the definition to ensure that you understand exactly what information that metric conveys.

## FUNDS FROM OPERATIONS AMERICAN FINANCIAL REALTY VERSUS NAREIT'S INDUSTRY STANDARD

**NAREIT Industry Standard Definition of FFO:** Funds from Operations means net income (computed in accordance with generally accepted accounting principles) *excluding gains (or losses) from sales of property* plus depreciation and amortization and after adjustments for unconsolidated partnerships and joint ventures. Adjustments for unconsolidated partnerships and joint ventures will be calculated to reflect funds from operations on the same basis.

**American Financial Realty's Definition of FFO in Its 2003 10-K:** We define FFO as net income (loss) before minority interest in our operating partnership (computed in accordance with generally accepted accounting principles or GAAP) *excluding gains (or losses) from debt restructuring including gains (or losses) on sales of property* plus real estate related depreciation and amortization and after adjustments for unconsolidated partnerships and joint ventures.

## Looking Back

### Warning Signs: Showcasing Misleading Metrics That Overstate Performance

- Changing the definition of a key metric
- Highlighting a misleading metric as a surrogate for revenue
- Unusual definition of organic growth
- Divergence in trend between same-store sales and revenue per store
- Inconsistencies between the earnings release and the 10-Q
- Highlighting a misleading metric as a surrogate for earnings
- Pretending that recurring charges are nonrecurring in nature
- Pretending that one-time gains are recurring in nature
- Highlighting a misleading metric as a surrogate for cash flow
- Headlining a misleading metric on the earnings release

## Looking Ahead

In Chapter 15, we shift from key metrics that present an overly optimistic view of a company's performance to those metrics that mislead investors about a potentially imminent deterioration in the Balance Sheet and the company's economic health.

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# 15

## KEY METRICS SHENANIGAN No. 2: DISTORTING BALANCE SHEET METRICS TO AVOID SHOWING DETERIORATION

As well as writing books, we also love reading them. We always make it a point to stop into bookstores as often as possible, whether it's megachains like Barnes & Noble or the literary jewel of Portland, Powell's Books. Once we're inside one of these places, it's hard not to notice the scores of self-help and diet books. They are everywhere. No doubt, we all yearn to look, feel, and be better at work, play, and all the other stuff. It's certainly a big business teaching people to feel better about their lives and to look fabulous.

A lot of diet books still advocate the perennially popular granddaddy of slimming solutions, Weight Watchers. This classic diet allows you to eat whatever you want, but restricts total calories and fat. The Atkins program, in contrast, trumpets the virtues of loading up your body with foods that are high in fat, but severely

restricting the intake of carbohydrates. The popular South Beach diet offers a variation on Atkins by limiting the consumption of “bad” carbs and increasing the consumption of “good” fat. And finally, the plan endorsed by the medical establishment today limits consumption of both fats and carbs and instead loads you up on veggies and basically expects you to graze like a cow.

Who knows if any of these plans can really make us healthier or make us look any better? We do know, however, that upper management spends a great deal of time trying to make its Balance Sheets look great, even if they are loaded up with junk. This chapter highlights four techniques that struggling companies might use to convince investors that the company not only looks great, but is in excellent health. Hopefully these folks won’t be as effective in fooling investors as the diet-book authors are in persuading readers to trust their advice.

## **Techniques to Distort Balance Sheet Metrics to Avoid Showing Deterioration**

1. Distorting Accounts Receivable Metrics to Hide Revenue Problems
2. Distorting Inventory Metrics to Hide Profitability Problems
3. Distorting Financial Asset Metrics to Hide Impairment Problems
4. Distorting Debt Metrics to Hide Liquidity Problems

### **1. Distorting Accounts Receivable Metrics to Hide Revenue Problems**

Company managements are well aware that investors review working capital trends carefully to spot signs of poor earnings quality or operational deterioration. They realize that a surge in receivables that is out of line with sales will lead investors to question the sustainability of recent revenue growth. What easier way could there be to keep these questions at bay and give investors what they cherish (stable receivable growth) than by distorting the numbers? This first section deals with games to keep the reported accounts receivable lower by (1) selling them, (2) converting them into notes receivable, or (3) moving them somewhere else on the Balance Sheet.

**Selling Accounts Receivable.** In Chapter 10, “CF Shenanigan No. 1: Shifting Financing Cash Inflows to the Operating Section,” we discussed how selling accounts receivable may be considered a useful cash-management strategy, but an unsustainable longer-term driver of cash flow growth. Selling accounts receivable also serves another useful purpose: it lowers the days’ sales outstanding (DSO) reported to investors (meaning that it makes it appear that customers have been paying more quickly). Dishonest management can easily conceal a jump in DSO simply by selling more accounts receivable.

Let’s refer back to our discussion in Chapter 10 of Sanmina-SCI’s stealth sales of receivables. After selling these receivables, the company highlighted a decline in DSO and an increase in cash flow from operations (CFFO) in its September 2005 quarterly results. Astute investors clearly understood that it was the sale of receivables, not operational efficiencies, that drove DSO lower and CFFO higher. Such investors understand that the sale of receivables, in substance, represents a financing decision (that is, collecting cash due on customer accounts earlier). Therefore, the now lower accounts receivable balance naturally also results in a smaller DSO figure.

**Tip:** Whenever you spot a CFFO boost from the sale of receivables, also realize that by definition, the company’s *DSO will have been lowered as well*.

Also recall how Peregrine recorded bogus revenue and then shamelessly faked the sale of the related bogus accounts receivable in order not to raise any alarms. Those receivables, obviously, went uncollected, and management became concerned that the bulging account balance would drive up DSO indefinitely—a clear warning for investors. By faking the sale of these receivables, Peregrine inflated its CFFO and removed the DSO red flag from investors’ sights in one fell swoop.

**Tip:** To calculate DSO on an apples-to-apples basis, simply add back sold receivables that remain outstanding at quarter-end for all periods.



The first examples of lowering receivables to improve DSO involved either selling them outright or faking the sale. Another popular way to hide accounts receivables is simply to reclassify them elsewhere on the Balance Sheet, like notes receivable.

**Turning Accounts Receivable into Notes Receivable.** When we introduced Symbol Technologies in Chapter 1, we discussed management's easy, yet dishonest, solution to its mid-2001 "receivables problem." Symbol's receivables had been growing rapidly as a result of aggressive revenue recognition and channel stuffing, surging to 119 days in June 2001 (up from 94 in March 2001 and 80 in June 2000). To allay investor concerns, management engineered a cosmetic reduction in accounts receivable.

It was a pretty dirty trick, in our view. Symbol simply asked some of its closest customers to sign paperwork that would convert these trade accounts receivable into promissory notes or loans. Apparently they acquiesced, since it made little difference to them; they owed the money either way. However, the new paperwork gave Symbol a convenient cover to move these accounts receivable to the notes receivable section of the Balance Sheet. In effect, Symbol waved a magic wand and, with the help of some compliant customers, "reclassified" these trade receivables to an account that is not closely monitored by many investors. It seems that Symbol's primary purpose for this reclassification was to lower its DSO in order to fool investors into assuming that sales had been kosher and customers had paid on time. And, according to plan, DSO fell from the 119 days in June 2001 to 90 days the following period, and unquestioning investors mistakenly proclaimed that the "receivables problem" had been solved.

**Tip:** Investors should be as concerned when they see a *large decrease in DSO* (particularly following a period of rapidly rising DSO) as they are when they see a large increase in DSO.

**Watch for Increases in Receivables Other Than Accounts Receivable.** UTStarcom pulled a similar switcheroo in 2004 by taking more payment in the form of "bank notes" and "commercial notes." Since these notes receivable were not categorized as accounts receivable

on the Balance Sheet (in fact, the bank notes were considered cash), UTStarcom was able to present a more palatable DSO to investors, despite a severe deterioration in its business. Diligent investors could easily have spotted this improper account classification by reading UTStarcom's footnotes. As shown in the accompanying box, the company disclosed clearly that it had accepted a substantial amount of bank and commercial notes in place of accounts receivable.

#### UTSTARCOM'S JUNE 2004 FORM 10-Q

##### **From Footnote 6 (Cash, Cash Equivalents and Short-Term Investments)**

The Company *accepts bank notes receivable* with maturity dates between three and six months *from its customers in China* in the normal course of business. *Bank notes receivable were \$100.0 million and \$11.5 million at June 30, 2004 and December 31, 2003, respectively, and have been included in cash and cash equivalents and short-term investments. [Italics added for emphasis.]*

##### **From Footnote 8 (Accounts and Notes Receivable)**

The Company *accepts commercial notes receivable* with maturity dates between three and six months *from its customers in China* in the normal course of business. Notes receivable available for sale were *\$42.9 million and \$11.4 million at June 30, 2004 and December 31, 2003, respectively. [Italics added for emphasis.]*

Investors received another warning on UTStarcom's Balance Sheet: notes receivable surged, from \$11 million in December 2003 to \$43 million the following quarter. By now, it should be abundantly clear that identifying the reason for such a change is extremely important. If management cannot provide you with a plausible reason, assume that it is playing a game with accounts receivable and trying to hide a bulging DSO. In the case of UTStarcom, you would have solved the mystery by simply reading the footnotes that disclosed that these notes receivable, effectively, had been transformed from accounts receivable.

**Watch Out for Varying Company DSO Calculations.** For the purposes of identifying aggressive revenue recognition practices, we suggest that investors use the ending (not the average) receivables balance. Using average receivables works fine when investors are trying to assess cash-management trends, but it works less well when they are trying to detect financial shenanigans. Investors who are searching for shenanigans should use the DSO calculation with ending receivables and ignore companies if they tell you that your DSO calculation is incorrect or is not in accordance with generally accepted accounting principles (GAAP). (Of course, DSO, like all other non-GAAP metrics, is outside of the rule makers' purview.)

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Accounting Capsule: Days' Sales Outstanding (DSO)

Days' sales outstanding (DSO) is generally calculated as follows:

Ending receivables/revenue  $\times$  number of days in the period  
(for quarterly periods, 91.25 days is a normal approximation)

While we recommend using this calculation for DSO, you may encounter different calculations suggested by companies or texts. For example, some people believe that DSO should be calculated using average receivables over the period, as opposed to the ending balance of receivables that we suggest.

Since DSO is not a GAAP metric, there is no absolute definition for it. It is important, however, that the calculation reflects the analysis that you are trying to perform. For example, if you are assessing the likelihood that a company has accelerated revenue by booking a significant amount of revenue on the last day of the quarter, (i.e., stuffing the channel), it makes sense to calculate DSO using the ending balance of receivables rather than the average one. Similarly, if you are worried about the collectibility of receivables and you are evaluating a company's exposure, it is best to use the ending balance. However, if you wish to calculate the average time over which a company collects its receivables, you may want to use the average balance of receivables.

The bottom line is that for financial shenanigan detection purposes, we advise calculating DSO using ending balances, even if a company tells you otherwise.

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**Watch for Changes in DSO Calculations.** Be especially wary if a company *changes its own DSO calculation* in a way that conceals deterioration, as Tellabs Inc. apparently tried to do in December 2006. Tellabs had been calculating DSO based on the ending receivables balance, but it then changed to using its quarterly average receivables balance. Since receivables surged in the quarter in which the change was made, the average receivables balance naturally would be much lower than the ending one, allowing for a much more favorable presentation of DSO on the earnings call with investors. As a result, Tellabs disclosed that DSO in December 2006 had increased only 5 days sequentially (to 59 days from 54 days in the previous quarter). Had management made no changes in its calculation, Tellabs would have reported an increase in DSO of 16 days (to 82 days from 66 days the previous quarter). The change in the DSO calculation was not difficult to find. In fact, management was kind enough to disclose it during its quarterly conference call with investors. Learning of the change in calculation was the easy part; in this case; knowing that it was a big deal, was the key for alert investors to realize that management was playing games and trying to hide its bulging receivables.

**Tip:** Alert investors who learn of a change in the calculation of DSO should immediately become concerned, when management changes how it computes operational metrics, it is attempting to hide some deterioration from investors.

## 2. Distorting Inventory Metrics to Hide Profitability Problems

Investors typically view an unexpected rise in inventory as a sign of upcoming margin pressure (through markdowns or write-offs) or falling product demand. Some companies with inventory problems seek to avoid this negative perception by toying with their inventory metrics.

**Covering Up a Cover-Up.** Symbol Technologies sold products aggressively, offering customers very generous return conditions. Moreover, some purported sales turned out to be completely bogus because customers sent back products that they had never desired

and, based on a side agreement with Symbol, could return them at any time and pay nothing. These returns became more than a minor nuisance, as they increased Symbol's inventory levels, an obvious warning sign for investors. So, as one cover-up often leads to the next, Symbol created an "inventory reduction plan" designed to reduce inventory levels. The plan (as described by the Securities and Exchange Commission [SEC]) included recording fictitious accounting entries to reduce inventory, leaving product deliveries on the receiving docks without recording them as inventory, and selling inventory to a third party, but agreeing to repurchase it.

**Watch for Inventory That Moves to Another Part of the Balance Sheet.** Companies will sometimes reclassify inventory to a different account on the Balance Sheet. Pharmaceutical giant Merck & Co., for example, in 2003 began reporting part of its inventory as a long-term asset, included in the "other assets" line on the Balance Sheet. A footnote revealed that these oddly classified inventories related to products that were not expected to be sold within one year. In December 2003, the long-term portion of Merck's inventory represented 13 percent of the total, and the next year, it jumped to 25 percent. Investors should certainly have included these long-term inventory totals when analyzing Merck's inventory trends. A sudden spike in long-term inventory warrants concern by investors.

**Be Cautious about New Company-Created Metrics.** Inventory balances at mall retailer Tween Brands Inc. had been bulging in late 2006 and early 2007, and management correctly assumed that investors would be less than overjoyed. Specifically, days' sales of inventory (DSI) jumped to 60 days in the May 2007 quarter from 52 days the preceding year, marking the third consecutive quarter of increase. Moreover, inventory per square foot (a non-GAAP metric often cited by Tween) increased by 18 percent.

To address potential investor concerns about inventory, management began highlighting a new metric: "in-store" inventory per square foot. In May 2007, management tried to further assuage these concerns by claiming that the surge in inventory should not be a source of worry because "in-store" inventory had increased only a modest 8 percent (\$27 per square foot versus \$25 last year). Despite

the irrationality of this statement, Wall Street bulls were pleased; all they needed was an explanation, no matter how absurd.

Tween's explanation should have given astute investors pause on two grounds. First, it would be completely inappropriate for Tween to simply ignore inventory that it owned and included on its Balance Sheet, but that was not on store shelves. "Out-of-store" inventory qualifies as inventory and has no less markdown risk than "in-store" inventory. Second, and even more troublingly, Tween tricked investors by providing an "apples-to-oranges" comparison of its inventory growth. Specifically, the \$25 cited by management as the prior year's *in-store* inventory per square foot actually reflected *total* inventory per square foot, according to a 2007 report by RiskMetrics Group. By definition, comparing the current year's in-store number with the prior year's total number would understate inventory growth; of course it was up only 8 percent! Since the in-store metric was new, the prior year's number was not previously disclosed, which made it difficult for investors to notice the inconsistency. However, diligent investors would have been *skeptical enough about the creation of a new inventory metric* at a time when inventory was increasing, and they would have tested its veracity and usefulness as a measure of company health.

### 3. Distorting Financial Asset Metrics to Hide Impairment Problems

Financial assets (such as loans, investments, and securities) are significant sources of income for banks and other financial institutions. Therefore, assessing the "quality" or strength of these assets should be a key part of understanding the future operating performance of such companies. For example, it is crucial for investors to understand whether a bank's investment portfolio consists of risky, illiquid securities and to know if its loan portfolio is weighted toward dicey subprime borrowers.

Consider two banks that are identical in every way, except for the composition of their loan portfolios. One bank's loan portfolio consists entirely of loans to subprime borrowers, 20 percent of which have failed to pay their bills on time. The other bank's loan portfolio consists mainly of loans to prime borrowers, only 2 percent of which have failed to pay on time. It does not take a banking

expert to realize that the second bank's operating performance will be steadier, and that the first one may be in deep trouble.

Financial institutions will often present extremely helpful metrics that allow investors to understand the strength and performance of their assets. For example, a bank might report delinquency rates (as we did in the previous example), nonperforming loans, and loan loss reserve levels. However, sometimes management dresses up or conceals important metrics that would show a deterioration in order to present itself to investors in a more favorable light and to preserve the perception that the firm's economic health is sound.

**Watch for Changes in Financial Reporting Presentation.** Consider the case of New Century Financial Corp., once the largest U.S. independent nonprime lender, whose risky mortgage lending culminated in its April 2007 bankruptcy. In Chapter 6, we discussed how New Century kept its earnings afloat in September 2006 by *reducing* its loan loss reserve, instead of increasing it, in the face of higher delinquencies and bad loans. However, when it released its September 2006 earnings, the company was less than completely honest with investors about its reserve level. Most investors reading the earnings release came away thinking that New Century had actually *raised* its loan loss reserve.

Here's why. New Century realized that investors would be seriously spooked if they knew that the company had reduced its reserves while its subprime loan portfolio was souring, and that this reduction was the primary driver of earnings. Indeed, analysts who followed New Century were monitoring the company's allowance for loan losses closely as the subprime market started to crack. So, when the company released its September 2006 results, management quietly changed its reserve presentation.

Previously, New Century's earnings release had presented the loan loss reserve on a stand-alone basis. However, in September 2006, the company grouped the loan loss reserve with another reserve (allowance for real estate owned) and presented the two together as one unit (see the associated box). By combining the two reserves, New Century was able to say in its release that reserves increased from \$236.5 million in June to \$239.4 million in September. However, the number on which investors had previously been focused—the loan loss reserve—actually *declined* from \$209.9 million to \$191.6 million, according to a November 2007 RiskMetrics



Group report. The loan loss reserve fell because bad loans that had been written off (called charge-offs) had accelerated and New Century had failed to record a sufficient expense to refill the reserve; if it had done so, earnings in September 2006 would have been sliced to \$0.47 from the \$1.12 reported.

### NEW CENTURY'S LOAN LOSS RESERVE DISCLOSURE

#### June 2006 Earnings Release

At June 30, 2006, the balance of the mortgage loan portfolio was \$16.0 billion. *The allowance for losses on loans held for investment* was \$209.9 million, representing 1.31 percent of the unpaid principal balance of the portfolio. This compares with 0.79 percent of the unpaid principal balance of the portfolio at June 30, 2005 and 1.30 percent of the portfolio at March 31, 2006. [Italics added for emphasis.]

#### September 2006 Earnings Release

At September 30, 2006, *the allowance for losses on mortgage loans held for investment and real estate owned* was \$239.4 million compared with \$236.5 million at June 30, 2006. These amounts represent 1.68 percent and 1.47 percent of the unpaid principal balance of the mortgage loan portfolio, respectively. [Italics added for emphasis.]

By simply changing the presentation of a key metric, New Century (1) avoided a devastating announcement and tricked investors into thinking that its loan loss reserve had increased, (2) pretended that its asset quality had not been deteriorating (i.e., that charge-offs were steady), and (3) reported earnings that were much higher than reality. This charade probably bought the company some time before its bankruptcy several months later. Astute investors who were monitoring not only the level of the loan loss reserve, but also the presentation, would have had advance warning of the company's demise. Investors who missed the presentation change in New Century's earnings release, but read the 10-Q released several days later, would have seen the disaggregated loan loss reserve and had fair warning as well.



Executives at New Century eventually got into trouble for their tactics. In 2009, the SEC charged New Century's former CEO, CFO, and Controller with securities fraud for misleading investors, alleging that the Company sought to assure investors that its business was not at risk and was performing better than its peers.

**Be Wary When Companies Stop Disclosing Important Metrics.** Until 2007, California-based East West Bancorp Inc. had provided helpful additional disclosure about problem loans (i.e., loans that were about to go bad) and the change in reserve levels by loan category. This disclosure, while not required, gave investors extra insight into East West's asset base. However, as the real estate market deteriorated in 2007, the company figured that it was better off not disclosing this additional data. By now you know that when important metrics disappear, you should also head for the exits.

#### **4. Distorting Debt Metrics to Hide Liquidity Problems**

A company's cash obligations, such as debt payments, may have an impact on future operating performance as well. Large near-term debt obligations may prevent a company from funding its desired growth initiatives or, at worst, send it spiraling toward bankruptcy.

#### **Maintaining Debt Covenants**

In order to minimize the probability of loan defaults, many lenders lay out rules that require borrowers to maintain a certain level of economic health (called debt covenants). For example, lenders may require a borrower to maintain a certain level of sales, profitability, working capital, or book value. These covenants often pertain to non-GAAP measures of operating performance such as EBITDA (earnings before interest, taxes, depreciation, and amortization). Sometimes management's motivation for fiddling with its numbers comes from the need to stay compliant with these debt covenants.

Investors should be alert to any shenanigans used by management that result in artificially meeting such covenants. Consider American Airlines' bank credit facility, which required the company to maintain a minimum "EBITDAR to fixed charge coverage ratio." (EBITDAR represented earnings before interest, taxes,

depreciation, amortization, and rentals; and fixed charges generally included interest and total rentals.) In early 2003, American found itself in terrible financial condition and embarked on a significant restructuring plan to avoid bankruptcy. As a part of this plan, American's lenders eased certain debt covenants, including this EBITDAR ratio.

Just one year later, however, American was struggling to maintain compliance with this covenant. According to reports from the Center for Financial Research and Analysis at the time, several changes may have enabled the company to stay compliant in early 2004, including (1) a change in assumptions on revenue recognition for nonrefundable tickets, (2) low reserving for expenses, and (3) a reclassification of leases. Alas, by September 2004, American ran out of fuel. The company announced that it was seeking to re-finance this bank facility (at a higher cost) because it was no longer in compliance with its EBITDAR covenant.

### **Europe's Enron**

Parmalat Finanziaria SpA, the Italian-based dairy company and one of the world's largest packaged food companies, grew its business rapidly in the 1990s by aggressively acquiring food service companies around the world. Parmalat relied heavily on the debt markets to fund its shopping spree, borrowing at least \$7 billion in various offerings between 1998 and 2003. As its business ran into serious problems, Parmalat began having trouble generating sufficient cash to pay down this debt. Moreover, top executives of this family-owned and family-dominated company began funneling hundreds of millions of dollars to other family businesses. As a consequence, when bonds came due, Parmalat had a desperate need to issue new bonds and float equity offerings to raise enough cash to pay off the older debt.

Normally, investors would be reluctant to purchase new bonds and equity from a poorly performing company that was strapped with heavy debt obligations and had no cash. So to attract investors, Parmalat concocted a widespread scheme to fraudulently hide its debt and conceal bad assets. By dressing up its Balance Sheet, Parmalat fraudulently portrayed itself to investors as a company that was in robust economic health. At September 2003 (the quarter before the fraud was revealed), Parmalat's unreported debt

amounted to an astonishing €7.9 billion. The company's net worth, reported to be €2.1 billion, was actually *negative* €11.2 billion—an inconceivable €13.3 billion overstatement!

The centerpiece of Parmalat's fraud seems to have been the company's use of offshore entities to fraudulently hide fictitious or impaired assets, fabricate the reduction of debt, and create fake income. The scope of the fraudulent activities that Parmalat is alleged to have engaged in is actually quite amazing. SEC litigation against the company names a few, including forging the repurchase of its debt, faking the sale of bogus or uncollectible receivables, falsifying the payment of payables, recording fictional revenue, mischaracterizing debt as equity, disguising intercompany loans as income, and diverting company cash to various businesses owned by members of the CEO's family.

As usual, there were warning signs for perceptive investors to find. One key warning occurred in late October 2003 when Parmalat's auditors (Deloitte & Touche) wrote in an audit report that they were unable to certify certain transactions involving an investment fund called "Epicurum," which later turned out to be one of these fraudulent offshore entities. These transactions were quite significant. Parmalat had recorded gains on a derivative contract just signed with Epicurum that *accounted for more than all of Parmalat's €119.9 million in pretax earnings* in the first half of 2003, according to a CFRA report at the time. Moreover, these gains were revealed as a result of Parmalat's commenting on Deloitte's review report, but had not previously been disclosed by Parmalat in its June 2003 earnings release.

Less than two weeks later, in early November 2003, Parmalat decided to formally respond to Deloitte's report in a very public manner. It issued four press releases over a span of three days seeking to clarify Deloitte's reasons for not signing off on its financial statements and trying to explain its Epicurum investment in further detail. To be clear, Parmalat decided to refute its auditor in a public forum over a transaction with an obscure offshore entity that had accounted for all of its recent earnings.

Okay, now take a deep breath, have a glass of Parmalat milk, and get ready for the final exam multiple-choice question. Imagine it is mid-November 2003 and you are a Parmalat investor. How would

you have reacted to the news coming out of the company? (Try to take this quiz seriously.)

- a. Parmalat is the cream of the crop. I am not a-moo-sed that the news media are milking this story.
- b. No need to cry over spilled milk. This minor issue won't spoil the fundamentals.
- c. The news is sour, but not enough to get me to mooove my investment.
- d. Holy cow, this is udderly ridiculous! I butter mooove my money out of Parmalat before I get creamed!

We are nearing the end of this book. If you answered anything but (4), then please close the book and start over from the beginning, or just give up on investing in individual companies and buy a stock index fund.

The late 2003 series of events at Parmalat is perhaps the reddest of red flags. As an investor, you should cringe when you see a company having a public disagreement with its auditor, particularly on a shady transaction of significant magnitude. Surprisingly, many investors in Parmalat did not feel that way. It was not until several weeks later that Parmalat's stock price plunged as the company defaulted on its debt.

Your impressive ability to identify red flags will give you a big edge over most investors, and you can proudly say that you now really know how to detect accounting gimmicks and fraud in financial statements.

## Looking Back

### **Warning Signs: Distorting Balance Sheet Metrics to Avoid Showing Deterioration**

- Distorting accounts receivable metrics to hide revenue problems
- Failing to prominently disclose the sale of accounts receivable
- Converting accounts receivable into notes

- Increases in receivables other than accounts receivable
- A huge decline in DSO following several quarters of growing receivables
- Inappropriate or changing methods of calculating DSO
- Distorting inventory metrics to hide profitability problems
- Moving inventory to another part of the Balance Sheet
- Distorting financial asset metrics to hide impairment problems
- Stopping the reporting of certain key metrics
- Distorting debt metrics to hide liquidity problems

## Looking Ahead

Chapter 15 completes not only the section on Key Metrics Shenanigans, but also the last of the three parts of the Financial Shenanigans mosaic. Part 5, “Putting It All Together,” takes you on a quick return tour of all the shenanigans covered in this book and suggestions for how investors can spot them.

## PART FIVE

# PUTTING IT ALL TOGETHER

Congratulations. You have descended the shenanigan mountain, and you are now almost ready to cross the finish line. As “world-class” athletes ourselves, we know the exhilaration of completing a long, arduous run. (We, as you have no doubt surmised, are two of the most fleet-footed accountants you will find anywhere.)

You should feel both intellectually nourished and invigorated. Let’s take one more lap around the “shenanigan track” to take it all in, and to review the key lessons throughout the book. We are confident that you will experience much success in all future competitions when it really counts: with *your money on the line*.

The final chapter provides a recap of (1) the holistic approach to detecting financial shenanigans, (2) the breeding ground for shenanigans, (3) Earnings Manipulation Shenanigans, (4) Cash Flow Shenanigans, and (5) Key Metrics Shenanigans.

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# 16

## SHENANIGANS RECAP AND RECOMMENDATIONS

Chapter 16 provides a thorough recap of Parts 1 through 4, and the accompanying tables can serve as handy reminders of what to look for when reviewing financial statements and searching for financial shenanigans.

### **A Holistic Approach to Detecting Financial Shenanigans**

In Part 1, we drew an analogy between the checks and balances provided by the three branches of the U.S. government and those provided by the three major financial statements (the Balance Sheet, the Statement of Income, and the Statement of Cash Flows). Just as the three branches of government rein in bad behavior by government officials, the three financial statements help to protect investors from misbehaving corporate executives. Specifically, investors can sniff out Earnings Manipulation Shenanigans by scrutinizing the Balance Sheet and the Statement of Cash Flows. Similarly, they can detect signs of misleading operating cash flow by finding unusual or troubling changes on the Statement of Income and the Balance Sheet. Additionally, investors can use the supplementary



Table 16-1. A Holistic Approach—Detecting Shenanigans Using Checks and Balances

Company	Financial Shenanigan	Warnings on Other Financial Statements
Earnings Manipulation Shenanigans		
WorldCom	Boosted income by capitalizing operating costs	SCF: Capital expenditures surged
Transaction Systems Architects	Recorded revenue too soon	BS: Rapid increase in long-term and unbilled receivables
IBM	Boosted income with one-time gain	SCF: Gain on investment sale in Operating section
AOL	Boosted income by capitalizing operating costs	BS: Deferred marketing costs exploded
Cash Flow Shenanigans		
Tyco	Inflated CFFO using acquisitions	BS: Receivables increase differs on BS and SCF
Home Depot	Boosted CFFO with unsustainable gain	BS: Accounts payable surged
Sun Microsystems	Boosted CFFO with unsustainable gain	IS: One-time litigation-related gain

disclosures and key metrics provided by management as another form of “checks and balances.” (See Table 16-1.)

Breeding Ground for Shenanigans

**Part 1.** This part established the foundation and described the breeding ground for shenanigans. The following box summarizes the key warning signs that investors should consider as creating a higher likelihood that shenanigans will be present.

Warning Signs: Breeding Ground for Shenanigans

- Absence of checks and balances among senior management
- An extended streak of meeting or beating Wall Street expectations

- A single family dominating management, ownership, or the board of directors
- Presence of related-party transactions
- An inappropriate compensation structure that encourages aggressive financial reporting
- Inappropriate members placed on the board of directors
- Inappropriate business relationships between the company and board members
- An unqualified auditing firm
- An auditor lacking objectivity and the appearance of independence
- Attempts by management to avoid regulatory or legal scrutiny

## Earnings Manipulation Shenanigans

**Part 2.** This part introduced seven Earnings Manipulation (EM) Shenanigans used to trick investors. The first five inflate current-period income, and the last two inflate that of future periods. The boxes given here show various techniques that management uses for each of the seven shenanigans.

### **Warning Signs: Recording Revenue Too Soon (EM Shenanigan No. 1)**

- Recording revenue before completing any obligations under contract
- Recording revenue far in excess of work completed on a contract
- Up-front revenue recognition on long-term contracts
- Use of aggressive assumptions on long-term leases or percentage-of-completion accounting
- Recording revenue before the buyer's final acceptance of the product

- Recording revenue when the buyer's payment remains uncertain or unnecessary
- Cash flow from operations lagging behind net income
- Receivables (especially long-term and unbilled) growing faster than sales
- Accelerating sales by changing the revenue recognition policy
- Using an appropriate accounting method for an unintended purpose
- Inappropriate use of mark-to-market or bill-and-hold accounting
- Changes in revenue recognition assumptions or liberalizing customer collection terms
- Seller offering extremely generous extended payment terms

### **Warning Signs: Recording Bogus Revenue (EM Shenanigan No. 2)**

- Recording revenue from transactions that lack economic substance
- Recording revenue from transactions that lack a reasonable arm's-length process
- Lack of risk transfer from seller to buyer
- Transactions involving sales to a related party, affiliated party, or joint venture partner
- Boomerang (two-way) transactions to nontraditional buyers
- Recording revenue on receipts from non-revenue-producing transactions
- Recording cash received from a lender, business partner, or vendor as revenue

- Use of an inappropriate or unusual revenue recognition approach
- Inappropriately using the gross rather than the net method of revenue recognition
- Receivables (especially long-term and unbilled) growing much faster than sales
- Revenue growing much faster than accounts receivable
- Unusual increases or decreases in liability reserve accounts

**Warning Signs: Boosting Income Using One-Time or Unsustainable Activities (EM Shenanigan No. 3)**

- Boosting income using one-time events
- Turning proceeds from the sale of a business into a recurring revenue stream
- Commingling future product sales with buying a business
- Shifting normal operating expenses below the line
- Routinely recording restructuring charges
- Shifting losses to discontinued operations
- Including proceeds received from selling a subsidiary as revenue
- Operating income growing much faster than sales
- Suspicious or frequent use of joint ventures when unwarranted
- Misclassification of income from joint ventures
- Using discretion regarding Balance Sheet classification to boost operating income

**Warning Signs: Shifting Current Expenses to a Later Period (EM Shenanigan No. 4)**

- Improperly capitalizing normal operating expenses
- Changes in capitalization policy or accelerated capitalization of costs
- New or unusual asset accounts
- Jump in soft assets relative to sales
- Unexpected increase in capital expenditures
- Amortizing or depreciating costs too slowly
- Stretching out depreciable asset life
- Improper amortization of costs associated with loans
- Failing to record expenses for impaired assets
- Jump in inventory relative to cost of goods sold
- Failure by lenders to adequately reserve for credit losses
- Decrease in loan loss reserve relative to bad loans
- Decline in bad debt expense or obsolescence expense
- Decrease in reserves related to bad debts or inventory obsolescence

**Warning Signs: Employing Other Techniques to Hide Expenses or Losses (EM Shenanigan No. 5)**

- Failing to record an expense from a current transaction
- Unusually large vendor credits or rebates
- Unusual transactions in which vendors send out cash
- Failing to record an expense for a necessary accrual or reversing a past expense

- Unusual declines in reserve for warranty or warranty expense
- Declining accruals, reserves, or “soft liability” accounts
- Unexpected and unwarranted margin expansion
- Unusually “lucky” timing on the issuance of stock options
- Failing to accrue loss reserves
- Failing to highlight off-balance-sheet obligations
- Changing pension, lease, or self-insurance assumptions to reduce expenses
- Outsized pension income

#### **Warning Signs: Shifting Current Income to a Later Period (EM Shenanigan No. 6)**

- Creating reserves and releasing them into income in a later period
- Stretching out windfall gains over several years
- Improperly accounting for derivatives in order to smooth income
- Holding back revenue just before an acquisition closes
- Creating acquisition-related reserves and releasing them into income in a later period
- Recording current-period sales in a later period
- Sudden and unexplained declines in deferred revenue
- Changes in revenue recognition policy
- Unexpectedly consistent earnings during a volatile time
- Signs of revenue being held back by the target just before an acquisition closes

**Warning Signs: Shifting Future Expenses to an Earlier Period (EM Shenanigan No. 7)**

- Improperly writing off assets in the current period to avoid expenses in a future period
- Improperly recording charges to establish reserves used to reduce future expenses
- Large write-offs accompanying the arrival of a new CEO
- Restructuring charges just before an acquisition closes
- Gross margin expansion shortly after an inventory write-off
- Repeated restructuring charges that serve to convert ordinary expenses to a one-time expense
- Unusually smooth earnings during volatile times

**Cash Flow Shenanigans**

**Part 3.** Part 3 expands the discussion to the Statement of Cash Flows. Since investors have started placing more emphasis on cash flow from operations (CFFO), not surprisingly, management has tried to perfect a new class of shenanigans—those that inflate the CFFO. Four general Cash Flow (CF) Shenanigans are used to inflate CFFO, and they are reflected in the accompanying boxes.

**Warning Signs: Shifting Financing Cash Inflows to the Operating Section (CF Shenanigan No. 1)**

- Recording bogus CFFO from a normal bank borrowing
- Boosting CFFO by selling receivables before the collection date
- Disclosures about selling receivables with recourse
- Inflating CFFO by faking the sale of receivables

- Changes in the wording of key disclosure items in the financial reports
- Providing less disclosure than in the prior period
- Big margin expansion shortly after an inventory write-off

**Warning Signs: Shifting Normal Operating Cash Outflows to the Investing Section (CF Shenanigan No. 2)**

- Inflating operating cash flow with boomerang transactions
- Improperly capitalizing normal operating costs
- New or unusual asset accounts
- Jump in soft assets relative to sales
- Unexpected increase in capital expenditures
- Recording purchase of inventory as an investing outflow
- Investing outflows that sound like a normal cost of business
- Purchasing patents, contracts, and development-stage technologies

**Warning Signs: Inflating Operating Cash Flow Using Acquisitions or Disposals (CF Shenanigan No. 3)**

- Inheriting Operating cash inflows in a normal business acquisition
- Companies that make numerous acquisitions
- Declining free cash flow while CFFO appears to be strong
- Acquiring contracts or customers rather than developing them internally
- Boosting CFFO by creatively structuring the sale of a business
- New categories appearing on the Statement of Cash Flows
- Selling a business, but keeping the related receivables



**Warning Signs: Boosting Operating Cash Flow Using Unsustainable Activities (CF Shenanigan No. 4)**

- Boosting CFFO by paying vendors more slowly
- Accounts payable increasing faster than cost of goods sold
- Increases in other payables accounts
- Large positive swings on the Statement of Cash Flows
- Evidence of accounts payable financing
- New disclosure about prepayments
- Offering customers incentives to pay invoices early
- Boosting CFFO by purchasing less inventory
- Disclosure about the timing of inventory purchases
- Dramatic improvements in CFFO
- CFFO benefit from one-time items

**Key Metrics Shenanigans**

**Part 4.** Part 4 introduces readers to a group of shenanigans that stretches management's creativity in deception to the limit. This section of the book shows Key Metrics (KM) Shenanigans used to distort an investor's understanding of the economic performance and health of that company. The accompanying boxes summarize exactly how it is done and how investors can spot these devices.

**Warning Signs: Showcasing Misleading Metrics That Overstate Performance (KM Shenanigan No. 1)**

- Changing the definition of a key metric
- Highlighting a misleading metric as a surrogate for revenue
- Unusual definition of organic growth

- Divergence in trend between same-store sales and revenue per store
- Inconsistencies between the earnings release and the 10-Q
- Highlighting a misleading metric as a surrogate for earnings
- Pretending that recurring charges are nonrecurring in nature
- Pretending that one-time gains are recurring in nature
- Highlighting a misleading metric as a surrogate for cash flow
- Headlining a misleading metric on the earnings release

**Warning Signs: Distorting Balance Sheet Metrics to Avoid Showing Deterioration (KM Shenanigan No. 2)**

- Distorting accounts receivable metrics to hide revenue problems
- Failing to prominently disclose the sale of accounts receivable
- Converting accounts receivable into notes
- Increases in receivables other than accounts receivable
- A huge decline in DSO following several quarters of growing receivables
- Inappropriate or changing methods of calculating DSO
- Distorting inventory metrics to hide profitability problems
- Moving inventory to another part of the Balance Sheet
- Distorting financial asset metrics to hide impairment problems
- Stopping the reporting of certain key metrics
- Distorting debt metrics to hide liquidity problems

## Concluding Thoughts

This third edition of *Financial Shenanigans* updates investors with lessons gleaned from examining many of the deceptive financial reporting practices employed during the last decade. Since we published the original edition of *Financial Shenanigans* in 1993, corporate management has continued to concoct new ways to manipulate its financial reports in order to inflate company stock prices and other compensation-related metrics. And, looking to the future, as management works to create newfangled tricks, diligent investors must continue to learn to detect new financial shenanigans.

The preface of this book quoted a proverb from the Bible (Ecclesiastes 1:9):

What has been will be again, what has been done will be done again; there is nothing new under the sun.

Corporate financial scandals have been around as long as corporations and investors themselves. Dishonest management has preyed on unsuspecting investors, and it is time for such investors to redouble their efforts to be alert for such financial shenanigans so that they can protect themselves.

Since shenanigans at their most basic level represent management's attempt to put a positive spin on a company's financial performance and economic health, our universal message is that investors should assume that the urge to exaggerate the positive and hide the negative will never disappear. And where temptation exists, shenanigans often will follow.

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