25th ANNIVERSARY

4th EDITION

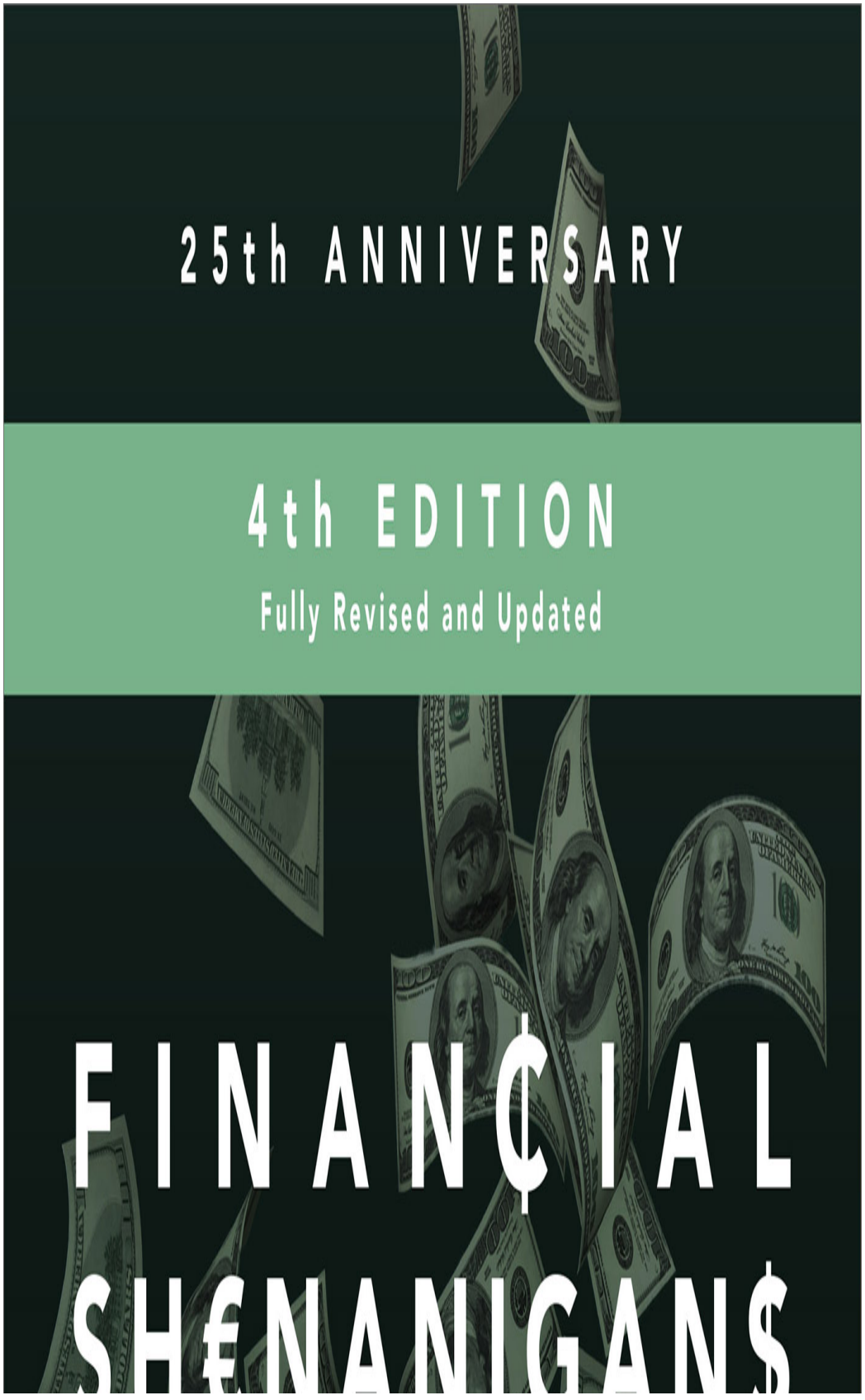
Fully Revised and Updated

FINANCIAL SHENANIGANS

How to Detect Accounting Gimmicks and Fraud in Financial Reports

Howard M. Schilit

Jeremy Perler | Yoni Engelhart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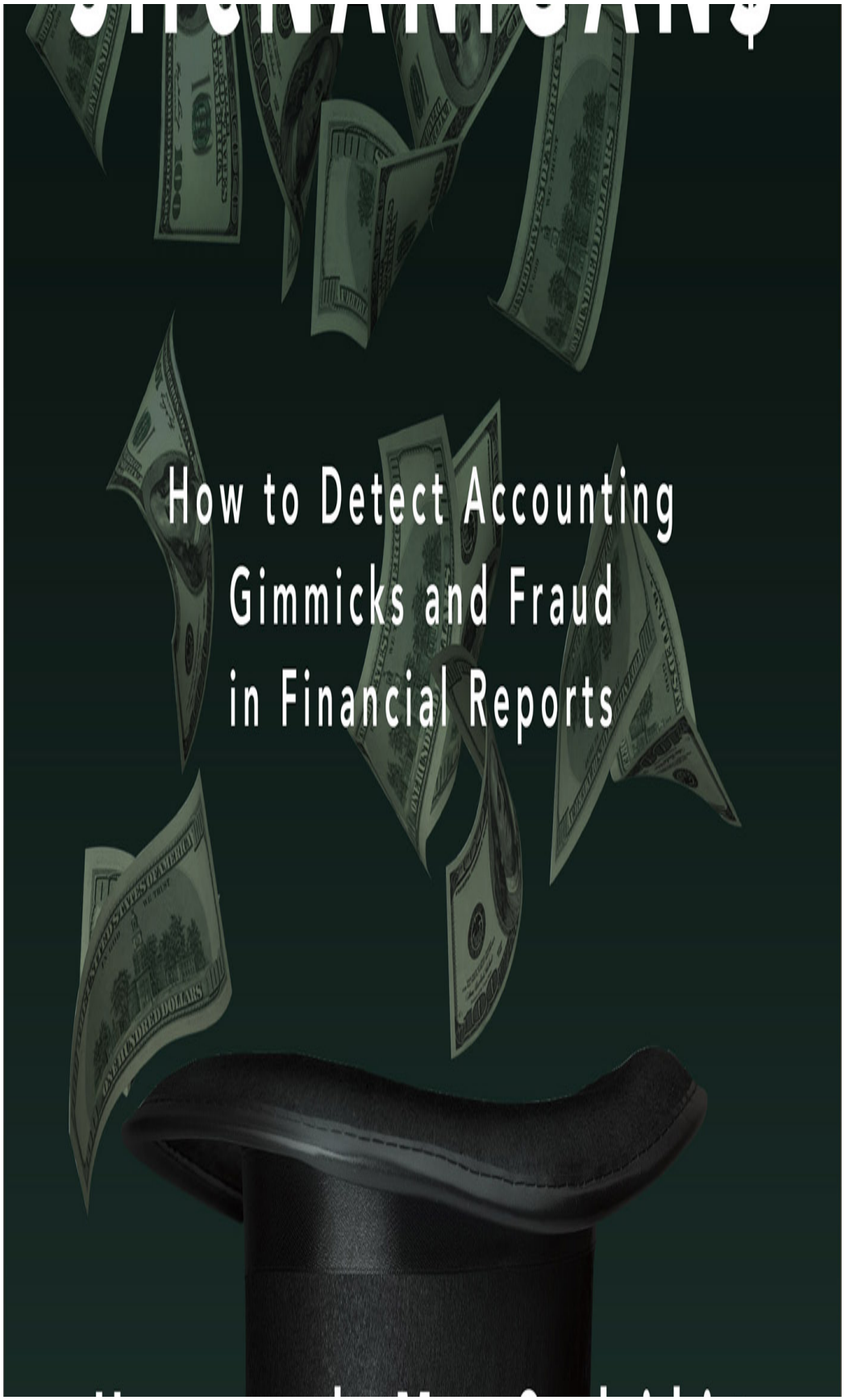
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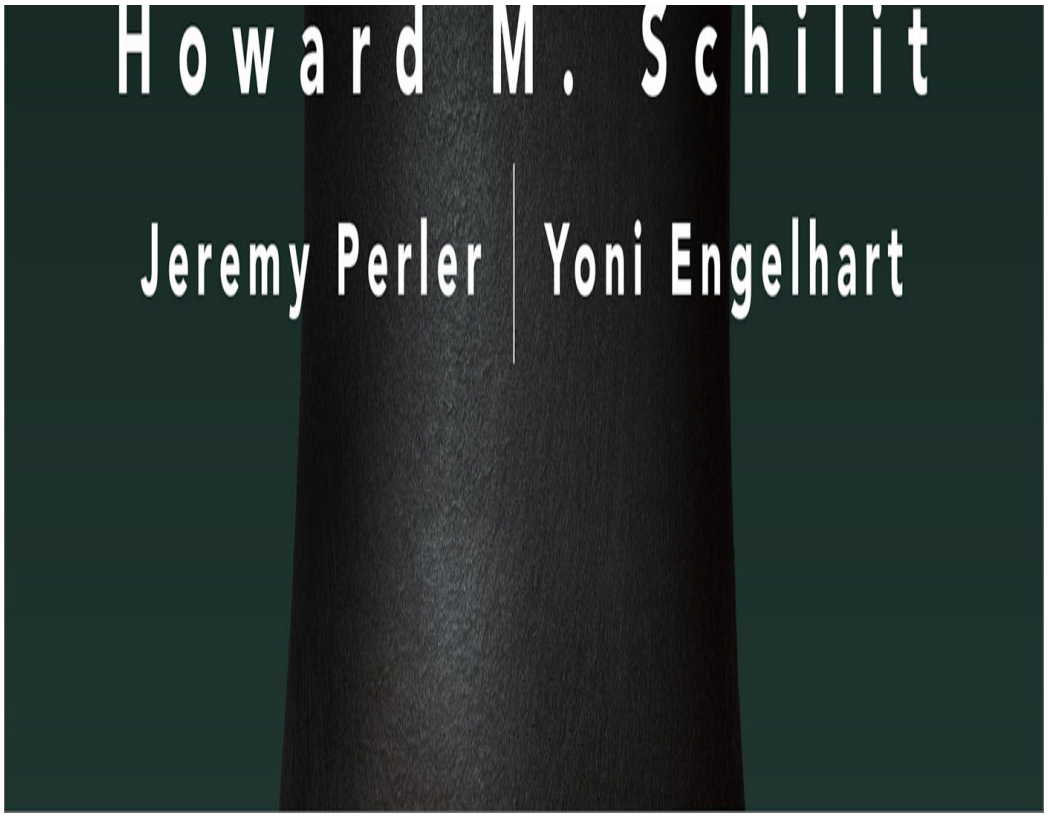

FINANCIAL SHENANIGANS

How to Detect Accounting
Gimmicks and Fraud
in Financial Reports

FOURTH EDITION

Howard M. Schilit
Jeremy Perler | Yoni Engelhart

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In loving memory of Rob Schilit, Howard's dear brother,
who contributed enormously to prior editions of
Financial Shenanigans, and is an ongoing source of inspiration.
He is sorely missed.

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Preface

Reflections on My Last 25 Years
Howard Schilit

Fall 2017

Dear Friends,
Having recently reached my sixty-fifth birthday, I began reflecting on my life and the many changes over the last quarter century since writing the first edition of *Financial Shenanigans*. In short, I feel very blessed. On a personal level, my wife Diane and I love spending time with our three young grandchildren, and are eagerly awaiting our fourth. Professionally, I am enjoying building my second business, a forensic accounting consultancy called Schilit Forensics, with my fantastic partners and coauthors, Jeremy Perler and Yoni Engelhart.

In addition to the research engagements we work on for our clients, we spend a fair amount of time teaching the trade of forensic accounting—to investors, regulators, journalists, and graduate students. After a recent presentation at Stanford's Graduate School of Business, my partners and I realized that seven long years had passed since publication of the last edition of *Financial Shenanigans* and that almost 25 years had passed since the first edition. Over that time, more than 100,000 readers have purchased the book around the globe, including translations in Chinese, Japanese, and Korean. We've learned a lot in the intervening years, and as such we felt it timely to share with you the latest accounting tricks as well as a more considered account of the most important lessons from the last quarter century.

But before turning the pages forward to begin this new edition of *Financial Shenanigans*, let's turn back the clock 25 years to share the beginning of my search for "shenanigans" and the unexpected and exciting journey since 1990.

The Beginning—the Early 1990s

As a professor of accounting at American University in Washington, D.C., I began researching the most prominent accounting frauds over the prior 40 years. Many have been documented in Accounting and Auditing Enforcement Releases (AAER) at the U.S. Securities and Exchange Commission (SEC). I began using many of those interesting vignettes in teaching my Intermediate Accounting and Auditing classes. As I saw that the students found those stories fascinating, I started publishing articles on this subject to share with a larger group. And, of course, the next logical step to reach an even greater audience was to write a book.

Publication of *Financial Shenanigans* and Early Years as Entrepreneur

Shortly after my forty-first birthday, in early 1993 McGraw-Hill published the first edition of *Financial Shenanigans*. The book introduced readers to seven broad categories of earnings misrepresentations, identified 20 discrete techniques that management might employ, and sprinkled in many examples of actual companies that had been sanctioned for tricking investors.

A few pleasant surprises emerged after the book was released. First, lots of readers reached out to thank me for shedding light on the steps that investors could take to safeguard their wealth. Second, the book had made its way into the ranks of big institutional investors, who sought to hire me to train their analysts on how to spot companies playing accounting games. Eventually they began asking me to examine the companies in their portfolios. Fortunately, on several occasions, I was able to use these techniques to alert them of major problems, and they were very thankful for keeping them out of harm’s way.

Founding the Center for Financial Research & Analysis (CFRA) in 1994

While 1993 was an eventful year with the publication of *Financial Shenanigans* and my introduction to some influential investors, it would have been impossible to predict the dramatic changes that followed in 1994 as I launched the Center for Financial Research and Analysis (CFRA). Out of the spare room in my house, I began publishing a monthly newsletter highlighting companies I believed to be struggling but that were using

accounting tricks to hide the problems. On the fifteenth of each month, I sent reports via overnight mail to our subscribers. (Remember, we were still living in the “dark ages” before the Internet and e-mail.) Thankfully, the service was well received, and over 60 investment firms became subscribers during our first year.

The Transition from Professor to Full-Time Entrepreneur

In 1995 I resigned my tenured teaching position at American University in order to devote myself fully to the growing business. I leased office space and began hiring a team of analysts; CFRA was off to the races. By 1999, we began posting our warnings for clients online and sending out e-mails. (Yay, no more printing and collating reports and sending them via overnight mail.) Our client count grew substantially as we became a major player on Wall Street and around the world, with clients on five continents and offices in Washington, D.C., London, New York, and Boston.

The Later Years Running CFRA and the Sale

During the early 2000s, accounting scandals proliferated, with frauds revealed at Enron, WorldCom, and Tyco. The Governmental Affairs Committee of the U.S. Senate investigating the Enron fraud asked me to testify in February 2002. I was regularly interviewed on TV and in print about the growing usage of accounting tricks.

In April 2002, the second edition of *Financial Shenanigans* was released, and sales spiked as the stock market was spooked by a seemingly endless parade of companies using accounting tricks.

As you might imagine, those were golden times for CFRA. Over 200 new subscribers signed up for our research product in 2002 alone, and by the end of the year we were serving over 500 clients. Investment firms needed more help in monitoring their portfolio companies, and short sellers were on the prowl for the “next Enron.” During this busy period at CFRA, we hired additional analysts, and fortunately, both Jeremy and Yoni joined the firm and quickly became leaders. Jeremy eventually became the global head of research, and Yoni led our quantitative research team and headed business strategy for the company.

In early 2003, several potential acquirers came knocking, and I decided to sell a majority stake to the Boston-based private equity firm TA Associates. Jeremy and Yoni remained at CFRA for several more years, while I left the day-to-day job of running the business and started my "years in hibernation," adhering to a long noncompete, which was in effect until late 2010. Yoni left for Harvard Business School in 2008, and upon graduation, he worked for an investment management firm in Boston. Jeremy remained at CFRA until 2011 and then became a forensic accounting specialist at a prominent hedge fund.

The Quiet Years and the Release of the Third Edition of *Financial Shenanigans*

My retirement years involved a lot of traveling, still giving seminars to investment groups and MBA students. By 2009, I was eager to share some of my new ideas and I approached Jeremy about partnering with me to coauthor a third edition of *Financial Shenanigans*. We worked very closely on the book during the summer and early fall of 2009, and the book was released the following April. Knowing that my noncompete would end later that year, I became much more active on the speaking circuit, giving seminars and interviews and doing in-depth research on companies. I was very excited about coming out of retirement and building a new business from scratch.

Building a Second Business: Schilit Forensics LLC

By late 2010, my noncompete had ended, sales of the third edition of *Financial Shenanigans* were brisk, and the media took note of my return from retirement. *Barron's* published a piece entitled "A Financial Sleuth Finds a World of Abuse."

So in 2011 I founded Schilit Forensics LLC on a small scale, taking on just a few clients to dip my toes in the water. I purposefully took it slow, as going from a life of leisure to a full-time commitment seemed daunting. Clients signed three-month agreements for my help in unraveling complicated accounting-focused problems. In contrast to my first business, Schilit Forensics operates as a consultancy engaged to work on custom research projects, not as a subscription service selling a newsletter.

I was really enjoying the nature of the work and close interactions with a small group of wonderfully appreciative clients. In March 2013, Jeremy surprised me with an auspicious phone call. He was still working at the same hedge fund, and while he was very happy there, he was thinking about more entrepreneurial ways to deploy his forensic accounting expertise. It quickly became clear to both of us that we should team up to further build Schilit Forensics. That weekend, he flew to my winter home in Florida, and we formalized our partnership.

Just a couple of months later, Jeremy and I approached our close friend and former colleague Yoni about joining us as a third partner. He was enjoying great success at a prestigious investment firm but harbored a strong desire to harness his entrepreneurial spirit. Yoni's enthusiasm mirrored ours, and he joined Schilit Forensics in July 2013. The three of us are now into our fifth year of working together, and we have developed an impressive team of analysts and diverse roster of clients. Each and every day we read through the fine print of regulatory filings, investor presentations, and other documents to identify signs of business problems before they surface. In doing so we are able to help our clients make better investment decisions.

My partners and I truly love teaching our clients and eager students about spotting companies trying to hide operating problems by using creative accounting games. And, with this same excitement, we are thrilled to impart our quarter-century of learnings and experiences with you, our readers and friends, in this special new edition of *Financial Shenanigans*. Enjoy reading and feel free to be in touch!

Howard M. Schilit
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PART ONE

ESTABLISHING THE FOUNDATION

1
25 Years of Shenanigans

In early 2001, Joe Nacchio, the CEO of Qwest Communications, stood onstage at a companywide meeting and delivered a rousing speech intended to energize his team and focus them on his priorities for the company. “The most important thing we do is meet our numbers,” Nacchio declared. “It’s more important than any individual product, it’s more important than any individual philosophy, it’s more important than any cultural change we’re making. We stop everything else when we don’t make the numbers.” Through his words and deeds, Joe Nacchio created a culture that resulted in $2.5 billion of phantom earnings, landing himself in federal prison and devastating investors who saw the stock price tumble by 97 percent in the 18 months following his speech.

Senior managers at all publicly traded companies yearn to report positive news and impressive financial results that will satisfy investors and drive the share price higher. While most companies act ethically and follow the rules when reporting their financial performance, some take advantage of gray areas in the rules (or worse, ignore the rules altogether) in order to “make the numbers.”

Executives’ desire to put a positive spin on financial results has been around for as long as corporations and investors themselves. Dishonest companies have long used these tricks to prey on unsuspecting investors, and it is unlikely that will ever change. 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 corporate performance by using financial shenanigans will always exist.

The lure of accounting gimmickry is particularly strong at struggling companies that are trying 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 innovate to find new tricks (and recycle old favorites) to fool shareholders.

The Art of Fooling Investors

At its core, this book is about the different ways that corporate management fools investors. The tricks are generally intended to cover up some serious deterioration in a company's business, such as slowing sales, contracting profit margins, or declining cash flow.

While accounting shenanigans have been a scourge to investors since time immemorial, the last quarter century has been particularly brutal. To better arm ourselves for the inevitable challenges of the next 25 years, let's begin by reviewing some of the most significant case studies and key lessons from the past quarter-century.

Waste Management: Investors Cannot Always Rely upon the Auditors

Described by the SEC as "one of the most egregious frauds we have seen," Chicago-based trash hauler Waste Management Inc. (WM) inflated its pretax earnings by $1.7 billion over a six-year period starting in 1992. At that time, it represented the biggest misstatement of income in U.S. corporate history.

Waste Management grew dramatically over the period from 1993 to 1995, spending billions acquiring an unfathomable 441 companies. With these acquisitions came the inevitable special charges against income. These "one-time" charges became so common that during the seven-year period from 1991 to 1997, WM took write-offs in six of those years, totaling $1.6 billion. Since investors typically ignore special charges in evaluating profitability, WM appeared to be in tip-top shape. Also, to keep investors in the dark about what was really happening, WM offset (or "netted") numerous one-time investment gains from asset sales against these special charges.

Waste Management was also notorious for finding ways to inflate profits by deferring expenses to a later period. The company aggressively capitalized maintenance, repair, and interest costs to the Balance Sheet rather than expensing them, and minimized the depreciation expense on its garbage trucks by using inflated salvage values and lengthening their useful lives.

As you will see throughout this book, big accounting problems can be conveniently covered up when companies make many acquisitions.

Following Waste Management's July 1998 acquisition of USA Waste Services, the company's newly hired CEO became concerned about internal controls and accounting practices and ordered a special review. One of the most troubling findings of the review was that the company's internal controls were so poor that previously reported financial statements could not be relied upon. WM issued the following warning to investors in its 10-Q report:

> The Company, after consultation with its independent public accountants (Arthur Andersen), has concluded that its internal controls for the preparation of interim financial information did not provide an adequate basis for its independent public accountants to complete its review… .

After the SEC sued Waste Management alleging fraud, we later learned in reviewing the legal documents that its auditor, Arthur Andersen, was aware of accounting problems much earlier but chose to "protect" its client. As far back as 1993, Arthur Andersen quantified misstatements totaling $128 million, which, if recorded, would have reduced net income before special items by 12 percent. The Andersen partners, however, determined that the misstatements were "immaterial," and they blessed the 1993 financial reports with a clean opinion.

Indeed, each year when Andersen raised accounting concerns with WM, the proposed adjustments and restatements—not surprisingly—were ignored by management. During the 1995 audit, Andersen clearly disagreed with WM's approach to netting one-time gains against special charges and the choice not to disclose the practice. Here are excerpts from the auditor's 1995 internal memorandum:

> The Company has been insensitive to not use special charges [to eliminate Balance Sheet errors and misstatements that had accumulated in prior years] and instead has used "other gains" to bury charges for Balance Sheet clean-ups.

Despite writing in the memo a strong disapproval of this practice, Andersen chose not to issue an adverse opinion for the 1995 report, nor take steps to end this practice in the following years. Was it because Andersen had become too close to WM executives and too economically dependent on the company, preventing Andersen from properly serving investors and

warning them of this problem? Indeed, WM was Andersen's largest account in its Chicago office, and Andersen had served as WM's auditor every year since its IPO in 1971.

CUC/Cendant: Acquisitions Cannot Make Business Problems Disappear

Just as at Waste Management, many accounting shenanigans can be found at companies using acquisition strategies to achieve rapid growth. Consider CUC International, a darling stock for much of the 1980s–1990s, run by Walter Forbes. By the mid-1990s, CUC started making acquisitions that should have given investors a wake-up call. In April 1996 the company acquired Ideon Group for nearly $400 million. Through the merger, CUC inherited substantial litigation obligations, and booked a reserve for these costs totaling $137 million. Shortly after Ideon closed, CUC bought Davidson and Sierra On-Line for around $2 billion. These businesses produced educational software games, completely unrelated to CUC's core business, and also came with significant merger-related reserves.

Cendant was created in December 1997, through the merger of Henry Silverman's HFS and Walter Forbes's CUC International. This practice of creating merger-related reserves continued in late 1997 (when CUC was about to merge with HFS to form Cendant), as CUC set up a reserve to write off a staggering $556 million associated with this deal.

The stock eventually collapsed in March 1998 when accounting problems at CUC were revealed to investors. When the subsequent investigations and litigation concluded, the total costs of the fraud were staggering. Consider that in 1996 and 1997 alone, investigators found more than $500 million of bogus operating income. Walter Forbes was sentenced to 12 years in prison and assessed $3.25 billion in restitution for his crime. And CUC's auditor, Ernst & Young, which failed to perform the appropriate tests to spot the fraud, paid $300 million to settle class-action litigation.

Enron: Numbers That Seem Unbelievable Should Not Be Believed

Unlike acquisition-fueled frauds like Waste Management and CUC, Enron's trickery was entirely organic: it simply changed its business model (and accounting policies) in a dramatic way. Enron, perhaps the most recognizable accounting fraud of the past generation, was a largely unknown producer of natural gas that within a few years morphed into an

enormous commodities trading company. This dramatic change in business model was accompanied by a meteoric rise in revenues through the late 1990s. In just five short years, Enron's revenue had increased by an astounding factor of 10, growing from $9.2 billion in 1995 to $100.8 billion in 2000. In 2000 alone, Enron's sales grew a staggering 151 percent, from $40.1 billion to $100.8 billion.

As shown in Table 1-1, despite Enron's dramatic revenue growth, net income grew much more slowly. Specifically, revenue grew 10-fold during this period, and net income struggled to even double.

Table 1-1 Enron's Revenue and Net Income, 1995 to 2000

($ millions)	1995	1996	1997	1998	1999	2000
Revenue	**9,189**	13,289	20,273	31,260	40,112	**100,789**
Net income	**520**	584	105	703	893	**979**

Curious investors might question how often other companies have managed to grow their revenue from under $10 billion to over $100 billion in just 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! Underlying the reported revenue growth was the company's unusual treatment of trading activities as sales. These transactions resulted in modest profits, but because the notional values of trades were accounted for as part of revenue (and cost of goods sold), it gave the appearance that the business was in a period of hypergrowth.

WorldCom: Focus on Free Cash Flow in Addition to Earnings

Throughout WorldCom's history, its growth came largely from making acquisitions. (As we will explain later in Part Five, acquisition-driven companies offer investors some of the greatest challenges and risks.) WorldCom's largest deal closed in 1998 with its $40 billion acquisition of MCI Communications.

Almost from the beginning, WorldCom used aggressive accounting practices to inflate its earnings and operating cash flows. Much like CUC, 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 releases into earnings.

This strategy 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 was left without the expected infusion of new reserves that it needed, as its prior ones had rapidly been depleted after being released into income.

By early 2000, with its stock price declining and intense pressure from Wall Street to hit earnings targets, WorldCom embarked on a new and far more aggressive shenanigan—moving ordinary business expenses from its Income Statement 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 access their networks. Accounting rules clearly required that such fees be expensed and *not capitalized*. Nevertheless, WorldCom removed hundreds of millions of dollars of its line costs from its Income Statement to please Wall Street. In so doing, WorldCom dramatically understated its expenses and inflated its earnings, duping investors.

As earnings were being overstated, investors would have found some clear warning signs in evaluating WorldCom's Statement of Cash Flows, specifically, its rapidly deteriorating free cash flow. WorldCom had 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 section rather than the Operating section of the Statement of Cash Flows, WorldCom similarly inflated operating cash flow. While reported operating cash flow appeared consistent with reported earnings, the company's free cash flow told the real story.

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

from there. The CFO was fired, the controller resigned, Arthur Andersen withdrew its audit opinion for 2001, and the SEC launched its 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.

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 its competitor MCI for about $7 billion. Two months later, former WorldCom chief executive Bernie Ebbers was found guilty of all charges and convicted of committing fraud and conspiracy and filing false documents. He was later sentenced to 25 years in prison.

Lehman Brothers: Balance Sheet May Not Reflect Actual Trends at Business

Just as the 1929 stock market collapse scarred our parents' and grandparents' generations, the 2008 financial markets carnage clearly has left a painful memory for all homeowners and investors. Perhaps no Wall Street brokerage had a worse outcome than Lehman Brothers, as its share price collapsed in September 2008 and will be remembered as the biggest bankruptcy (based on asset size) in U.S. corporate history.

In a report commissioned by the bankruptcy court judge to investigate the Lehman collapse, attorney Anton Valukas alleged that the company had cleverly misled investors and creditors by hiding $50 billion of debt from its Balance Sheet. This deception related to Lehman's aggressive interpretation of an arcane (and since changed) accounting rule known as "Repo 105."

When borrowing cash through very short-term collateralized loans, say for payroll, the cash received should be reflected on the Balance Sheet as a

liability, and the assets given in collateral should remain on the borrower's Balance Sheet. The "Repo 105" rule allowed for an exception when the value of the assets given as collateral represented at least 105 percent of the loan value. In these cases, the transaction was no longer accounted for as a loan, rather it was considered a sale and subsequent repurchase of the collateral assets. Lehman seized upon this loophole and in doing so recorded its collateralized borrowings as asset sales. As such, instead of recording a short-term liability for the cash received, Lehman would record a temporary reduction to its assets.

The bankruptcy examiner's report highlighted a suspicious spike in Lehman's Repo 105 transaction balance at the month-ends corresponding with either a quarterly or year-end filing. Since the need for overnight borrowings should remain fairly consistent throughout a quarter, the jump in Repo 105 transactions *only* on dates corresponding to financial filings may suggests that Lehman artificially depressed its liability balance in order to mislead investors into believing that the company's leverage was lower. Table 1-2 shows the monthly trend in Lehman's Repo 105 balance. Note that in May 2008, the Repo 105 balance jumped to $50.8 billion from $24.6 billion in March and $24.7 billion in April 2008. This same suspicious phenomenon is found in the earlier period, as well.

Table 1-2 Lehman Repo 105 Spikes at Quarter End

	Q4 '07			Q1 '08			Q2 '08
($ billions)	11/07	12/07	1/08	2/08	3/08	4/08	5/08
Repo 105 Balance	$38.6	N.A.	$28.9	$49.1	$24.6	$24.7	$50.8

Valeant Pharmaceuticals: It's Dangerous to Rely on Management's Favored Performance Metrics

Unlike the more celebrated frauds mentioned at Enron, WorldCom, etc., Valeant is less a story of outright fraud and more of a clever company using misleading metrics to dupe some of the most successful institutional investors. And if it could happen to them, it could happen to all of us, if we let our guards down or grow too close to corporate management.

But oh how investors loved this company. In less than a decade, Valeant's market value elevated from just a few billion dollars to $90 billion by early

August 2015. Over the next two years, however, it would fall 96 percent, losing a staggering $87 billion of market value. To give a sense of scale in those numbers, the equity value destruction for investor totaled $74 billion at Enron and $29 billion at Cendant.

Valeant would not have been able to realize or sustain its massive run-up in market value based on its GAAP-compliant earnings; in most years, the company reported steep losses. However, management pointed investors to a misleading non-GAAP "cash earnings" metric as a better measure of performance. Cash earnings scaled up quickly as sales from acquisitions fueled top-line growth, and the amount of expenses excluded from the earnings measure increased. The company had persuaded investors to ignore all expenses that did not manifest as normal, recurring cash outflows during the period, and then the company embarked on a strategy to grow through M&A, which ensured that most costs would come through as either depreciation, amortization, or a one-time acquisition-related charge. During the period 2013–2016, Valeant reported cash earnings totaling $9.6 billion, while its audited GAAP net income amounted to *losses* of $2.7 billion, a whopping difference of $12.2 billion.

Looking Ahead

Our tireless journey over the last quarter century has been driven both to uncover games used by management to trick investors and to share these lessons with our readers. In this special twenty-fifth anniversary of *Financial Shenanigans*, we have added a new category of shenanigans, *Acquisition Accounting Shenanigans*, since acquisitions provide a convenient cover for management to play accounting games.

We hope this new edition provides you the tools to sniff out key warning signs and confidently protect and grow your wealth.

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 shareholders 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 unpleasant truths 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 accepting the diagnosis of his deteriorating health, the patient immediately responded to the dreadful news by asking the doctor to simply touch up the x-rays. Buffett uses this story to warn investors about companies that try to hide the truth about their 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.

The chapters ahead provide a wide range of case studies covering companies that have simply papered over their financial performance and economic health problems in order to delay the inevitable bad news, and the techniques to identify them in advance.

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 tricked into believing that the company's earnings are stronger, its cash flows more robust, and its Balance Sheet position more secure than they really are.

Some shenanigans can be detected in the numbers presented by carefully reading a company's Balance Sheet (formally called the Statement of Financial Position), Income Statement (Statement of Operations), and Statement of Cash Flows. Signs of other shenanigans might not be as easily seen in the numbers and instead require scrutiny of the narratives contained in Footnotes, quarterly Earnings Releases, and other representations by management. We classify financial shenanigans into four broad groups (discussed in Parts Two to Five in the book): Earnings Manipulation Shenanigans (Part Two), Cash Flow Shenanigans (Part Three), Key Metric Shenanigans (Part Four), and Acquisition Accounting Shenanigans (Part Five).

Earnings Manipulation Shenanigans (Part Two)

Investors judge corporate executives harshly when they fail to meet Wall Street's earnings expectations. Not surprisingly, to steer the share price (and often executives' compensation packages) higher, some companies engage in a variety of shenanigans to manipulate earnings. We have identified the following seven categories of 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 the current period

Cash Flow Shenanigans (Part Three)

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).

Many investors believe that unlike earnings, cash flow is rock solid and difficult to manipulate. Sadly, this is wishful thinking. The Statement of Cash Flows is not immune to accounting gimmicks, and in many ways, manipulating cash flow can be just as easy as manipulating earnings. We have identified the following three categories of Cash Flow (CF) Shenanigans that result in misrepresentations of a business's real cash profitability.

CF Shenanigan No. 1: Shifting financing cash inflows to the Operating section

CF Shenanigan No. 2: Moving cash outflows from the Operating section to other sections

CF Shenanigan No. 3: Boosting operating cash flow using unsustainable activities Shenanigans

Key Metric Shenanigans (Part Four)

So far, we have addressed shenanigans in the traditional financial statements. Increasingly however, business results are presented outside of this format in order to cater to a wider range of company-specific and industry-specific metrics. These include measures such Same-Store-Sales, Bookings, Average Revenue per User (ARPU), Return on Invested Capital (ROIC), Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) and many others. Since they are outside the realm of GAAP, companies have much more latitude in calculating and reporting key metrics. Naturally this creates an opportunity for shenanigans. Part Four introduces two categories of Key Metric (KM) Shenanigans.

KM Shenanigan No. 1: Showcasing misleading metrics that overstate performance

KM Shenanigan No. 2: Distorting Balance Sheet metrics to avoid showing deterioration

Acquisition Accounting Shenanigans (Part Five)

Over the last quarter century, we have found some of the most disturbing shenanigans hidden through the complicated acquisition accounting process. We have therefore added this section to this new edition of *Financial Shenanigans* to highlight the complexities inherent in evaluating M&A-driven companies and to identify the common shenanigans that often trip up investors.

AA Shenanigan No. 1: Artificially boosting revenue and earnings

AA Shenanigan No. 2: Inflating reported cash flow

AA Shenanigan No. 3: Manipulating key metrics

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, D.C., 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 the American 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.

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 distinct "branches," an Income Statement, a Balance Sheet, and a Statement of Cash Flows. When one of these financial statements contains shenanigans, warning signs generally appear on the other ones. Thus, Earnings Manipulation Shenanigans can often be detected indirectly through unusual patterns on the Balance Sheet and the Statement of Cash Flows. Similarly, deciphering certain changes on the Income Statement and the Balance Sheet often can help investors sniff out Cash Flow Shenanigans.

What Environment Breeds Shenanigans?

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?

Management Teams Devoid of Checks and Balances

In the best companies, senior executives can freely criticize and disagree with one another—sort of like in a good marriage. In unhealthy companies, a single dictatorial leader runs roughshod over the others—not unlike in a bad marriage. Investors face great risks if that dictatorial leader is also bent on creating misleading financial reports. Who can stop the CEO when a culture of fear and intimidation exists? 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 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 bad behavior.

Watch for Senior Executives Who Push for Winning at All Costs

At beginning of the previous chapter, we shared Joe Nacchio's words about the necessity of always "making the numbers" when he spoke to his team at a 2001 company meeting.

With that scary philosophy, no one should have been surprised that Nacchio and six former Qwest executives were sued by the SEC, accusing them of orchestrating a sweeping $3 billion accounting fraud from 1999 to 2002. Nacchio was later convicted and sentenced to almost six years in federal prison.

Be Skeptical of Boastful or Promotional Management

Investors should be particularly careful when management publicly boasts about its long consecutive streak of meeting or exceeding Wall Street's expectations. Invariably, tough times or speed bumps emerge, and management may feel more pressured to use accounting gimmicks and

perhaps fraud to keep the streak alive, rather than announcing that its run of success has ended.

Consider the case of Symbol Technologies, the Long Island–based maker of bar code scanners. Symbol seemed to be obsessed with never disappointing Wall Street. For more than eight consecutive years, the company either met or exceeded Wall Street's estimated earnings—32 straight quarters of sustained success. In reality, Symbol was using almost every shenanigan in the book to maintain its "winning streak." The SEC ultimately caught up with Symbol and accused the company of perpetrating a massive fraud from 1998 until 2003.

Companies engaged in many other blockbuster frauds have emphasized 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, which later emerged as one of largest frauds in Europe, 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.

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 (of a certain age) 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 NFL gridiron great (and convicted felon) O.J. Simpson was assigned the duty of faithfully protecting investors' interests by serving on the all-important *audit committee* of Infinity Broadcasting in the 1990s. It is unlikely that O.J. (or frankly, most any professional athlete) would have the necessary expertise and experience to navigate the intricacies of a Balance Sheet, let alone overseeing financial reporting and disclosure processes. Investors should insist that outside board members have the essential knowledge and experience and serve only on appropriate committees that suit their technical skills.

Failure to Challenge Management on Related-Party Transactions

In 2008 executives at India's information technology giant Satyam decided to acquire a company, Maytas, in a transaction that required board approval. The board met and acquiesced to management's request, even though 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 objected to the acquisition not only because the CEO's sons controlled the target company 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 (certainly not its core business) at a time when its core business was under pressure and additional investments would have likely been better directed toward 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.

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 very strange and reckless compensation plan.

Sometimes, even thoughtful compensation schemes, if taken to an extreme, can lead to very risky behavior by management and disastrous results for investors. Consider Valeant's pay-for-performance agreement with its senior executives. The principal factor used to determine stock-based compensation was the average increase in share price, referred to as "total shareholder return" (or TSR). The higher the TSR, the greater number of additional shares received by these executives. And with annualized returns at Valeant exceeding 60 percent, CEO Michael Pearson's wealth grew beyond anyone's imagination—to over $3 billion at its peak! But, of course, it led to incredibly risky behavior, to the detriment of its long-term investors.

Moreover, in addition to its misguided stock-based compensation based solely on stock price appreciation, its annual cash incentive program (AIP) left much to be desired. Rather than basing this payout on certain reliable, audited GAAP-based results, Valeant used two non-GAAP metrics—adjusted earnings and adjusted revenue. (As we show in Chapter 17 , Valeant's adjusted earnings grossly inflate its true performance.)

Upon reflection, a few important lessons emerge: Too much of a good thing could be very bad. Yes, pay for performance generally is a good thing, *but only if it is applied to sensible metrics and if it encourages prudent risk taking.* The compensation plan at Valeant was irreparably flawed in two fundamental ways: (1) it was based solely on stock price appreciation and unreliable non-GAAP metrics, and (2) its excessive pay for extreme TSR growth encouraged reckless management behavior.

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.

Auditors 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 financial markets nosedived.

The auditor, however, can be either friend or foe to investors: a friend if the auditor is competent, independent, and fastidious in sniffing out problems; a foe if the auditor 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 falls—friend or foe.

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 "Enron of Europe." While the business 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 its primary auditor 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 offshore accounts, which turned out not to exist (many of which were still audited by Grant Thornton at the time, 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.

Like Parmalat, one of the biggest accounting frauds to hit Japan went undetected for far too long because the auditor had a long and cushy 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

Every region seems to have its "Enron." India's is IT consultancy Satyam Computer Services, which earned its dubious distinction as the "Enron of India" in 2009 upon exposure that it was a massive fraud. "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. Allegations claimed 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 the setting of 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 Regulatory Scrutiny Before Going Public

If managers really want to avoid serious scrutiny from SEC reviewers, they 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.

Looking Ahead

Now you are ready to jump in and learn about the four categories of financial shenanigans: Earnings Manipulation (Part Two), Cash Flow (Part Three), Key Metrics (Part Four), and Acquisition Accounting (Part Five).

Earnings Manipulation 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.

PART TWO

EARNINGS MANIPULATION SHENANIGANS

Investors rely on the information that they receive from companies 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 Two fleshes out the seven categories of Earnings Manipulation (EM) Shenanigans and suggests how skeptical investors can ferret out these tricks to avoid losses.

EARNINGS MANIPULATION SHENANIGANS

EM Shenanigan No. 1: Recording revenue too soon (Chapter 3)

EM Shenanigan No. 2: Recording bogus revenue (Chapter 4)

EM Shenanigan No. 3: Boosting income using one-time or unsustainable activities (Chapter 5)

EM Shenanigan No. 4: Shifting current expenses to a later period (Chapter 6)

EM Shenanigan No. 5: Employing other techniques to hide expenses or losses (Chapter 7)

EM Shenanigan No. 6: Shifting current income to a later period (Chapter 8)

EM Shenanigan No. 7: Shifting future expenses to the current period (Chapter 9)

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

Inflating Current-Period Earnings

Quite simply, 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 Nos. 1, 2, and 3 push revenue or one-time gains into current-period operations, and Nos. 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 *inflated* by inappropriately including revenues or gains and by excluding rightful expenses or losses of that period. Conversely, earnings can be *deflated* by inappropriately excluding revenues or gains of that period and by including expenses or losses that really pertain to another period. Of course, a scheme to deflate current-period earnings pays off when those benefits are released into a later period.

Of the seven categories of Earnings Manipulation Shenanigans, the first five serve to inflate earnings, and the last two serve to lower profits. For most readers, the use of Shenanigans Nos. 1 through 5 to exaggerate earnings might seem more logical or intuitive. After all, higher reported profits often lead to a higher stock price and higher executive compensation. The logic of using Shenanigans Nos. 6 and 7 may be less obvious, but they do serve a purpose. These schemes serve to shift earnings from one period (with excess profits) to another (in need of profits). Put differently, management may simply be attempting to smooth out volatile earnings to portray a less volatile business.

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 to help remember the number of days in each month. Frankly, it still comes in handy as a reminder well into our adult years. It was much later in life though when we realized that February was not necessarily the only exception to the 30- or 31-day rule. In fact, every month could be the exception for a company that wishes to inflate its revenue. Computer Associates (CA) had become the poster child for this revenue inflation trick, regularly stretching out its months to 35 days on the books in order to capture sales booked after the conventional month-end. 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. This chapter 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 material 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 Material Obligations Under the Contract

Riding the Tech Wave at Microstrategy

Who could forget the raging Internet-driven bull market during the late 1990s (with the Nasdaq Index up 94 percent in 1999) and the almost-anything-goes accounting practices used to fuel the stratospheric growth of many tech companies? Perhaps the poster child for this crazy period would be Virginia-based software seller MicroStrategy (MSTR). In less than two years after going public, its market value reached $25 *billion*, a staggering 60-fold increase. A key driver of its growth, it turns out, was a practice of recording sales to parties that MicroStrategy had recently invested in. While it's impossible to know for sure whether these were in fact sham transactions, the fact pattern raised serious suspicion. In addition to these questionable sales, MSTR pushed customers to sign contracts just before quarter-end, believing that the signing of a contract was the key event to permit recording revenue. As we will discuss later, revenue is recognized when earned, that is, when services have been performed.

Living a Dream—and a Nightmare Imagine living the American dream during the Internet era. You and your college buddy create a software company. For the first few years, you work around the clock, but you take virtually no cash compensation. Instead, you reward yourself and your valued employees with stock and stock options. You begin meeting with investment bankers to plan your much-anticipated initial public offering (IPO). Then it happens—the bankers successfully peddle your shares to the public. You now have your first few million. But that's only the beginning. The share price of your (now public) company begins to levitate wildly, you

become one of the wealthiest people in America, and at age 34, you are not even old enough to run for the presidency. The media treat you like royalty.

This was the real-life dream of MicroStrategy's founder, Michael Saylor. Founded in 1989, MSTR went public in 1998 at a market valuation over $200 million. That was only the beginning of an incredible odyssey. In the last four months of 1999, the share price began to rise dramatically, from $20 to over $100. Over the next 10 weeks, the stock soared incredibly to $333. Michael Saylor's net worth reached an almost inconceivable $14 billion.

Then the dream turned into a nightmare of epic proportions. On March 20, 2000, MSTR disclosed to investors that its financial reports contained material accounting irregularities. The financial reports for 1997 to 1999 had to be restated, resulting in massive losses, rather than the previously reported profits. Shocked investors started dumping the stock, dropping the share price $140 (from $226 to $86) *in a single day*. But that was only the beginning. It didn't bottom out until reaching $1.75 twelve months later. (The share price continued declining through 2002, at which point the company announced a 1-for-10 reverse split [effectively pushing its share price up 10-fold] to avoid being delisted from the stock exchange.)

What Led to the Collapse? In early March 2000, only weeks after its auditors, PricewaterhouseCoopers (PwC), had blessed MSTR's 1999 financial reports (contained in a prospectus for a proposed stock offering), *Forbes* magazine broke the story that raised troubling questions about the company's revenue recognition practices.

After the *Forbes* article, PwC then conducted an internal investigation and concluded that the company's audited financial reports indeed were false and misleading. The auditor's swift about-face, an extremely rare event, sent the share price into a free fall.

Warning Signs for Investors Found in Odd Press Releases On October 5, 1999, MSTR announced in a press release that it had signed a deal with NCR Corporation. In the release, MSTR described a $52.5 million licensing agreement and a partnership with NCR Corporation. Under the agreement, MSTR invested in an NCR partnership, and NCR returned the favor and purchased MSTR's products. When money flows in both directions, from seller (MSTR) to customer (NCR) and then from customer to seller, we call it a "boomerang" transaction. As the press release put it:

> Under the terms of the partnership, NCR signed a $27.5 million OEM [original equipment manufacturer] agreement for MicroStrategy's products and personal information services. In addition, MicroStrategy has chosen to purchase an NCR Teradata Warehouse worth $11 million to power the Strategy.com network.
>
> As part of the OEM agreement, NCR will become a master affiliate of Strategy.com. As a master affiliate, NCR will join the network, sell Strategy.com affiliations, and sell MicroStrategy products and services. As part of the agreement, MicroStrategy will provide NCR's future OLAP technology. MicroStrategy has agreed to purchase NCR's TeraCube business and all related intellectual property in exchange for $14 million in MicroStrategy stock.

Then just after the December 1999 quarter ended, on January 6, 2000, MSTR sent out another press release (excerpts shown below), also including a suspicious "boomerang" payment scheme that contributed to reported revenue, likely in the preceding period.

> Under the terms of the agreement, Exchange Applications will pay MicroStrategy an initial $30 million fee, payable through the combination of cash and Exchange Applications stock, of which approximately one-third will be recognized by MicroStrategy as revenue during the fourth quarter of 1999. In addition, MicroStrategy can earn up to an additional $35 million for future eCRM applications over the next two to three years. As part of the agreement, Exchange Applications will become a master affiliate of Strategy.com. As a master affiliate, Exchange Applications will join the network, sell Strategy.com affiliations, and sell MicroStrategy products and services.

Key Lessons for Investors Two important lessons can be gleaned from the MicroStrategy story: (1) Funds flowing back and forth between a customer and seller should raise suspicions about the legitimacy of both transactions, and (2) the suspicious timing of press releases announcing new sales (just after a period ended) should raise questions about whether revenue might have been recognized too early. Indeed, as we learned from other sources, MSTR regularly rushed to have sales contracts signed and dated *just before a period ended*, with the goal of accelerating revenue into that earlier period. We believe that from an accounting perspective such efforts were all

for naught, as revenue should be recognized when earned, not at the point of signing a contract.

Calendar Games

Imagine if you could place a bet on a horse race *after* the race ends. That sounds ridiculous; since you already would know the results beforehand, naturally, you would always win. Well, that approach reminds us of companies in jeopardy of "losing"—that is, failing to meet Wall Street's consensus estimates—those companies that at quarter-end stretch out the end date (like CA using 35 days) to ensure that they also always win by closing their books only *after* reaching the desired sales and profits.

Be Wary of Companies That Extend Their Quarter-End Date CA was not alone in improperly inflating revenue by keeping the books open beyond the prescribed quarter-end. 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 core operations and $15 million more from its recently acquired Coleman Corporation.

Not to be outdone by CA 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."

Changing Accounting Policies to Keep the Streak Alive

As we discussed earlier, when senior executives boast about an amazing record streak of performance, it is more likely that they will resort to financial shenanigans to keep that streak alive.

Consider how the popular coffee seller Keurig Green Mountain (Keurig) tried to hide its slowing revenue growth from investors. The company whimsically changed its decision rules on *when* recognition begins and *where* large-quantity rebates get categorized on the Income Statement. Keurig was growing very fast in the 2005–2008 period, and CEO Lawrence J. Blanford, proud of this achievement, regularly boasted to investors in Earnings Releases:

> It is great to be sharing such favorable results again this today. 2007 was a year of strong financial returns with net sales and earnings increasing 52% over the prior year. It was Green Mountain Coffee's 20th consecutive quarter of double-digit net sales growth and eighth consecutive quarter with growth in excess of 25%.

As we know, compounding anything at over 25 percent for a long time produces pretty big numbers. In the case of sales growth, it would be virtually impossible that a streak at that elevated level could be sustained. So it would be only a matter of time before Keurig would have to either announce that the streak had ended or figure out a way to make it appear that the streak had continued. Unfortunately, Keurig chose the latter approach. Reading the company's 10-K filings for fiscal 2007 and 2008, we came across two subtle (but important) accounting policy changes that management made in 2008 to inflate revenue. First, the company began to recognize some revenue earlier in the sales process—at the point of shipment, rather than delivery. Second, it started to treat incentives or "rebates" to customers as an operating expense rather than a reduction of sales.

KEURIG GREEN MOUNTAIN FOOTNOTES DESCRIBING ITS REVENUE RECOGNITION POLICY

10-K 2007—Revenue from wholesale and consumer direct sales is *recognized upon product delivery*. In addition, the Company's customers can earn certain *incentives, which are netted against sales* in the consolidated income statements. [Italics added for emphasis]

10-K 2008—Revenue from wholesale and consumer direct sales is *recognized upon product delivery, and in some cases upon product shipment*. In addition, the Company's customers can earn certain *incentives, which are netted against sales or recorded in operating and selling expenses* in the consolidated income statements. [Italics added for emphasis]

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

The first section illustrated how companies improperly recognize revenue by recording sales before significant activities by the seller even take place. Next, we discuss revenue recognition when the seller has started to deliver on the contract; however, management records revenue in a far greater amount than is warranted.

Changing Revenue Recognition Policy to Record Revenue Sooner (and Greater Amounts)

Like Keurig, companies can also change their revenue recognition policy for ongoing projects to inflate sales and operating profits. Consider the plight of Japanese manufacturer Ulvac when its business struggled mightily and management considered ways to "solve" its problems by changing its accounting policies.

Watch for a Change in Revenue Recognition Policy to Hide Collapsing Business What to do when your business is collapsing and you hope to hide that fact from investors? In 2010, Ulvac found a very clever solution, but it involved an outrageous financial shenanigan. Table 3-1 shows the audited results Ulvac reported for the fiscal years ended June 2008, 2009, and 2010.

Table 3-1 Ulvac Results for 2008–2010, as Reported

(Yen million)	FY 2008	FY 2009	Percent Change	FY 2009	FY 2010	Percent Change
Sales	241,212	223,825	**–7%**	223,825	221,804	**–1%**
Operating profit	9,081	3,483	**–62%**	3,483	4,809	**38%**

After a rocky 2009 (with sales plummeting 7 percent and operating profits declining 62 percent), 2010 looked like a successful turnaround period (with sales growth improving to just *negative* 1 percent and operating profits jumping an impressive 38 percent). It certainly appeared that the company had done an excellent job in managing costs in a period of no top-line growth. The problem, however, was that the 2010 results were woefully misleading. Specifically, Ulvac had just changed its revenue recognition approach to percentage-of-completion (POC), and as a result, it began booking sales much earlier than it would with its traditional

approach. Table 3-2 shows the results Ulvac would have reported, assuming no change in revenue recognition policies. Sobering and shocking results for investors.

Notice in the right-hand column, "Adjusted Percent Change" in 2010, and compare with the change shown Table 3-1—a decline in sales of 1 percent. Rather than sales basically stabilizing in 2010, after a 7 percent decline the prior year, sales would have plummeted 21 percent, completely freaking out investors. So in order to avoid that disappointment, Ulvac's management found a solution, and its auditors inexplicably approved—changing its revenue recognition policy and hiding its big problems from investors.

Table 3-2 Ulvac Results for 2009–2010, Results Assuming No Change in Accounting Policy

(Yen million)	As Reported, Jun-09	As Reported, Jun-10	Accounting Adjustment	As Adjusted, Jun-10	Adjusted Percent Change
Sales	223,825	221,804	(44,037)	177,767	**–21%**
Operating profit	3,483	4,809	(12,033)	**(7,224)**	NM

Changing Estimates and Assumptions When Using POC Accounting

Ulvac provides an illustration of the dramatic jump in reported revenue when a company switches from standard revenue recognition practices to the more aggressive POC approach. Investors also should be alert for companies using POC that simply change some key estimates or assumptions, as those actions can also materially inflate revenue.

Consider solar energy leader First Solar (FSLR) and its accounting changes to hide business setbacks from investors. In 2014, FSLR was building out some of the largest solar-powered power plants in the United States. Since these were long-term construction projects, First Solar applied percentage-of-completion accounting, and it determined the proportion of progress on each contract by calculating the costs incurred on the project as a percentage of the total expected costs. Under this method, any changes in the company's estimate for total project costs would have had an immediate impact on reported revenue since it would have either increased or decreased the estimated progress toward completion.

Accounting Capsule: Background on Percentage-of-Completion (POC)

POC revenue recognition allows companies to report revenue even before a project has been completed. It was introduced so that firms working on long-term construction-type contracts could report business activity each period even if a product was not delivered to the customer. Under this framework companies are expected to estimate the proportion of the project that has been completed and to recognize a pro rata share of the total project's revenue, expenses, and profits. Investors should be extra vigilant when analyzing companies using percentage-of-completion accounting, since the reported results hinge on the company's estimates about its own progress.

Astute investors would have been tipped off about growing changes in estimates by reading the footnotes in First Solar's 2014 10-K filing. When the company updated its estimates for total project costs in 2014, with one click of the mouse inside a spreadsheet, management immediately recognized an additional $40 million of sales (following a boost of $8.5 million in 2013). Moreover, since no additional costs were associated with this windfall revenue, gross profit and operating income increased by an equal amount.

POC accounting provides management with unusual latitude in its ability to pull forward revenue, but CA, an enterprise software company, took matters much further by pulling forward license revenue on multiyear licenses, which would not actually be earned for many years to come.

Be Alert for Up-Front Recognition of a Long-Term License Contract CA 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, CA recorded substantial amounts of long-term receivables on its Balance Sheet.

Regulators Also Strongly Disagreed with the Approach

The SEC charged that from January 1998 through October 2000, CA prematurely recognized *over $3.3 billion* in revenue from at least 363 software contracts with customers.

CA's bulging long-term receivables should have alerted investors to the company's aggressive revenue recognition. A careful review would have alerted investors to the firm's surging long-term and total receivables as early as September 1998. Investors should use a measure called "days' sales outstanding" (DSO) to evaluate how quickly customers are paying their bills relative to how quickly revenue is recorded. A higher DSO could indicate more 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 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.

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 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 could void the sale.

Seller Records Revenue Before Shipment

One problematic and often controversial method of revenue recognition involves so-called bill-and-hold arrangements. With this approach, the seller bills the customer and recognizes revenue but continues to hold the product. For most sales, revenue recognition requires shipment of the product to the customer. In certain cases, however, accounting guidelines allow revenue to be recognized under bill-and-hold transactions, 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 it seems like the seller has initiated a bill-and-hold transaction, investors should assume that the seller has attempted to recognize revenue too early. For example, Sunbeam CEO Al Dunlap used a bill-and-hold strategy 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 and longer payment terms, retailers agreed to purchase merchandise that they would not physically receive until months later. 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 $35 million in bill-and-hold transactions. When outside auditors later reviewed the documents, they reversed a staggering $29 million of the $35 million and shifted the sales to future quarters. In doing the initial audit, Arthur Andersen had 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 simply used improper financial engineering to drive the stock price higher.

Seller Records Revenue upon Shipment to Someone Other Than the Customer

Auditors often look to shipping records as evidence that the seller delivered its 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 would certainly be appropriate for the company to record sales revenue upon shipment of a machine to a franchisee—provided, of course, that the machine was received by the franchisee. In 2003, Krispy Kreme went to great lengths to fool its auditors by pretending to ship equipment to franchisees. It 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 customers had failed to take possession of the machines shipped.

Watch for Shipping Product to an Intermediary, Rather Than the Actual Customer Sometimes a seller will ship out product to a reseller before a deal has been fully completed. Autonomy was one of the largest software companies in the United Kingdom until being acquired by HP. To juice its revenue, it would book sales on software deals still under negotiation with end users (but had not yet closed) and transfer the associated product to resellers, which in turn would take ownership immediately and hold on to the product until the sales process with the end user was finalized. In exchange for "stepping into the transaction" and allowing Autonomy to *recognize revenue immediately*, Autonomy paid commission rates (akin to a bribe) of up to 10 percent, even though the reseller had virtually no role in the underlying sales process and often did not even have any information about the status of the deals.

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. Normally the manufacturer (called the "consignor") should recognize no revenue until the sales agent consummates a transaction with an end customer. Chainsaw Al Dunlap and his minion at Sunbeam, not surprisingly, ignored that standard and recorded $36 million in consignment sales before an end user had even been found.

Who Is the Actual Customer—the Distributor or the End User? Companies that sell products through a distribution network must decide whether to book sales when they ship to the distributor ("sell-in" approach), or later when the distributor sends goods to the actual user of the product ("sell-through" approach). While both approaches are widely used, the sell-through approach is considered more conservative, as it more directly aligns reported revenue with end-customer demand. More aggressive (and most concerning) is when a company switches from the more conservative sell-through to the sell-in approach, which of course inflates sales. We saw an example of such a change at Medicis, shortly after the company was acquired by Valeant in December 2012.

Valeant cleverly changed the existing revenue recognition policy at the newly acquired Medicis unit in the first quarter after the deal closed, so its sales would be recognized sooner and reported growth would be higher. Medicis sold product through its distributor, McKesson, which then sold it to physicians. Medicis historically used the more conservative sell-through approach, booking no sales until the distributor sold to the physicians. To goose sales at the Medicis unit after the deal closed, Valeant had Medicis immediately switch to the sell-in approach and started recognizing sales much earlier—when product was sent to the distributor. That brazen change in revenue recognition caught the attention of astute investors and eventually the SEC, which issued a formal letter of reprimand.

Medicis was not the only case of revenue shenanigans in Valeant's M&A path. Salix, acquired by Valeant in early 2015, had a string of even more troubling shenanigans in dealings with distributors. In the last quarter of 2013 and the first three quarters of 2014, it aggressively "stuffed the

channel," meaning it shipped much more product to the distributors than they could sell to their customers. And by using the sell-in approach, Salix materially inflated its revenue. When the scheme was detected late in 2014, Salix was forced to restate its previously released financial statements to lower revenue and profits during each of these four quarters.

Since all these details were publicly disclosed in late 2014, we are completely baffled why Valeant would still have closed on the acquisition. (We will have more on this in Part Five.)

Seller Records Revenue, but Buyer Can Still Reject the Sale

The final part of this section discusses 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 the wrong product and recording the related revenue, although they know full well that the product will be returned. Symbol Technologies allegedly shipped incorrect product without customer approval in order to report higher sales. Similarly, at the end of the fourth quarter of 1996, Informix recorded revenue but failed to deliver the required software code prior to year-end. Then in January 1997, Informix delivered a beta version of the software that did not function properly with the hardware. It took the company another six months to deliver usable software code. As it turned out, Informix recorded revenue far too early in the fourth quarter of 1996 rather than when the company had satisfied its obligations in the third quarter of 1997.

Be Alert to Sellers Shipping Product Before the Agreed-upon Shipping Date The fiscal quarter is ending, and profits are sagging. What can a company do? Why not simply start shipping 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 more products were shipped late in a quarter than usual.

Even if a company ships its 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 the right to return the products within a certain period of time.

Be Mindful of Sellers Recording Revenue Before the Lapse of the Right of Return Many businesses permit the buyer a "right of return" if the customer is not satisfied with the goods. In those cases, companies are required to either delay revenue recognition until the right of return lapses or estimate the amount of expected returns and reduce revenue by that amount. If the actual level of returned products is more than the company's initial estimates, the company may be guilty of having recognized 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 uncertain) 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

Kendall Square Research Corporation, a computer systems maker in Cambridge, Massachusetts, 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 truth, the sale was contingent on the receipt of outside funding, and thus no revenue should have been recognized until such funding had been secured. Kendall Square must have been aware of those contingencies, since it was later revealed that the company had provided customers with "side letter" agreements that essentially voided the sales if the customers 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 sufficient 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.

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 might not pay. Under a new policy, Openwave could recognize revenue immediately, simply by concluding that the customer no longer was a deadbeat.

Investors who noticed this subtle change by management would have recognized that Openwave's business was actually growing 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 2015 10-Q would have easily spotted this change in the revenue recognition footnote, as shown below. However, investors who

relied only on the company's quarterly Earnings Release and conference call may have missed the boat, as those disclosures made no mention of 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 collectability*, 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 buyer's lack of ability to pay.

Watch for Seller-Provided Financing To accelerate revenue in recent years, a number of high-tech companies have lent 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. When the dot-com 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 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.

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, as shown in Table 3-3. 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. Astute analysts would have surmised that extended payment terms were needed to avoid reporting disappointing sales growth. Several months later, Trex announced that its revenue for June 2005 would be much lower than Wall Street expectations. Trex’s sharp increase in receivables, together with the company’s disclosure of extended payment terms and an early buy program, should have alerted investors to the coming slowdown in sales growth.

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

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

More recently, investors in San Francisco–based Fitbit were jolted during the company's November 2016 conference call when management suddenly lowered guidance for future sales growth by a stunning 15 percent. To put that in some perspective, in Q4 2015 sales grew 92 percent, and now the sales growth estimate in Q4 2016 would be only 2 to 5 percent. Yikes!

That announcement by management marked the end of a period of hypergrowth fueled by new fitness tracking products and geographic expansion. But were there no warnings for investors that business was really starting to struggle? Indeed, signs of a weakening business (obscured by shenanigans) could be found in the second-quarter earnings conference call. In his remarks, the CFO mentioned in passing that Fitbit had just *extended payment terms* to "certain customers in Asia Pac [Pacific], due to the channel inventory levels previously discussed." In that one cryptic sentence, management signaled serious business challenges in Asia, which had been covered up by offering distributors there more time to pay. As is often the case when business problems are being covered up by management, the deceptions tend to work only for a short period; sure enough, by December 2016, unsuspecting investors were stunned as Fitbit's stock collapsed 50 percent.

Looking Ahead

This chapter addressed accounting tricks involving mainly legitimate sources of revenue. Chapter 4 describes a more sinister 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 a company might employ to create bogus revenue and warning signs for investors to spot these nefarious shenanigans.

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 lacks economic substance. In these transactions, the so-called customer is either under no obligation to keep or pay for the product, or no product or service was even 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, technology pioneers (like Bill Gates and Steve Jobs) imagined exciting ways to create new products, such as Microsoft’s Windows and Apple’s iPhone, that enhance our enjoyment of life.

Occasionally, though, imagination can run amok. Many corporate executives have given imagination a bad name when they’ve used theirs to get too creative with reported revenue. For example, insurance industry leader AIG imagined 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.

AIG and several other insurers began to market a new product called “finite insurance.” This 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 addictive drug that allowed companies to cover up quarterly blemishes by artificially 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 legitimate insurance arrangements at all; rather, they were complex and highly structured 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, as a result, that 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 netted 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.”

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. 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.

Regulators Considered This Scheme to Be a Scam

Brightpoint got into trouble with the 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.

Peregrine Dupes Investors with Sales That Lack Economic Substance

Creating bogus revenue from transactions that lack any economic substance extends far beyond insurance companies. Plenty of technology companies apparently got the memo of 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 negotiated 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" to help Peregrine achieve its revenue forecasts. Peregrine engaged in other deceptive practices as well to create bogus revenue, including entering reciprocal transactions in which the company essentially *paid for its customers' purchases* of its software. In 2003, Peregrine restated its financial results for several earlier 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.

Be Aware That with Bogus Revenue Come Those Fake 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 avoid these questions, Peregrine played several tricks that made it seem like the receivables had been collected. These shenanigans inappropriately lowered the receivables balances, and in doing so, improperly inflated cash flow from operations (CFFO). We break down the mechanics of this chicanery and discuss Peregrine's Cash Flow Shenanigans further in Chapter 10.

Symbol 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 the distributor or any of its customers. Instead, to fool the auditors into believing that a sale had 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 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.

Watch for Barter Transactions with Related Parties Investors should always be wary in seeing sales booked when *no cash is paid* (i.e., a barter transaction). And when such transactions are with a related-party customer, investor concerns should rise to the highest level.

Consider how D.C.-based comScore tried to cover up sluggish 2014 sales growth in its core business of selling web traffic data to advertisers. Management entered into agreements with other data providers to exchange certain "data assets." Because no money changed hands, these transactions were disclosed and described as "nonmonetary" in its Footnotes to the Financial statements. Arrangements in which goods or services are swapped are inherently suspicious, because the amount of sales recorded for the exchange is subject to the company's own estimate of its value, and that amount can easily be inflated, or even conjured up entirely, reflecting no real substantive economic activity.

These nonmonetary (barter) arrangements accounted for $16.3 million of total 2014 sales (5 percent of total sales), representing a big portion of comScore's reported growth. Not only were these transactions suspicious on a stand-alone basis, but almost all (88 percent) of these barter sales were to related parties of comScore. By the third quarter of 2015 the company had already recognized $23.7 million of additional barter revenue (now representing 9 percent of total revenue). And by the end of 2015, investors had raised enough troubling questions about the true nature of these

arrangements that management found it impossible to properly file its financial statements. And by failing to file, comScore was eventually delisted from the Nasdaq stock exchange.

TIP

Be extremely cautious when a company reports barter or "nonmonetary" sales, especially when the buyer is a related party.

Failing to Detect Accounting Tricks at Autonomy Costs Hewlett-Packard Billions

As Hewlett-Packard (HP) tried to jump-start its struggling business, it went shopping in October 2011 for an acquisition across the pond and paid $11.1 billion for software maker Autonomy Corporation. That turned out to be a colossal mistake; one year later, HP took an $8.8 billion impairment charge, recognizing that it had materially overpaid for Autonomy. Worse yet, HP claimed that most of this massive loss was linked to serious accounting improprieties.

When this bad news became public, not only did HP's share price plummet 12 percent in a single day, but HP alleged that Autonomy executives had fraudulently inflated revenue to trick investors. In short, HP's leaders claimed that they were duped by Autonomy.

The SEC investigated these allegations and concluded that Autonomy indeed used a variety of schemes to vastly overstate sales in the years prior to the acquisition. In many cases, these tricks allowed Autonomy to accelerate revenue recognition on software sales earlier in the selling process; in some cases, however, the revenue may have been *completely fabricated* as Autonomy was not ultimately successful in closing a deal with the end user. For example, it not only sold products to a distributor but later repurchased from that same distributor unwanted, unused, or overpriced products, initiating a "round-trip" cash payment that would come back to Autonomy. According to the SEC, this scheme alone inflated Autonomy's reported revenue by nearly $200 million between 2009 and 2011.

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

While recognizing that revenue on transactions that lack economic substance should 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 quality of the seller's recorded revenue may be suspect. For example, a sale to a vendor, relative, corporate director, majority owner, or business partner raises doubt about 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-Brillian, the Arizona-based maker of high-definition televisions. In 2007, Syntax-Brillian was flying high. Extraordinary demand in China sent sales of TVs soaring, and the start of a 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-Brillian was bankrupt and under investigation for fraud.

Syntax-Brillian'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 10-fold increase in sales to a suspicious related party. The sales accounted for nearly half of Syntax-Brillian's total revenue, and the related party was an Asian distributor named South China House of Technology (SCHOT). Syntax-Brillian's relationship with SCHOT was much more incestuous than a typical customer-supplier arrangement. The two companies seemed to be involved in a tangled web of

joint ventures (which also, oddly, included Syntax-Brillian's primary supplier). Syntax-Brillian was close enough with SCHOT that it granted it 120-day payment terms and routinely extended those terms even further.

Syntax-Brillian 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 suddenly, in February 2008, Syntax-Brillian 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-Brillian 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-Brillian should never have recognized this revenue in the first place!

Syntax-Brillian'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-Brillian's March 2006 10-Q that would have led even the most novice investor to raise questions.

SYNTAX-BRILLIAN'S ACCOUNTS RECEIVABLE DISCLOSURE–MARCH 2006

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 Transactions with Parent Companies Consider the case of Hanergy Solar, the Chinese manufacturer of clean energy equipment (and dirty accounting tricks). In 2013, business was just starting to heat up as revenue grew 18 percent to HK$3.3 billion. The following year, revenue

tripled to HK$9.6 billion. From May 2013 to May 2015, Hanergy's stock surged 1,300 percent, bringing the total market value to a whopping HK$40 billion and making founder and chairman Li Hejun one of China's richest men.

Digging just beneath the surface of reported revenue growth revealed a shocking fact: Hanergy's primary customer also happened to be its majority owner, Hanergy Group Holdings (the same name was no coincidence). In 2013, 100 percent of Hanergy's revenue came from sales to its parent company. Hanergy had other customers in 2014, but the parent still made up 61 percent of revenue. Moreover, Hanergy barely received any cash from sales to its parent, causing accounts receivable to swell to sky-high levels, resulting in DSO ballooning to 500 days at the end of 2014 (with 57 percent of its trade receivables listed as past due). Clearly, these sales were not arm's length in nature.

By May 2015, the gig was up. One morning, when Chairman Li failed to show up for the annual meeting amid investigations of insider trading, Hanergy's stock fell 50 percent before trading was suspended by the Hong Kong Stock Exchange.

Be Alert for Suspicious Revenue from Transactions with Joint Venture Partners New York–based brand management company Iconix (ICON) was launched in 2004 by Neil Cole, younger brother of the fashion mogul Kenneth Cole. ICON had a relatively straightforward business model: purchase trademarks related to fashion brands and then license out the right to manufacture and sell clothes under these brand names. Customers generally paid ICON royalties based on a percentage of sales for each brand.

Iconix spent its first few years buying up established, but tired, fashion trademarks (such as London Fog, Joe Boxer, Starter, and Umbro). While the company may have generated a positive return on its trademark investments over time, the slow-and-steady business model failed to produce strong organic growth. To jazz up its revenue growth, management resorted to creative accounting games. One trick was to accelerate sales and earnings by carving up its trademark assets into geographic regions and selling certain ones outright. So in 2013, for example, Iconix sold its Umbro trademarks in South Korea for $10 million, recording a gain on sale for the

full $10 million. Inexplicably, this gain was recorded as a *component of revenue*—rather than as a one-time gain from an asset sale.

In some cases, Iconix would actually create the customers that would buy these regional trademarks. In 2013, for example, it formed a 50-50 joint venture with supply-chain partner Li & Fung and transferred several trademarks to this JV. Iconix claimed *not to control* this JV (despite it being named Iconix SE Asia), and therefore was also able to record these trademark transfers as part of its total sales. The company disclosed in its September 2014 filing that sales to this JV alone had generated $18.7 million, which accounted for 16 percent of its total revenue for the quarter —essentially out of thin air!

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 necessarily would be revenue or even directly pertain to the company's core operations. Some inflows are related to financing activities (borrowing and stock issuance) and others to the sale of businesses or other assets. Companies that recognize ordinary revenue or operating income from these noncore sources should be viewed suspiciously.

Question Revenue Recorded When Cash Is Received in Lending Transactions

Never confuse money received from your friendly banker with money 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 a liability that needed

to be paid back, Delphi improperly recorded it as the sale of goods—as if the inventory posted as collateral had been purchased by the bank. As you will see with Delphi in Chapter 10, not only did this twisted interpretation allow Delphi to record bogus revenue; it also provided bogus cash flow from operations.

Pay Attention to Accounting for Vendor Rebates

When purchasing goods from a vendor, cash normally flows in one direction—from the customer to the vendor. Sometimes, cash will flow in the opposite direction, usually in the form of a volume rebate or refund. Booking these cash rebates as revenue would clearly be inappropriate, as they should be considered an adjustment to the cost of inventory purchased. However, the creative folks 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, or course, recorded as revenue.

Royal Ahold, owner of U.S. supermarkets Stop & Shop and Giant, played similar games with its vendor rebates. Executives manipulated vendor accounts to create fake rebates that boosted earnings and allowed the company to reach its earnings targets. Overstated rebates totaled over $700 million in 2001 and 2002, which led to massively overstated earnings. The executives who perpetrated this scheme were ultimately found guilty of fraud and sent to prison.

Similarly, in September 2014, British grocer Tesco announced that it had overstated its profits by recording too much income related to supplier discounts and rebates. Turmoil ensued as the stock fell by over 50 percent since the beginning of the year. Tesco's chairman, CEO, CFO, and other key executives and board members left the company. In September 2016, the U.K.'s Serious Fraud Office announced that it would prosecute three former employees for fraud and false accounting.

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 were derived from non-revenue-producing activities. The 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 and/or (2) grossing up revenue to make a company appear much larger than it really is.

Enron Uses an Inappropriate Methodology to Recognize Revenue

As we discussed in Chapter 1, long before Enron became infamous as the "biggest accounting fraud," for many years it operated as a small gas pipeline business in Houston, Texas. During the 1990s, the company gradually transitioned from a producer of energy to a company that facilitated trading in energy and related futures.

To understand Enron's new business, and how it would impact the company's reported financial statements, it's worth considering a simple commodity brokerage transaction. Typically, if a broker facilitates a transaction with a $100 million notional value and a 1 percent commission rate, the broker would recognize just the $1 million commission as its revenue and gross profit. Enron, however, took a much more aggressive (and inappropriate) approach to recording this type of transaction. Enron would have "grossed up" this transaction by recording revenue of $101 million offset by cost of goods sold of $100 million, resulting in the same gross profit of $1 million. This uber aggressive accounting is why Enron showed the odd combination of rapidly growing revenue and puny profit margins.

A Chance Meeting with Enron CFO Andrew Fastow

So that was our working thesis for years, but we were unable to speak to senior management people to confirm this thesis because they were locked up in prison. But in December 2015, Howard's path crossed with that of former Enron CFO Andrew Fastow, as both were invited speakers at a conference in Park City, Utah. During the Q&A of Fastow's presentation, Howard had the opportunity to describe what he believed to be the main

accounting fraud (using the same commodity example as above), and he asked Andrew whether the thesis was correct. Was Enron grossing up the notional value of a transaction and counting that amount as its revenue, rather than just counting the commission earned? His first five words to the answer were, "You are fundamentally correct, but … ," and he then went on to describe why this underlying accounting rule was not applicable to Enron. Howard just rolled his eyes and smiled, as the thesis had been confirmed.

Watch for Companies Grossing Up Revenue to Appear to Be Much Larger E-commerce phenom Groupon burst onto the scene in November 2008, and only 17 months later it was privately valued at a billion dollars—the quickest that any company had reached that threshold. Then by its third birthday in November 2011, Groupon went public, raising an astonishing $700 million, becoming the second largest tech IPO at that time (after Google's $1.7 billion raised in 2004). But before its public offering, Groupon had a tough time gaining SEC approval for its IPO, as it had to amend its registration statement eight times. The most consequential restatement pertained to Groupon's revenue recognition, resulting in changes that sliced its revenue by over 50 percent. (See Table 4-1.)

Table 4-1 Groupon's Gross and Net Revenue

	Year Ended		Six Months	
($ thousands)	**Dec-09**	**Dec-10**	**Jun-10**	**Jun-11**
Initial (gross)	30,471	713,365	135,807	1,597,423
Restated (net)	14,540	312,944	58,938	688,105
Difference	15,931	400,421	76,869	909,318
% inflated	110%	128%	130%	132%

Groupon's main shenanigan was trying to make the business seem larger by booking as sales the gross amount its members paid for a deal, without deducting the sizable portion it owed to the merchants. In the restated registration documents (contained in Form S-1A), the SEC mandated that Groupon change from the "gross" to "net" method, causing revenue to melt down from almost $1.6 billion to only $688 million, a decline of 57 percent during the six months ended June 2011.

Surprisingly, investors seemed to ignore this very ominous development; the November IPO proved to be a major success, with Groupon's share price jumping 31 percent on the first day traded as a public company. It closed at $26.11 on November 4 with a market value of $16 billion. But things began to unravel quickly with another (company-initiated) restatement in early 2012. And by its first anniversary in November 2012, the share price plummeted to $2.76—an astounding 90 percent decline for one of the most anticipated IPOs. Investors had seen enough, and by February 2013, CEO Andrew Mason was dismissed.

When traditional businesses migrate into e-commerce, there are often opportunities to revisit the gross vs. net revenue distinction. Take, for example, the games played by advertising agencies who began placing ads online. These companies typically record revenue for the commission fees that they earn on ads placed by their clients on television or radio spots, newspapers, or billboards. However, most agencies have approached online ads differently, electing to recognize revenue on a gross basis, thereby including the full value of the ads in reported revenue. It might seem simple enough for investors to see through this shenanigan; however, in many cases the online ad revenue is commingled with other agency fees recognized on a net basis, making it quite difficult to assess the true performance of the agency's commissions. Since online advertising tends to grow as a share of the advertising market each year, this revenue treatment has been providing an artificial boost to reported sales growth of the agencies.

Looking Ahead

This chapter and Chapter 3 both 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 Operation. 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. This chapter explores such methods, which, if undetected, might confuse investors. In this chapter we examine 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

Dot-Com Hysteria Had the Blue Chips Feeling Blue

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 often 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 (COGS) 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 Income Statement 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 COGS 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 either had a large one-time gain that was hidden from view—or had chosen another shenanigan to boost income or hide expenses.

Table 5-1 IBM’s 1999 Income Statement, as Reported

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

And that is precisely what happened. A footnote in the 1999 10-K disclosed that IBM booked a $4.1 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 $14.7 billion to $18.8 billion. Operating income would, in turn, decline by the same amount, from $11.9 billion to $7.9 billion. As a result, both operating and pretax income would be sliced by $4.1 billion.

Now we can compare the results (as reported versus our adjusted figures that excluded the gain) and clearly see the dramatic differences. SG&A expenses really *increased* by 12.7 percent (rather than the reported *decline* of 11.6 percent), and operating and pretax profits *declined* by 14.1 and 14.8 percent, respectively (rather than the reported *increases* of 30.2 and 30.0 percent).

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

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

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 products from that sold business unit. These transactions are common in the technology industry and are often used by companies to quickly "outsource" an in-house process. For example, a mobile 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 products 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 Corporation 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 semiconductor 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. The contracted period 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 products. This certainly works out well for Intel, as investors are far more impressed with a recurring revenue stream than cash received from the sale of a business.

Of course, 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.

Watch for Changes in Accounting Policies That Accelerate Recognition of Income In 2013 Boston-based Dunkin' Brands (franchisor of Dunkin' Donuts and Baskin-Robbins) got an earnings boost from an unlikely source. Like many other chain retailers, Dunkin' Donuts sold preloaded gift cards that could be used at any national location. At the beginning of the year, the company had an accounting policy that assumed that any card that had not been used for five years was considered lost, and any remaining balance on

the card was recognized as income after 60 months of inactivity. However, in the second quarter of 2013 management changed its practice to begin recognizing income for the amount that would likely go unused on an *ongoing basis*, starting from when the card was first used. This change had the effect of accelerating those gains, providing an opportune boost to reported earnings per share. Moreover, it shed a light for investors to see that management had desperately engaged in tricky accounting changes to make up for a softening franchise business.

The second part of this chapter illustrates the techniques that management may use to shift income or losses around to obfuscate any deterioration in a company's recurring 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 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 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 normal operating *expenses* (i.e., the "bad stuff") to the nonoperating section, (2) shifting nonoperating or nonrecurring *income* (i.e., the "good stuff") to the Operating section, and (3) using questionable management decisions regarding Balance Sheet classification to help offload the bad stuff or upload the good stuff.

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 to 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 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 from their operating income 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 has recorded below-the-line restructuring charges in just about every quarter since the early 1990s. Annually, these charges amounted to hundreds of millions of dollars, and occasionally billions. Whirlpool also recorded restructuring charges nearly every year since 1990 until present, prompting the SEC, in an October 2016 correspondence letter to the company, to challenge management: "Please explain to us why these are not normal, recurring cash expenses necessary to operate your business."

Watch for Companies That Shift Losses to Discontinued Operations An easy trick that can magically improve a company's operating profit 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 headline 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.

Consider how Sabre Corporation cleverly inflated its income from continuing operations shortly before selling its Travelocity division to Expedia. Once Sabre decided to sell this business, as required by GAAP, it shifted all revenue and expenses of this money-losing business to "discontinued operations." In so doing, Sabre artificially inflated its income from continuing operations since the business that previously deflated the company's earnings (Travelocity) was treated as if it no longer was part of Sabre's business. Of course, this money-losing business had not yet been sold, but it was all but ignored by investors. Astute investors might have noticed that Sabre had increased the historical allocation of costs to the Travelocity segment after it was designated as a discontinued operation, leaving the remaining business segments with lower expenses and higher profits.

Specifically, in its S-1 filing (before the online travel site was designated as "discontinued"), the Travelocity segment reported selling, general, and administrative expenses of $331 million for 2013. Subsequently, when Travelocity was separated out as a discontinued business, the amount of selling, general, and administrative expenses that were removed from continuing operations jumped to $389 million for the same 2013 period. This higher allocation of cost had the effect of making the rest of the business appear more profitable. Sure enough, following the divestiture, Sabre's reported operating expenses increased back to the normal level.

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 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 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 substantial 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.

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. 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 all the revenue and operating expenses as operating income (that is, above the line) as if it were its own; the 40 percent owned by others would be subtracted later on the Income Statement (shown below the line). Consider this hypothetical situation assuming a subsidiary with total revenue of $1 million and 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 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 an operating profit of $600,000, not the real economic profit of $360,000 (or 60 percent of $600,000), which 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 outcome.

Using Discretion Regarding Balance Sheet Classification to Boost Operating Income

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

If executives of a company believe that they exercise significant influence over a subsidiary or other entity (but do not control it), a proportionate share of the entity's income or loss should flow to the Income Statement (under the equity method of accounting). Conversely, if the company lacks such influence, the Balance Sheet account related to the joint venture is simply adjusted periodically to fair value. Thus, shenanigan opportunities abound for people in management who wish to push income onto the Income Statement by asserting that they possess that influence in periods when the income from a subsidiary is strong, or to push losses off to the Balance Sheet by stating that no significant influence exists when the venture's operations are weaker.

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 Income Statement. 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 Income Statement. 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."

Enron Boosts Operating Income by Shifting Losses on Joint Ventures to the Balance Sheet

The executives at Enron understood perhaps better than anyone else 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 Income Statement. Enron knew that lenders and credit rating agencies would blanch if it showed bulging loans payable, and that investors would disapprove of big losses and the earnings dilution that would come from equity financing. 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 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 simply because its own stock price increased 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, 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 forgot to report the resulting $90 million loss to shareholders. Instead, Enron conveniently announced that the results remained "unconsolidated" and, of course, were not included on the Income Statement. So by Enron's rules, on the very same investment vehicle, gains were included and losses were hidden from investors' view. In other words, for Enron it was—heads I win, tails I still win! Well, we all know how that story ended.

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 this chapter 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 ("Earnings Manipulation 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 ("Earnings Manipulation 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 1980s 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 fox-trot 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 Income Statement 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-term 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 they 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 Income Statement. This chapter 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. Excessively 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. Excessively 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.

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.

Improperly Capitalizing Routine Operating Expenses

At the height of the 1990s' dot-com boom, telecom services behemoth WorldCom signed many long-term network access arrangements to lease line capacity from other telecommunication carriers. These agreements included 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 Income Statement.

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 2000, it began concealing some line costs through a sudden, and very significant, change in its accounting. (Red flag!) Rather than record 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 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 Income Statement reported fewer expenses. As pointed out in Chapters 1 and 2, 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). Well-trained investors should have seen this trend as a sign of trouble.

Table 6-1 WorldCom's Free Cash Flow

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

Specifically, WorldCom's sizable 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 $8.7 billion to $11.5 billion) in capital expenditures and questioned why this spending made sense during a technology slowdown in which the company's operating cash flow had contracted by 30 percent. Flagging such a massive increase in spending would prove to be an 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 sizable increase 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 also examples of normal operating expenses that produce near-term benefits to a business. Most companies need to 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 take a more aggressive approach to 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 period.

Until 1994, AOL treated its solicitation costs for new customers as an operating expense. However, in 1994 AOL started recording these costs as assets on its Balance Sheet, called "deferred membership acquisition costs" (DMAC). 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.

Table 6-2 AOL's Deferred Membership Acquisition Costs

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

Notice the dramatic increase in the DMAC balance over the next few years. By June 1996, DMAC 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 DMAC that existed as of the end of fiscal year 1994), and AOL's 1996 pretax income of $62 million would have been *transformed to a loss of $175 million*. On a quarterly basis, the effect of capitalizing DMAC was that AOL reported profits for six of the eight quarters in fiscal years 1995 and 1996, rather than reporting losses for each period.

Investors should have been alarmed when reviewing these numbers for several reasons. First, the company made the *change from expensing* these costs to the much more aggressive approach of capitalizing them. Second, the *enormous growth* in the unamortized DMAC represented a material underreporting of expenses and overreporting of profits during these three years. Third, AOL had merely shifted expenses from earlier periods to later

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 the accounting rules (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 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 required 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 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 by starting to capitalize internal-use software costs, mandated by a new accounting rule.

TIP

Regardless of the legitimacy of an accounting change, investors should strive to understand the impact that this change had on earnings growth. Simply put: *any growth related to the change will not recur*. 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, Syntax-Brillian began

reporting on the Balance Sheet curious new asset accounts 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. Oddly, both accounts dwarfed the total amount of inventory reported on the company's Balance Sheet. Moreover, not only was Kolin Syntax-Brillian's largest supplier, but it also was a related party, owning over 10 percent of the company's stock and serving as a counterparty to several joint ventures.

Investors had reason to be skeptical about these new asset accounts, not only because of their unusual and related-party nature, but also because of the rapidly increasing balances. As shown in Table 6-3, Syntax-Brillian 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-Brillian's Unusual Asset Accounts

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

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 an Increase in Software Capitalization An accelerating rate of software capitalization is often a red flag that earnings growth is benefiting from keeping more costs on the Balance Sheet. The Ultimate Software Group (ULTI), a Florida-based developer of human resources software, went from not capitalizing any software costs in 2011 to capitalizing $19 million (22 percent of its total R&D spend) just two years later. The capitalized costs were quite material, amounting to nearly 5 percent of total sales and 44 percent of the company's $43 million in operating income in 2013. This practice shifted significant costs to the Balance Sheet and inflated profits.

Watch for Growing Advances or Prepayments Consider the case of snack foods company Diamond Foods (DMND), purveyor of Emerald nuts, Pop Secret popcorn, and Kettle Chips. As walnut prices spiked in early 2010, Diamond found itself in a situation where it needed to compensate its walnut vendors for the increase in price for that year's crop. Facing pressure from investors to continue its 11-quarter streak of outperformance, CFO Steven Neil orchestrated a scheme in which the company would pay the walnut growers to make them whole for the 2009 crop, but they would call the payment an "advance" on the next year's crop. This sleight of hand gave Neil the justification he needed to capitalize these payments on the Balance Sheet, rather than expense them in the current year. Despite this sneaky trick, the walnut growers knew that this payment was not really an advance on the 2010 crop; rather it related to the already-delivered 2009 crop.

The truth eventually came out as investor scrutiny led to an internal investigation. DMND wound up restating its results in November 2012 to properly account for the cost of acquiring walnuts, and the company's stock

price fell to $17, down from a high of $90 in 2011. The SEC ultimately charged the company and its CFO Neil with fraud.

Improper Capitalization of Costs Also Inflates Operating Cash Flow

While normal operating costs are reflected as an operating cash outflow, capitalized costs are typically 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, "Cash Flow Shenanigan No. 2: Moving Operating Cash Outflows to Other Sections."

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 business benefit has yet to be realized. Step 2 involves recording those costs as expenses, shifting them from the Balance Sheet to the Income Statement.

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 on the Balance Sheet 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 shown in Table 6-2)? We discussed the 1994 change in accounting, attributing it to an aggressive capitalization of advertising

costs and the decision to spread those costs over the following 12-month period. This aggressive capitalization completely misled investors, who believed that the company had been profitable, although it continued 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 decided to double 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 simple accounting adjustment helped hide AOL's huge losses from investors.

A careful review of the Statement of Cash Flows, however, would have revealed 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. By carefully reading the footnotes, investors would have noticed that the aggressive capitalization of marketing costs inflated operating and net income. (See Table 6-4.) With more typical treatment of solicitation costs as expenses, AOL would have posted huge operating and net losses ($154.8 million and $124.2 million, respectively), which would surely have led to a stock price correction.

Table 6-4 AOL 1996 Results Reported and Adjusted

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

Be Particularly Wary of Big Income Boosts from Stretching Out Depreciable Lives

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 be wary.

Consider how Intel revised its depreciation schedule for manufacturing equipment in 2015. Based on an internal review, management determined that the assumed useful lives should be extended from four to five years. This change alone lowered the company's depreciation expense by approximately $1.5 billion in 2016, with roughly half the benefit accruing to gross margin, which had come under pressure as competition in the industry intensified.

While Intel may have had good rationale for arriving at the new estimate (management cites longer product life cycles and increased reuse of machinery), the decision to make the change at a particular time often signals an underlying weakness in the business or management's anxiety about the future. Healthy and confident companies are far less likely to tinker with these types of accounting assumptions that only provide optical benefits.

Be Alert for Slow Amortization of Inventory Costs

In most industries, the process of turning inventory into an expense is straightforward: when a sale takes place, inventory is transferred to the expense called "cost of goods sold" (COGS). In certain businesses, though, determining when and how inventory turns into expense can be more complicated.

In the aerospace business, for example, the initial development costs of a new jet fighter, which could be quite substantial, might first be included on the Balance Sheet as inventory and later amortized once customers start taking delivery of the aircraft.

One Classic Example: Lockheed's Ill-Fated TriStar L-1011 Program

Lockheed (which later merged with Martin Marietta to become Lockheed Martin) provides one of the best examples of difficulties in determining how best to amortize development costs for new aircraft. Unlike a traditional retailer, for example, which amortizes inventory costs to COGS quickly when a product is sold, aircraft manufacturers place development costs in inventory on their Balance Sheet for years, as development and manufacturing are a multiyear endeavor.

During the 1970s and early 1980s, Lockheed was pouring billions into developing a new aircraft, called TriStar L-1011. The accounting method used for planes is known as the "program method." As each plane in the

program was sold (initial estimated total was 300 aircraft), Lockheed would assign a presumed average cost, regardless of the actual production costs. So any actual costs *greater than the assigned costs* (based on the estimate) would be capitalized until the production cost curve had come down. Since Lockheed expected that costs in producing later planes would be less than the average, the previously capitalized excess costs would be amortized into the costs of these more recent (and profitable) later planes. In theory, this sounds fine—unless, of course, the incremental cost per plane always exceeds the incremental revenue. Unfortunately for Lockheed, that indeed was the case.

By late 1975, Lockheed had accumulated approximately $500 million of costs in its "production costs curve" asset account within inventory, and the ill-fated TriStar program showed no signs of profitability. Indeed, things continued to worsen, as cumulative losses from the period 1975–1981 totaled $974 million. (See Table 6-5.) The handwriting was on the wall, and Lockheed began writing off some of the $500 million "blob." But rather than write off the entire amount when the losses became virtually certain, it used an "installment plan," at the rate of $50 million annually (even though the company continued posting staggering losses on the TriStar program).

Table 6-5 Lockheed: Annual Losses from the TriStar L1011 Program

($ millions)	1975	1976	1977	1978	1979	1980	1981	Total
TriStar Losses	94	125	120	119	188	199	129	974

Program accounting is not just an accounting quirk of the past; it persists today at the largest aviation companies. Just like Lockheed did in the 1970s with its TriStar L-1011 program, Boeing uses program accounting for its state-of-the-art 787 Dreamliner. Boeing started developing the Dreamliner in 2003, but it was not until 2011 that it started delivering planes to customers. There were many production and development issues along the way that wreaked havoc with the company's delivery timeline and, more interestingly, with the program accounting estimates. For example, in 2009, after several failed test flights, Boeing wrote off nearly $2.5 billion in program accounting inventory costs that it no longer expected to recoup. Boeing eventually solved its major development problems, and production accelerated in the early 2010s leading to a substantial amount of program accounting inventory. By December 2015, Boeing had accumulated a

whopping $28.5 billion of these production costs on its Balance Sheet to be recognized as cost of revenue in the years ahead.

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 continually review these assets for possible impairment and record an expense whenever the assumed future benefits fall below the 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 appropriately in earlier periods.

Failure to Write Off Obsolete Inventory

Companies naturally build up inventory in anticipation of selling their products to customers. Sometimes, however, the demand for a product fails to meet a company's expectations. As a result, the company may have to lower its prices to move the less-marketable inventory. Or it may have to 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) 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 when compared with revenue in a period, DSI standardizes the inventory balance relative to 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.

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 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 ex post facto as a defensive

response to the inventory buildup. Investors should be skeptical if no mention of this growth strategy had previously been made.

An additional measure can be used to test whether an inventory buildup might be justified by upcoming demand: simply compare the growth in the absolute level of inventory with 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.

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

Recall the two broad 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 Income Statement, or as we presented it, manipulating the two-step accounting dance. In this concluding section of the chapter, we focus on games played with the other category of assets. Specifically, we show how companies can 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 Income Statement ("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 incurring $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 versus $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 $162 million in annual 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.

TIP

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

Watch for a Decline in Allowance for Doubtful Accounts Under normal business conditions, a company's allowance for doubtful accounts (ADA) will grow at a rate like that of 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 has therefore overstated earnings.

Such a decline occurred at publisher Scholastic Corporation. Its accounts receivable balance jumped 5 percent in fiscal 2002, yet the 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.

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 Income Statement (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 the gross loans asset.

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 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 then be forced to write off bad loans.

Watch for a Decline in Loan Loss Reserves Heading into the painful real estate collapse of the 2008 financial crisis, 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 many 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 (the first subprime mortgage company to collapse during the financial crisis) completely defied logic in late 2006 by *reducing* its allowance for loan losses in the face of higher delinquencies and increasing nonaccrual (bad) loans. In the September 2006 quarter, New Century shockingly lowered its loan loss reserve from $210 million (29.5 percent of bad loans) to $191 million (23.4 percent). Management seemed to have understood that this action was inappropriate, as the company obfuscated its presentation of the loan loss reserve in its Earnings Release to make it appear its reserve had increased. (We explore such creative manipulation of important metrics in Part Four, "Key Metric Shenanigans.") Had the company kept its loan loss reserve at a similar percentage of nonaccrual loans as in the previous quarter, earnings per share 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.

Be Extra Cautious When Companies Lend Money to Their Own Customers Sometimes companies will lend money directly to their customers through in-house customer financing programs. These arrangements warrant extra scrutiny to ensure that the company is not boosting sales by lending to customers that won't be able to pay back their loans. A struggling company desperate for sales growth, for example, may decide to loosen its lending terms and worry about the bad debts later.

Consider the case of Signet Jewelers, owner of a host of jewelry retailers including Kay, Zales, Jared, and H. Samuel. In fiscal 2015, 61 percent of sales in the company's sterling segment were made using Signet's in-house customer financing. This was a big step up from 58 percent credit participation a year earlier and from the low-to-mid 50 percent range throughout the previous decade. Increases in customer lending helped the company achieve its coveted same-store sales growth targets, but unfortunately that growth proved fleeting. In fiscal 2017, credit participation growth slowed, and Signet reported negative same-store sales growth for the first time since the financial crisis.

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 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 substantial portion of their assets.

Investors should watch for companies that fail to take impairment losses during market downturns, as occurred with the collapse of almost every asset class in the 2008 global financial crisis and the resulting losses across 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 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. At that point investors saw enormous write-down charges as their portfolio companies finally took the medicine they had previously avoided.

Watch for Tricks to Make Losses from Impaired Assets Disappear The massive accounting fraud at Japanese camera maker Olympus started out fairly benign, with the company making risky investments in the 1980s and early 1990s. Initially, these investments were properly shown on the Balance Sheet at their original cost. As the investments declined in value however, Olympus failed to properly impair them. Eventually management decided to hide these losses, using a variety of fraudulent schemes, known as *tobashi* schemes, to make the losses disappear. *Tobashi* is Japanese for "flying away." It describes a practice where a company sells or otherwise takes money-losing investments off its books and moves them to another company to conceal losses from its investors. In that sense, the losses are made to disappear, or "fly away."

In Part Five, "Acquisition Accounting Shenanigans," we present details of the Olympus fraud, outlining the specific techniques the company employed to hide almost $2 billion of losses using acquisitions and divestitures as a cover-up.

Looking Ahead

Unlike this chapter, Chapter 7 discusses costs that use a one-step process. While conceptually all costs incurred logically provide some economic benefit, those with only short-term benefit (like rent) never appear on the Balance Sheet and are immediately shown as an expense. Shenanigan No. 5 shows techniques used by management to hide those expenses from investors.

7

Earnings Manipulation Shenanigan No. 5: Employing Other Techniques to Hide Expenses or Losses

Failing to report all of your expenses when filing your taxes with the Internal Revenue Service would be foolish and pointless because you would only wind up with a higher tax bill. Failing to report all your expenses when filing your financial reports, while also foolish, would be useful if you were running a ruse to trick shareholders into thinking profits were stronger than they really are. Chapter 6 profiled how management can try to hide costs on the Balance Sheet, pretending that they are really assets. This chapter presents a more challenging shenanigan for investors to detect: when management depresses its expenses by failing to record a real cost or by expensing an inappropriately low amount. It's amazing that people would try this trick to begin with; what's even more astounding 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.

Employing Other Techniques to Hide Expenses or Losses

1. Failing to record an expense at the appropriate amount from a current transaction
2. Recording inappropriately low expenses by using aggressive accounting assumptions
3. Reducing expenses by releasing reserves from previous charges

1. Failing to Record an Expense at the Appropriate Amount from a Current Transaction

This first technique aims to lower the period's total expenses by failing to record an actual obligation giving rise to an expense (like rent).

Failure to Record an Entire Transaction Regarding an Invoice Received Late in the Quarter

One of the simplest ways to hide an expense 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 result in underreported expenses (and the related accounts payable) and would therefore overstate income.

A good example of failing to record end-of-period expenses can be found at 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 to 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.

Getting a Little Help from Your Friends

Sometimes clever management can elicit help from other parties, like vendors, to make reported expenses appear smaller. This 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 view cash receipts from vendors with suspicion. Cash normally flows out to vendors, not in from vendors, so unusual cash inflows from vendors may signal an accounting shenanigan.

Watch for Unusually Large Vendor Credits or Rebates Syntax-Brillian took the concept of vendor rebates to a completely different level. The company received various vendor "credits" from its primary supplier (Kolin), which, as we discussed in the previous chapter, was also a significant shareholder of the company. Syntax-Brillian 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-Brillian's gross profit over its brief history as a public company.

Specifically, between December 2005 and June 2007, the company reported a 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-Brillian showed decent profitability, but it showed 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 footnote disclosures of unusually large vendor credits and significant related-party transactions.

Be Alert for Companies Failing 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.

Remember to Review Off-Balance-Sheet Purchase Commitments Existing obligations that result from past transactions are reported as liabilities on the Balance Sheet. Additionally, as discussed above, liabilities for certain contingent payments sometimes also are accrued as a liability. 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 fund a project or a long-term real estate rental.

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 is required to disclose significant commitments in the Footnotes to the Financial Statements. Despite not being reflected on the Balance Sheet, these obligations could doom the company. Investors who fail to notice them could be in serious jeopardy.

Accounting Capsule: 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.

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2. Recording Inappropriately Low 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 post-retirement 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 Lease Assumptions

Lease accounting provides management with another massage parlor in which it can knead estimates to help inflate earnings. When Deere & Company leases its farming equipment to customers in the agriculture industry, it receives agreed-upon rental income, and the main expense recorded is the depreciation of the leased equipment. It sounds simple enough, but here's where the massage starts. The depreciation expense is a function of the value of the asset at the beginning of the lease (initial value) and the expected value of the asset at the end of the lease (residual value). The difference between these two values is divided equally across the rental period.

But accounting games can be played reducing the gap between the initial value and the ending value (that is, total future depreciation expense) simply by arbitrarily increasing the portion assigned to the residual value. Stated simply, since the residual value represents the portion that will not be depreciated, the game is to assign a higher percentage to residual value.

In 2012, Deere estimated that the residual value of its rental equipment would amount to 55 percent of the initial value, leaving 45 percent of the initial cost to be depreciated. However, in each subsequent year, this estimate increased, reaching 63 percent in 2015. By increasing the estimate, the company would now be depreciating only 37 percent (down from 45 percent) of the initial value. Because of this subtle change in estimate of the residual value, Deere materially lowered its depreciation expense and artificially boosted its gross margin and operating income.

Self-Insurance Reserves

Some companies balk at paying expensive business insurance premiums (for example, for employee healthcare or disability insurance), and they 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 they 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 depends on estimates. With a simple tweak of those estimates or a change in assumptions, management can obtain 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 merits of this change, it provided Rent-A-Center with a nonrecurring boost to earnings. This change alone might have provided virtually all of Rent-A-Center's earnings growth over the subsequent four quarters.

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 Income Statement; instead, it is simply grouped with other employee salary costs (usually as a component of cost of goods sold or selling, general, and administrative expense). Investors should 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.

Watch for Changes in Pension Estimates and Assumptions Several important actuarial assumptions must be used to calculate pension expense, including discount rates, mortality rates, compensation growth rates, and expected asset return 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 remaining life expectancy of plan participants from 12 years to 18 years. By increasing the remaining life expectancy assumption, Navistar spread "unrecognized losses" over a longer period, and in doing so, it reduced its pension expense (and inflated its income) by $26 million.

Watch for Changes in the Measurement Date Just a simple change in the month designated as the measurement 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 bump to earnings per share) 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 pension 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 to not break out pension expense (or income) separately on its Income Statement. As a result, investors who failed to read the pension footnote would have missed this critically important piece of information.

3. Reducing 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, "Earnings Manipulation Shenanigan No. 7: Shifting Future Expenses to the Current 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. In this section, we discuss reserves that are recorded as liabilities as they represent obligations to another party. While accrual accounting requires companies to create a reserve for costs incurred but not yet expended (such as warranties), these reserves can easily be abused to manipulate earnings.

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.

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 Earnings Boosts When a Company Misses Its Bonus Targets

Consider how Baltimore-based athletic apparel company Under Armour tried to hide the full extent of its business slowdown in 2016. While annual

sales had grown by an impressive 22 percent over the prior year, they fell short of the 24 percent growth target that investors expected, and perhaps more significantly, gross margin fell by more than 150 basis points.

This disappointment, however, provided a small silver lining for reported profits in the fourth quarter. The company had accrued for year-end bonuses in each of the first nine months of the year; however, by the fourth quarter, management realized that it would miss key performance targets, and bonuses would not be paid. So to correct the accounts and remove those previously recorded expenses, in the fourth quarter management reversed the entire previous bonus expenses. This meant recording $48 million of *negative* selling, general, and administrative (SG&A) expense, which boosted reported earnings per share by $0.07. The reversal was not prominently disclosed, making it seem like lower SG&A in the fourth quarter was the result of effective cost management, when, in reality, it was simply due to a one-time accounting adjustment.

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 huge restructuring charges, thereby creating reserves to be used for future expenditures related to the restructuring plan. However, according to the SEC, Sunbeam recorded many improper restructuring and other "cookie jar" reserves as part of this plan. These improper reserves later were released into income, inflating profit margins and creating the illusion of a successful restructuring.

Accounting Capsule: Release of a Restructuring Reserve

Assume that the company announces a 1,000-person layoff with a severance package totaling $10 million.

Increase:	Restructuring expense	$10 million
Increase:	Liability for severance	$10 million

Six months later, the layoffs have been completed, and 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

Thus, by inflating the estimated restructuring cost, this company created a $3 million profit out of thin air when the unnecessary reserve (and expense) was eliminated. Companies can take great liberties in setting up large restructuring (or other) reserves and later inflate profits when closing out these unnecessary expense accounts.

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.

Getting a Lot of Help from Your Friends—Marvell Cleverly Lowers Its Expenses

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, while simultaneously Marvell agreed to pay above list price for a certain amount of products later to be purchased from Intel. (See Marvell's footnote shown below.) As explained in Chapter 5, Intel appeared to structure this transaction in a way that understated the gain from the one-time asset sale and overstated the more valuable 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, Marvell agreed to purchase inventory from Intel at an inflated price. While it sounds as if this transaction would cause Marvell's earnings to be lower in future periods, as it is overpaying for inventory, this is 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. Thus, 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 provided Marvell with more discretion over its earnings each quarter.

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's targets) is to tweak these assumptions. To illustrate, consider the shenanigans that were used by 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 below) provide some fantastic, juicy details about Dell's games with reserves (don't skip reading this; there is some amazing stuff in here).

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 adjustment 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.

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 Income Statement as appropriate. Additionally, certain adjustments in the warranty liability estimation process were identified where expected future costs or estimated failure rates were not accurate.

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 be inflated; if it chooses too much, profits will be understated (and perhaps 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 an excellent job of explaining the mechanics that we figured we'd let the committee teach you directly.

Looking Ahead

This chapter completes our presentation of 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. 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 the current period. The results of using these tricks lead 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.

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 mislead its investors by reporting *smaller profits*? 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 earnings growth.

As you may recall from Chapter 3, "Earnings Manipulation 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 it decided to accelerate revenue from a later period to 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 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 replicate or even exceed them tomorrow. Meeting these elevated investor expectations may be daunting, leading management to feel compelled to use the techniques discussed 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. Smoothing income by improperly accounting for derivatives

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

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 fails to record some revenue that was rightfully earned during the current period, instead storing it on the Balance Sheet until it is needed during a later period. This is 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.)

Accounting Capsule: Creating Deferred (or Unearned) Revenue

Assume a company made a cash sale for $900. The correct journal entry would be:

Increase:	Cash		$900
Increase:		Sales revenue	$900

Instead, if management decided to only record $600 of the sale this year and squirrel away the rest for next year, it would record:

Increase:	Cash		$900
Increase:		Sales revenue	$600
Increase:		Deferred revenue	$300

Then next year, management would simply release that "pent-up" deferred revenue into sales revenue.

Decrease:	Deferred revenue	$300
Increase:	Sales revenue	$300

Saving Up for a "Rainy Day"

During the late 1990s, software giant Microsoft faced enormous scrutiny over its alleged anti-competitive 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 have become fodder for regulators. It certainly would have been tempting for the company to delay recognition of certain 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 $2.0 billion at the beginning of 1998 to $4.2 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.

Table 8-1 Microsoft's Unearned Revenue, Quarterly Trend

($ millions, except %)	Q3, 3/98	Q4, 6/98	Q1, 9/98	Q2, 12/98	Q3, 3/99	Q4, 6/99	Q1, 9/99
Unearned revenue (beginning balance)	2,038	2,463	2,888	3,133	3,552	4,195	4,239
Additions	885	1,129	1,010	1,361	1,768	1,738	1,253
Usage	(460)	(704)	(765)	(942)	(1,125)	(1,694)	(1,363)
Unearned revenue (ending balance)	2,463	2,888	3,133	3,552	4,195	4,239	4,129
Net addition (subtraction)	425	425	245	419	643	44	(110)
% change sequentially	20.9%	17.3%	8.5%	13.4%	18.1%	1.0%	(2.6%)

While several factors probably contributed to this big buildup and then sudden drop in unearned revenue, one theory 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 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.

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.

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]

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 to "mask the extent and volatility of its windfall trading profits." Compared with the rest of Enron's shenanigans, this scheme was 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 more 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 5 hurricane for investors!*

Using Reserves to Smooth Income Is a Serious Transgression Smoothing of income is not an uncommon strategy for management, 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. Smoothing Income by Improperly Accounting for Derivatives

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 a $5 billion fraud.

Volatile Interest Rate Market Makes "Steady Freddie" Much Less Predictable

Freddie's earnings manipulation was largely related 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 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, respectively, when earnings growth was a much more volatile negative 14 percent in 2001 and positive 220 percent in 2002.

Table 8-2 Freddie Mac Restatements for Errors

($ millions, except %)	2000	2001	2002	Total
Reported net income	2,547	4,147	5,764	**12,458**
Restated net income	3,666	3,158	10,090	**16,914**
Effect of restatement	1,119	(989)	4,326	**4,456**
Reported net income *growth*		63%	39%	
Restated net income *growth*		(14%)	220%	

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 (SFAS 133) that created enormous volatility in the company's investment activities involving derivatives. It quickly became clear to management that the change in accounting would create huge windfall gains for the company. 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.

General Electric 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 uses derivatives agreements, called "interest rate swaps" (named 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 would 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 novel 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 much greater than losses in the underlying asset or liability. Consider Washington Mutual Inc. (WAMU), 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, WAMU'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 5, "Acquisition Accounting 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.

Minimizing Revenue During the Acquisition "Stub Period"

Imagine that you recently signed an agreement to sell your business, with it closing in two months. You also receive instructions from the acquiring company's management team to refrain from recording any more revenue until the acquisition is complete. Somewhat baffled, you comply and record no more revenue. In so doing, you have given your new owner a generous (and inappropriate) gift, as the two months of revenue you held back will be counted as revenue by the acquiring company.

Consider the 1997 merger of 3Com with U.S. Robotics. Because the two companies had different fiscal year-ends (3Com's was in May and U.S. Robotics' in September), 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 in its August 1997 quarter, 3Com included revenue that U.S. Robotics refrained from booking 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).

Table 8-3 U.S. Robotics' Revenue Plummets During Its Preacquisition Stub Period

($ millions)	Q3, 6/96	Q4, 9/96	Q1, 12/96	Q2, 3/97	Two Months, 4/97 and 5/97
Revenue	546.8	611.4	645.4	690.2	15.2

Be Alert for Lower Revenue at a Target Company Just Before Acquisition Closes Remember how management at CA (Computer Associates)

manipulated the numbers to help senior management take home $1 billion in bonuses? We pointed out some of the many tricks the company used to accomplish this feat, including the “35-day” month and immediate revenue recognition on 10-year installment sale contracts. Well, like 3Com, CA may have also benefited from revenue that was held back before an acquisition.

Consider, for example, CA’s 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 because of its proposed acquisition by CA. 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 CA was buying a business with rapidly shrinking revenue.

Table 8-4 Platinum Technologies’ Revenue Falls Immediately Before Being Acquired by Computer Associates

($ millions)	Q2, 6/97	Q3, 9/97	Q4, 12/97	Q1, 3/98	Q2, 6/98	Q3, 9/98	Q4, 12/98	Q1, 3/99
Revenue	164.2	190.8	242.7	193.4	217.4	250.3	314.7	170.1

4. Recording Current-Period Sales in a Later Period

Imagine that late in a very strong period, management has achieved all the earnings targets needed to reach its maximum bonuses. 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 Ahead

This chapter showed what management might do to hold back legitimate revenue 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 techniques used to accelerate expenses, making the current period seem like a disaster to show beautiful profits tomorrow.

9

Earnings Manipulation Shenanigan No. 7: Shifting Future Expenses to the Current Period

Remember the 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 day game with expenses. You recall that the whole point of Earnings Manipulation Shenanigans Nos. 4 and 5 was to either push expenses to a later period or simply make them disappear forever. In the *opposite* scheme, the objective is to find ways to *increase* current period expenses.

Doing this involves two basic principles: (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.

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 moving 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, "Earnings Manipulation 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 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 mentioned AOL in Chapter 6, the company was struggling to show a profit and had begun capitalizing marketing and solicitation costs to push the company into the black. We criticized AOL for inflating profits by capitalizing normal expenses on the Balance Sheet. We then found fault with the company for stretching out the amortization period for these costs from one to two years, as 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 membership acquisition costs" (DMAC). (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 quite unwelcome.

Table 9-1 AOL's Deferred Membership Acquisition Costs

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

So three months later, when its DMAC asset had ballooned to $385 million, AOL shifted to Plan B and started playing its version of the opposite day game. Rather than continuing with the two-step dance and amortizing the marketing costs over the next eight quarters, AOL switched gears by announcing "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 claimed 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.

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—this was to give investors the impression of its being a profitable company, when in fact the company was unprofitable and 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 sleeves—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 will 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 day 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 day game here, though, let’s assume that management decides to write off the inventory cost as an expense long before any sale takes place.

Watch for Reversals of Prior Inventory Impairment Charges When chip maker NVIDIA took an impairment charge to write down the value of its 2016 inventory, management cited a new product cycle that would make some of the company’s older processors obsolete. Based on those concerns, NVIDIA materially increased its impairment expense to $112 million—up from $59 million in 2015 and $50 million in 2014. Those impairment estimates proved to be too high, since in the following year (2017) NVIDIA reported that it had *sold $51 million of previously written-off goods*. And by reversing the inflated impairment charge in 2017, NVIDIA received a 70-basis-point boost to its gross margin.

Too Many Toys

Toys ‘R’ Us accumulated excess inventory that it determined it wouldn’t be able 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: moving slow-selling inventory off the shelves), as well as the closing of stores and distribution centers. 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 accelerating deferred marketing costs, NVIDIA writing off inventory that it did not throw away (and later sold), or Toys 'R' Us taking large one-time charges, each seemingly had the same ultimate result: accelerating future-period expenses 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.

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.

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 values become 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 Let's assume you are prepping to become CEO of a struggling company and want to get off to a flying start by showing huge profit improvement almost immediately. Here are a few suggestions, assuming you have no ethical qualms about using some shenanigans to achieve your objective.

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 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 came out. 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 an 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 like 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 in the previous chapter that U.S. Robotics gave its new parent 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.

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 a regular occurrence. As we discussed in Chapter 5, "Earnings Manipulation 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. We showcased Alcatel and Whirlpool, which posted restructuring charges in just about every quarter for years on end. After a while, investors must question whether companies know the difference between nonrecurring and recurring. If a company incurs a certain type of cost every year, it should be shown with all 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 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 to keep *future* expenditures from being reported as expenses. With this trick, management loads up the current period with expenses, 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 related bogus liabilities will be reversed, resulting in underreported operating expenses and inflated profits. Let's examine these 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 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 significant 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.

Table 9-2 Sunbeam's Operational Performance

($ millions)	9 Months, 9/96	9 Months, 9/97	% Change
Revenue	715.4	830.1	16%
Gross profit	124.1	231.1	86%
Operating income	4.0	132.6	NM
Receivables	194.6	309.1	59%
Inventory	330.2	290.9	(12%)
Cash flow from operations	(18.8)	(60.8)	NM

Watch for "Big Bath" Charges During Tough 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 less likely to draw ire; indeed, they are often seen as a positive. As we discussed earlier, it is not difficult 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? Creating and releasing reserves as needed is a technique that 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), future compensation expense will be shifted to the current period and classified as a below-the-line expense. That intraperiod movement to below the line works fine for most, but some executives become too greedy and use a second (and unethical) trick. When management is planning to lay off employees, it instead takes an inappropriately large restructuring charge (e.g., it plans to lay off 100 people but 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.

The company then pays out the promised $25,000 to each of the 100 folks who are now out of work. Of course, another $2.5 million 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."

Watch for Companies That Create Reserves at the Time of an Acquisition In December 2000, Symbol Technologies recorded $185.9 million in charges related to 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 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 a 20 percent stake in its own European subsidiary that had been owned by the U.K.-based Rank Group. Related to 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 estimates. 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; seven years of 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. When seven years later the famine hit, Pharaoh and all of Egypt were ready.

Companies also consider 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 Ahead

Chapter 8 and this chapter both illustrated games that management might play 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 to dazzle investors.

These two chapters complete our discussion of the seven Earnings Manipulation Shenanigans. As EM Shenanigans Nos. 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 Nos. 6 and 7 will get the job done.

Chapter 10 begins Part Three, “Cash Flow Shenanigans.” Conventional wisdom for years has been that playing accounting games with earnings is quite easy, but the cash flow numbers are rock solid. In Part Three, we debunk this myth and demonstrate that Cash Flow Shenanigans also are pervasive and just as easy for management to use to trick investors as the earnings manipulation gimmicks we discussed in Part Two.

PART THREE
CASH FLOW SHENANIGANS

With so many recent financial frauds going undetected, investors have increasingly questioned the value of the accrual-based figures shown on the Income Statement. Time and time again, companies have duped investors by recording revenue too soon or hiding expenses, leading some to conclude that earnings can be manipulated and therefore they should put more faith in the "purer" measure of 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 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 Three, we showcase three specific types of Cash Flow (CF) Shenanigans, highlighting techniques that companies have employed to inflate reported cash flow from operations (CFFO). 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.

THREE CASH FLOW SHENANIGANS

CF Shenanigan No. 1: Shifting financing cash inflows to the Operating section (Chapter 10)

CF Shenanigan No. 2: Moving operating cash outflows to other sections (Chapter 11)

CF Shenanigan No. 3: Boosting operating cash flow using unsustainable activities (Chapter 12)

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. That simply means 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, the significance of cash inflows and outflows is muted 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 earnings.

As discussed in previous chapters, savvy investors often compare net income with CFFO and become concerned when CFFO lags 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 Income Statement 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 almost all present only the indirect method. Here we present the Income Statement (accrual-based), cash flow from operations (direct method), and cash flow from operations (indirect method).

Income Statement: Accrual-Based

Sales revenue	1,000,000
Less: Operating expenses	(850,000)
Operating income	150,000
Less: Nonoperating expenses	(50,000)
Pretax income	100,000
Less: Income tax @35%	(35,000)
Net income	**65,000**

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	(40,000)
Cash flow from operations	**(475,000)**

Cash Flow from Operations: Indirect Method

Net income	65,000
Adjustments to reconcile to net cash	
Depreciation and amortization	40,000
Provision for doubtful accounts	10,000
Changes in working capital	
Accounts receivable	(820,000)
Inventory	(80,000)
Prepaid expenses	50,000
Accounts payable and deferred revenue	260,000
Cash flow from operations	**(475,000)**

Although net income and CFFO represent different measures of a company's performance, investors should generally expect them to move in the same direction. That is, if a company reports growing net income, it would be worth raising questions if cash flow from operations is shrinking. Notice in the example of the indirect method above, CFFO lagged 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." Executives know that investors test earnings quality by benchmarking earnings 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 investors have even completely turned away from earnings and instead focus primarily on analyzing a company's ability to generate cash.

It should therefore come as no surprise that companies have become more creative in their financial reporting and disclosure practices. Many have found innovative ways to mislead investors, using deceptive practices that may go undetected in traditional quality of earnings analysis. As you will learn in Part Three, many of these shenanigans involve 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.

Figure P3-1 The Statement of Cash Flows is Organized into Three Sections: Operating, Investing, and Financing Activities

	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

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 changes in its 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?

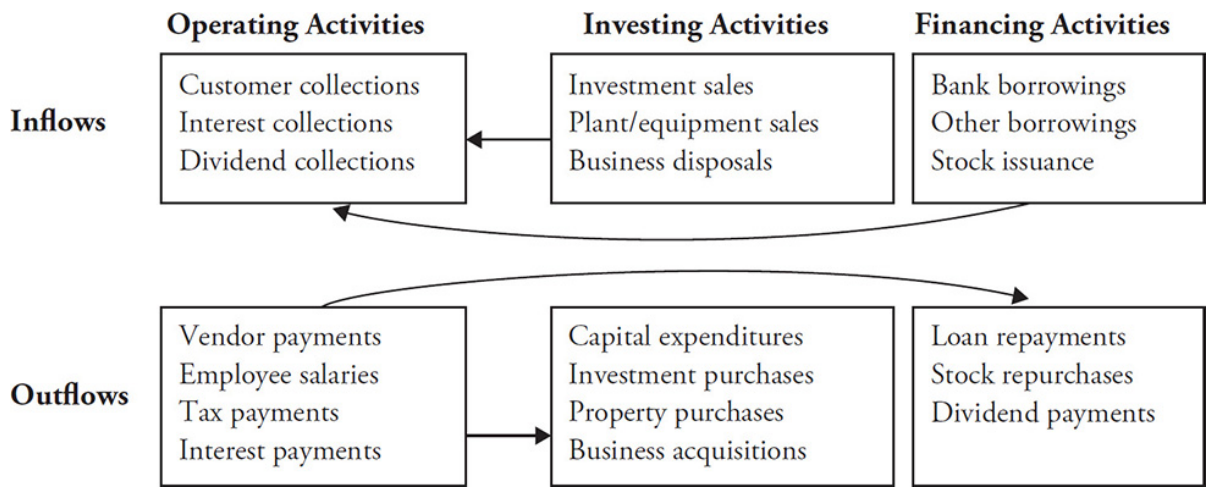
Well, not really. Companies can exert a great deal of discretion when presenting cash flows. Many of the Cash Flow Shenanigans can be considered *intraperiod geography games*—under which companies take liberal interpretations of "what goes where" on the Statement of Cash Flows. For example, should an outflow be shown in the Operating or the Investing section? Clearly, management's decision 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 to portray an overly rosy economic picture.

Robin Hood Tricks

Think of these intraperiod geography games as "Robin Hood" tricks: stealing from the rich sections of the Statement of Cash Flows and giving to the poor one. In these 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 de-emphasize.

As you will see, these Robin Hood tricks are 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 to 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 come 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 standards 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 "accomplices" to Robin Hood's 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 there are many techniques that allow companies to portray misleading cash flows. 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 that may attempt 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.

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*. The twins 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 the desirable traits to one child while sending the "genetic trash" to the other. In so doing, they created an intelligent Adonis (Schwarzenegger), but 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 while 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 the desirable cash inflows to the most important section (Operating) and the unwanted cash outflows to the other sections (Investing and Financing).

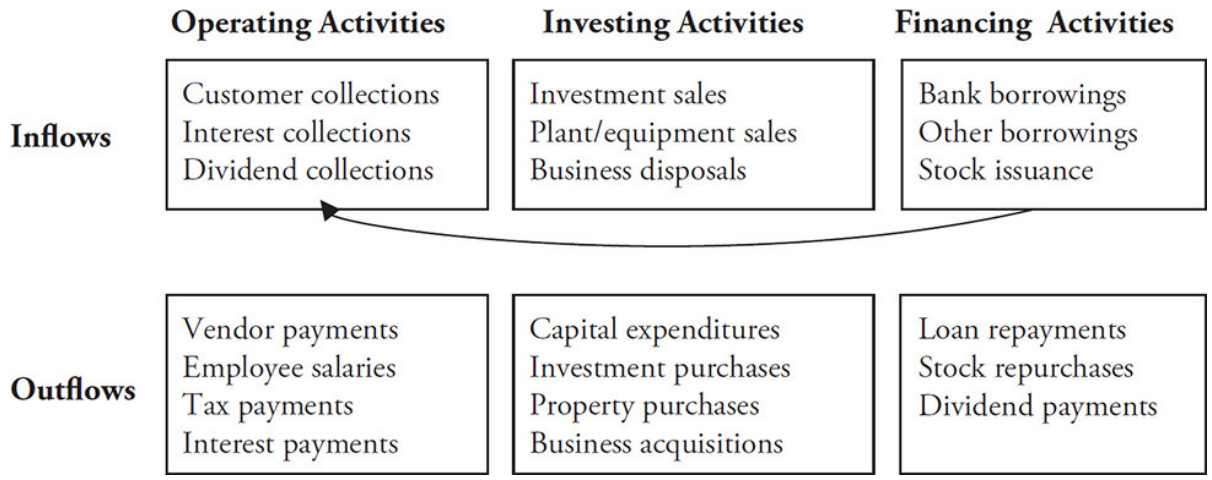
In recent years, many companies have seemingly been operating their own *Twins* genetics labs. But rather than attempting to create the perfect child, they are attempting to create the perfect Statement of Cash Flows. In this chapter, we expose one of the most important secret procedures being performed 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

At the end of 2000, Delphi Corporation found itself in a bind. It had been spun out from General Motors 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 entire year (rather than the $268 million reported), including a dismal negative $158 million in the fourth quarter.

Table 10-1 Delphi's Cash Flow from Operations, Adjusted for the Impact of a Sham Loan

($ millions)	**FY 2000**
Cash flow from operations	268
Less: Borrowed cash improperly recorded as CFFO	(200)
Normalized CFFO	68

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 this decision unwise. Investors should understand that *bogus revenue might also signal bogus CFFO*. This was clearly the case in the Delphi example, as well as in many other so-called boomerang transactions. Thus, as a rule, signs of bogus revenue may portend inflated CFFO as well.

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 Four, "Key Metric 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 $1.6 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 13.) 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 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 Releases. 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 cosigning 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 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 dangerous schemes 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 quite popular and considered completely appropriate: 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 quite simple: a company wishes to collect