on its receivables before they come due. The company finds a willing investor (i.e., a bank) and transfers ownership of some receivables. In return, the company pockets a cash payment for the total receivables, less a fee.

Let's think about the underlying transaction, its purpose, and the other party's interest. Does this arrangement sound like a financing transaction or an operating one? Many people would agree that an arrangement in which a bank simply cuts you a check looks strikingly like an old-fashioned loan—nothing more than a form of financing, particularly since management determines the timing and the amount of cash received. They therefore expect that this transaction will not affect CFFO. However, the rules state otherwise. The appropriate place to record cash generated from the sale of receivables would be an Operating inflow, not a Financing inflow. Why Operating? Because the cash received could be viewed as representing collections from past sales. Indeed, this is one of many gray areas that cause confusion among even the savviest investors.

ACCOUNTING CAPSULE: SELLING ACCOUNTS RECEIVABLE

It is important to recognize when a company is selling its receivables, as these transactions are recorded as CFFO inflows. There are a variety of ways in which companies can sell their receivables, including factoring transactions and securitizations. Keep an eye out for these key words in financial statements.

- **Factoring:** The simple sale of receivables to a third party, often a bank or a special-purpose entity
- **Securitization:** The sale of receivables to a third party (often a specialpurpose entity) for the purposes of creating new financial instruments ("securities") by repackaging the receivable inflows

Selling Accounts Receivable: An Unsustainable Driver of Cash Flow Growth

In 2004, pharmaceutical distributor Cardinal Health needed to generate a lot more cash. So management decided to sell accounts receivable to help the company raise cash very quickly. By the end of the second quarter (December 2004), Cardinal Health had sold $800 million in customer

receivables. This transaction was the primary driver of the company's robust $971 million in CFFO growth in December 2004 over the prior-year period.

While Cardinal Health certainly was entitled to any cash received in exchange for its accounts receivable, investors should have realized that this was an *unsustainable* source of CFFO growth. Cardinal Health essentially collected on receivables (from a third party, rather than from its customers) that would normally have been collected in future quarters. By collecting the cash earlier than anticipated, the company essentially shifted future-period cash inflows into the current quarter, leaving a "hole" in future-periods' cash flow. The transfer of cash flow to an earlier period is likely to result in disappointing CFFO in the future—unless, of course, management finds another CF Shenanigan to plug the hole.

Watch for Sudden Swings on the Statement of Cash Flows Even novice investors could have identified that something important had changed in Cardinal Health's accounts receivable and that CFFO growth was largely driven by this change. Look at the company's Statement of Cash Flows in Table 10-2. Notice that the $971 million increase (from $548 million to $1.5 billion) in CFFO had been driven primarily by a $1.1 billion "swing" in the impact of receivables. Specifically, in the six months ending December 2004, the change in accounts receivable represented a cash inflow of $622 million, while in the previous year, the change in accounts receivable had contributed a cash *outflow* of $488 million. Without doubt, the massive receivable sale, not an improvement in Cardinal Health's core business, produced the impressive CFFO improvement. To emphasize, investors should focus not only on *how much* CFFO grew, but also on *how* it grew—a very notable difference.

Table 10-2 Cardinal Health's Cash Flow from Operations, as Reported

($ millions)	Six Months Ended 12/31/03	12/31/04
Earnings from continuing operations	**697.1**	**421.6**
Depreciation and amortization	143.2	198.2
Asset impairments	4.8	155.8
Provision for bad debts	(2.7)	0.8
Decrease/(increase) in trade receivables	**(488.3)**	**622.3**
Increase in inventories	(841.4)	(707.5)
Decrease (increase) in sales-type leases	22.0	(95.3)
Increase in accounts payable	964.3	794.1
Other accrued liabilities and operating items, net	49.4	129.2
Net cash provided by operating activities	**548.4**	**1,519.2**

Sudden swings like these at Cardinal Health signal the need to explore more deeply. In this case, you would have found that the company began selling more accounts receivable. This was fairly easy to find, and the company clearly did nothing improper. In fact, the company was very forthcoming, disclosing the accounts receivable sales clearly in its Earnings Release as well as in the 10-Q filing (although disclosing it on the Statement of Cash Flows would be preferred). While perhaps casual or lazy investors were too easily impressed with Cardinal Health's ability to grow its CFFO, savvy investors would certainly have realized that the growth came from a nonrecurring source.

Stealth Sales of Receivables

Unlike Cardinal Health, which was relatively transparent with its disclosure, some companies try hard to keep investors in the dark when their CFFO benefits from the sale of receivables. Take, for instance, the case of a certain electronics manufacturer. Sanmina-SCI Corporation reported its fourth-quarter results for September 2005 in early November. In the Earnings Release, Sanmina decided to prominently display its strong CFFO as one of its fourth-quarter "highlights." Accounts receivable had decreased, and Sanmina also proudly pointed out the decline in receivables near the top of the release.

But the Earnings Release didn't tell the whole story. Nearly two months later, deep in the 10-K filed on December 29, 2005, while many investors were on holiday, Sanmina disclosed what had really happened: *the primary driver of CFFO in Q4 was the sale of receivables*. Sanmina reported that $224 million in receivables that it had sold were still subject to recourse at the end of the quarter. This was quite an increase from the $84 million reported in the previous quarter. Sanmina had been quietly selling receivables for the past couple of quarters, but never at this magnitude. As shown in Table 10-3, without this increase in receivables sold, Sanmina's CFFO would have been $139 million lower, falling to $36 million instead of the reported $175 million.

Table 10-3 Sanmina-SCI's CFFO in Q4, 9/05, Adjusted to Remove the Impact of Sold Receivables

($ millions)	Q4, 9/05
Cash flow from operations	175
Quarterly change in sold receivables	(139)
Normalized CFFO	36

TIP

When normalizing CFFO to exclude the impact of sold receivables, use the change in sold receivables *outstanding at the end of the quarter*. In this way, you could focus on receivables outstanding last quarter but collected during this one.

Read the Quarterly Filings to Know What to Anticipate Certainly, a full reading of the 10-K would have revealed that sales of receivables drove CFFO. But could you have suspected that this was the case before the 10-K was even filed? Indeed, the answer would be yes. Astute investors would have read the previous quarter's 10-Q and noticed that Sanmina discussed the sale of receivables no fewer than four times. They also would have noted that the company had mentioned the arrangement in passing on its earnings conference call two quarters earlier. These A-plus investors would have known that they should be wary in the fourth quarter when the CFFO

suddenly surged because of a significant decline in receivables. They certainly would have been able to connect the dots.

Shun Opacity It is clearly inappropriate for companies to be opaque when reporting sensitive and impactful structured arrangements such as selling receivables. Be wary if companies fail to provide investors with details. Question their reasons for not being transparent about how they monetize their receivables. Perhaps management's objective is simply to window-dress its Statement of Cash Flows. The worst-case scenario would be that the company is trying to hide a real cash crunch from investors. Such a cover-up clearly goes far beyond simple window dressing and points to a company camouflaging a material deterioration in its business. Dot-com high-flyer Global Crossing sold $183 million in receivables just six months before it filed for bankruptcy in 2002. Similarly, Xerox raised the ire of the SEC by silently selling $288 million in receivables at the end of 1999 to report a positive year-end cash balance of $126 million.

3. Inflating CFFO by Faking the Sale of Receivables

In the previous section, we discussed the implications of normal receivable sales for CFFO. We pointed out that in many cases, selling receivables may be not only appropriate, but also s prudent business decision. However, investors also need to understand that the cash flow that was expected in a future period has now been collected, and this inflow should be viewed as unsustainable. In this section, we take a step into more nefarious territory. We will encounter another top-secret procedure being performed in the companies' *Twins* labs: faking the sale of receivables.

Sham Sales of Receivables—the "Watergate" of Shenanigans

President Nixon resigned in disgrace because of trying to cover up the break-in at the Watergate Hotel. The smoking-gun evidence apparently was included on an 18½-minute section of a White House recording that was conveniently erased to cover up the crime. Similarly, Peregrine Systems used a convenient cover-up to hide its accounting fraud. As we discussed in Chapter 4, "Earnings Manipulation Shenanigan No. 2: Recording Bogus Revenue," Peregrine embellished its revenue in the years leading up to its 2002 bankruptcy, using deceptive practices such as recording bogus revenue and entering into reciprocal transactions. This fake revenue

resulted in bloated receivables on the Balance Sheet that would never be collected. Peregrine became concerned that these bloated receivables would become the smoking gun of its bogus revenue. So the cover-up began in earnest with *fake sales of accounts receivable*.

In this cover-up, Peregrine transferred its receivables to a bank in exchange for cash; however, the risk of collection loss remained with Peregrine. That collection risk was huge, of course, because *there were no customers*—many of the related sales were bogus. Since the risk of loss had not been transferred, Peregrine remained on the hook to return the cash to the bank when the receivables inevitably were not collected.

Since the receivables had never actually been transferred, the economics of this transaction would be more akin to a collateralized loan, just as we saw with Delphi earlier in this chapter. Peregrine borrowed money from the bank and used receivables as collateral. On the Statement of Cash Flows, this should be presented as a *Financing* inflow. Peregrine, however, ignored the economic reality of the situation. Instead, it recorded the transaction as the sale of receivables and shamelessly reported the cash received as an *Operating* inflow.

Watch Carefully for Disclosure Changes in the Risk Factors Many investors overlook the "Risk Factor" section of corporate filings because it seems like legal boilerplate. *Warning to investors:* ignore the risk factors at your own peril. While most of the text may be similar from quarter to quarter, investors should carefully try to identify *changes* in the verbiage. If new risks have been added or previously listed ones have been changed, then the change is deemed worthy of disclosure by the company or its auditors, and you need to know about it.

For instance, in 2001, the year before Peregrine imploded in fraud, the company inserted an important new risk factor disclosure that should have awakened investors from their slumber. Peregrine changed its risk factor disclosure twice, first in June 2001 and then again in December 2001. The new disclosure in June 2001 informed readers that Peregrine was engaging in new customer financing arrangements, including loan financing and leasing solutions. It also reported that some customers were failing to meet their obligations. The mere fact that this disclosure found its way into the risk factors tells you it must have been significant.

PEREGRINE'S NEW RISK FACTOR DISCLOSURE IN JUNE 2001

In addition, other factors, including indirect factors resulting from the macroeconomic climate, could have an adverse effect on our operating results in one or over several quarterly periods. For example, in the current economic environment, we have experienced increased demand from some customers for customer financing, including loan financing, and leasing solutions. We expect this demand for customer financing to continue, and we have engaged in customer financing where we believe it is a competitive factor in obtaining business. Although we have programs in place to monitor and mitigate the associated risks, there can be no assurance that such programs will be effective in reducing related credit risk. We have experienced losses due to customers failing to meet their obligations. Future losses, if incurred, could harm our business and have a material adverse effect on our operating results and financial condition.

Then, in December 2001, Peregrine added one small sentence to the end of the new disclosure from the June period. While it was only 12 words, it read like a five-alarm fire:

PEREGRINE'S NEW RISK FACTOR DISCLOSURE IN DECEMBER 2001

The Company may at times market certain client receivable balances without recourse.

Peregrine was doing more than just finding new ways to provide its customers with financing; it was also trying to sell its accounts receivable. The cryptic nature of this new sentence, together with the hush-hush disclosure in the risk factors with no mention of it elsewhere, is extremely concerning. Peregrine was clearly hiding something big from investors and trying to comply with the minimal level of disclosure requirements.

TIP

It is well worth your time to look for changes in disclosure each quarter, particularly in the most important sections of the filings. Most research platforms and word processing software have "word compare" or "blackline" functionality. Reviewing both filings side by side is not as cumbersome as it sounds.

Computer Associates Makes an Accounting "Decision"

Computer Associates' 2000 10-K revealed that one of its primary sources of operating cash flow that year had come from its fourth quarter "decision" to assign accounts receivable to a third party. No other details were provided. Investors were given no insight into the details of the arrangement, the mechanics of the "assignment," or the magnitude of the impact.

COMPUTER ASSOCIATES ACCOUNTS RECEIVABLE DISCLOSURE 2000 10-K

The primary source of cash for the year was higher net income adjusted for non-cash charges. Other sources of cash included strong collections of outstanding accounts receivable and *the Company's decision, in the fourth quarter, to assign selected existing installment accounts receivable to a third party*. The Company may continue to explore the use of financing companies as a means of expediting debt reduction, mitigating interest rate risk, and reducing installment accounts receivable balances. [Italics added for emphasis]

Recall from Chapter 3, "Earnings Manipulation Shenanigan No. 1: Recording Revenue Too Soon," that the SEC charged Computer Associates (CA) with prematurely recognizing more than $3.3 billion in revenue from 1998 to 2000. Well, like Peregrine, CA needed a cover-up to conceal this bogus revenue. CA found one by offloading receivables, and the company seemed to try to keep that transfer under wraps. Whenever companies disclose that a mysterious new arrangement is a driver of CFFO (or of any important metric, for that matter), investors should seek to understand the mechanics of the arrangement. Only significant changes would require new disclosure, so when you notice something new, consider it a big deal. At the

benign end of the spectrum, it may simply be a nonrecurring benefit that might be important to your analysis. However, on the other end of the spectrum (think CA), it may be a red flag signaling a major impropriety.

Recourse or Nonrecourse?

When a company sells its accounts receivable, it typically it does so under a "nonrecourse" arrangement, which means that the risks of customer default are passed on to the buyer (usually a financial institution). In cases where receivables are sold on a "nonrecourse" basis, the cash received is treated as an Operating cash inflow. By contrast, in cases when the seller retains some of the credit risk ("recourse"), the transaction is considered a form of borrowing, and the cash received is classified as a Financing inflow, with no impact on operating cash flow. In these recourse arrangements, Operating cash flow and free cash flow should be unaffected.

Sometimes companies get confused and include cash received as part of cash flow from operations even though credit risks remain and the proper categorization should be in the Financing section. That was the case with Zoomlion, a Chinese manufacturer of construction equipment, when the company claimed to have sold accounts receivables on a nonrecourse basis (thus including the RMB5.2 billion proceeds as part of the operating cash flow), when in fact it still retained some credit risk. Specifically, astute analysts would have noticed that Zoomlion disclosed its obligation to repurchase equipment from financial institutions that repossess equipment as a result of customer defaults. (See the footnote below contained in the company's 2014 Annual Report.) Even though Zoomlion is not directly on the hook for bad debts, the repurchase commitment mandated that the company provide cash should the debts go bad. In our view, this is tantamount to providing recourse, only in a more convoluted way.

ZOOMLION 2014 ANNUAL REPORT

During the year ended 2014, trade receivables of RMB5,197 million (2013: RMB2,021 million) were factored to banks and other financial institutions without recourse, and were therefore derecognized. Under the non-recourse factoring agreement, the Group has *agreed to repurchase equipment at fair value from banks and other financial institutions to which the Group previously factored receivables, upon*

repossession of the equipment under the relevant equipment sales contracts by such banks or financial institutions. [Italics added for emphasis]

Looking Ahead

A second clever way in which management may inflate operating cash flows is by pushing some of the "bad stuff" (i.e., the outflows) from the Operating section to another place on the Statement of Cash Flows. The next chapter shows just how easy it is to move these outflows to the less-scrutinized Investing section.

11

Cash Flow Shenanigan No. 2: Moving Operating Cash Outflows to Other Sections

Jimmy Hoffa, corrupt boss of the Teamsters Union, left a Detroit restaurant on July 30, 1975, and vanished without a trace. It is widely believed that he was "whacked" in a mob hit; yet despite having searched for the past 35 years, the FBI has been unable to locate his remains. Urban legends run rampant, providing many different accounts of his final resting place, including a New Jersey landfill, a Michigan sanitation plant, the Florida Everglades, and even (the old) Giants Stadium. Only one thing is for certain: whoever buried Jimmy Hoffa did not want him to be found.

Like Hoffa's handlers, many companies have a secret dumping ground for pesky cash outflows that they don't want anyone to find. It's called the Investing section of the Statement of Cash Flows. Companies have found numerous clever ways to dump normal operating cash outflows into the Investing section, hoping that those outflows will vanish forever. And most investors, like the FBI in its hunt for Jimmy Hoffa, seem to have very few clues about where to look.

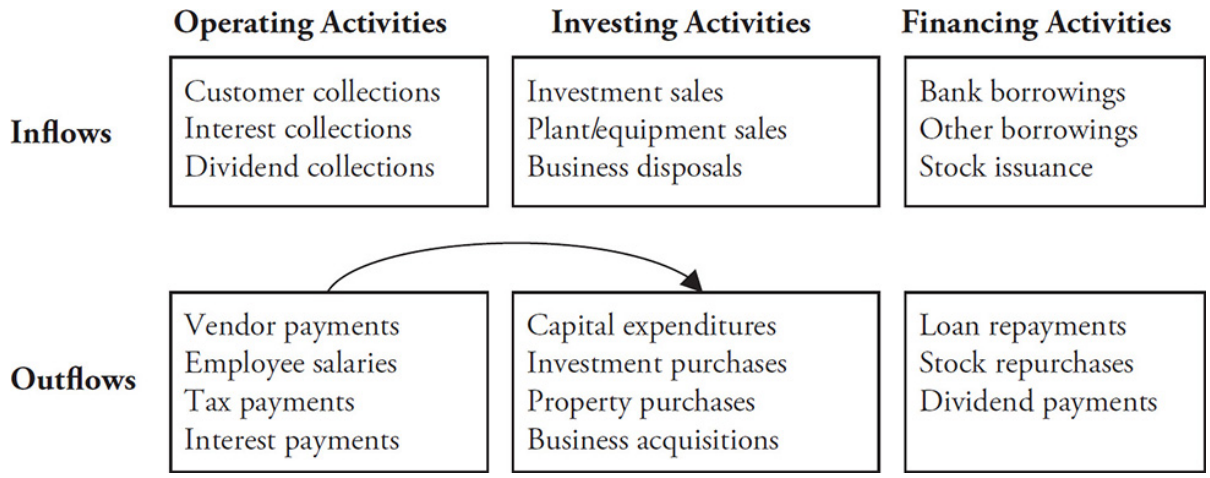
While unfortunately we can be of no help to the FBI in its search for Hoffa, we certainly can help investors find clues to the whereabouts of hidden cash outflows. This chapter will show you exactly where to look. We'll show you how to find these outflows that management loves to bury in the Investing section, even though they seem more like operating-related outflows. And we'll discuss the following four primary techniques that companies use to shift these operating cash outflows to the Investing section.

Techniques to Move Cash Outflows to Other Sections

1. Inflating CFFO with boomerang transactions
2. Improperly capitalizing normal operating costs
3. Recording the purchase of inventory as an investing outflow
4. Shifting operating cash outflows off the Statement of Cash Flows

All four methods are examples of those used by companies that inflate cash flow from operations (CFFO) by dumping normal operating costs into the Investing section, as shown in Figure 11-1.

Figure 11-1



1. Inflating CFFO with Boomerang Transactions

Global Crossing was one of the highest-flying technology companies during the 1990s dot-com bubble. It was building an undersea fiber-optic cable network that would connect more than 200 cities across four continents, and investors appeared thrilled over its prospects. However, as the project neared completion in 2000 and early 2001, critics began to wonder whether Global Crossing would ever sell enough network capacity to recoup the extensive costs of the project and pay down its massive debt.

When questioned, Global Crossing always seemed to have a great rebuttal for these naysayers: “Look at all the cash we are generating.” Global Crossing signed many substantial contracts in which it sold future capacity for cash from customers paid up front—and it had the CFFO to prove it. In 2000, despite a negative $1.7 billion in earnings, the company

reported to investors a positive $911 million in operating cash flow. (See Table 11-1.)

Table 11-1 Global Crossing's Cash Flow from Operations Versus Net Income

($ millions)	FY 1998	FY 1999	FY 2000	H1, 6/01
Cash flow from operations (CFFO)	349	732	911	677
Net income (loss) (NI)	(88)	(111)	(1,667)	(1,246)
CFFO – NI	437	843	2,578	1,923

Normally, investors would be overjoyed about a company that generates substantially more CFFO than net income. Indeed, some of the differential was legitimately explained by these advances received from customers. However, a sizable portion related to a boomerang scheme to manipulate its CFFO.

As the technology industry was facing a slowdown, Global Crossing and other telecom players came up with a plan to effectively sell products to each other and, in so doing, boost revenue. From a purely economic standpoint, it was like taking money out of your right pocket and putting it into your left: nothing really changed.

Here's how it worked: Global Crossing sold large blocks of future network capacity to telecom customers. At the same time, the company purchased a similar dollar amount of capacity from these same customers. In other words, Global Crossing would sell capacity to a customer and *simultaneously buy a similar amount of capacity* on a different network. This was a classic *boomerang* transaction. You can almost picture some Global Crossing executive telling the company's customers, "You scratch my back, and I'll scratch yours."

So what does this have to do with cash flow? Well, Global Crossing recorded these boomerang transactions in a way that artificially inflated CFFO. The company recorded the cash that it received from its customers in these transactions as an Operating inflow; however, the cash that it paid to the same customers was recorded as an Investing outflow. Essentially, Global Crossing inflated cash flow from operating activities by depressing cash flow from investing activities. This allowed the company to show strong CFFO that clearly exceeded the economic reality of the transaction. It mattered little that the overstated CFFO was offset by understated cash

from investing activities, because *CFFO was the key cash flow metric on which investors were focused*. Did we mention the word "chutzpah" before?

Be on the Lookout for Boomerang Transactions

These are very sneaky transactions that make you wonder about the economic substance of the arrangements. Diligent investors should be able to detect these transactions most of the time; look for disclosure of them in 10-Q and 10-K filings, but don't expect that companies will use the term "boomerang." Of course, companies will make investors work to find them, not present them on a silver platter. However, there are often plenty of details about these transactions, particularly when they are substantial in size. Consider Global Crossing's disclosure of its boomerang transactions in its March 2001 10-Q filing.

This disclosure alone should have spooked investors. On page 11, Global Crossing discloses that $375 million of its $441 million in EBITDA came from sales to customers "to whom the Company made substantial capital commitments during the quarter." Page 16 reminds readers that Global Crossing purchased capacity from customers and states that "new capital commitments total an estimated $625 million."

DISCLOSURE OF BOOMERANG TRANSACTIONS IN GLOBAL CROSSING'S MARCH 2001 10-Q FILING

Page 11: For the March quarter, $375 in consideration, which is included in the $441 of Recurring Adjusted EBITDA below and in the $1,613 of cash revenue above, *was received from significant Carrier customers who signed contracts during the quarter to purchase $500 of capacity on the Global Crossing Network, and to whom the Company made substantial capital commitments during the quarter.* [Italics added for emphasis]

Page 16: During the quarter, *the Company also entered into several agreements with various Carrier customers for the purchase of capacity and co-location space.* These transactions were implemented in order to acquire cost-effective local network expansions; to provide for cost-effective alternatives to new construction in certain markets in which the Company anticipates shortages of capacity; and to provide additional levels of physical diversity in the network as the Company implements

> its global mesh architecture. *These new capital commitments total an estimated $625*, including the cost of the possible construction of the Caribbean system. [Italics added for emphasis]

Raise Your Antennae When You See a Boomerang Transaction

Once you identify a boomerang transaction, it is imperative that you dig around and understand the true economics of the arrangement. Look for further disclosure. Call the company and have management explain the arrangement to you. Assess the economics of the transaction and understand how it contributes to the company's results. Consider whether the company has been deliberately avoiding or complicating the disclosure—it may not want you to understand how its boomerang transactions work. If you cannot get comfortable with a boomerang transaction, steer clear of the company.

Key Metric Shenanigans

You may be wondering about the odd metrics that Global Crossing highlighted in the excerpts shown: "cash revenue" and "recurring adjusted EBITDA." The company used these metrics in its communications with investors and advertised them as being better performance measures than GAAP revenue and earnings. As you might imagine, these metrics were defined in such a way as to circumvent GAAP. The definitions allowed Global Crossing to take credit for cash received in these boomerang transactions that could not legitimately be recognized as revenue until far in the future. The whole concept of management's deliberately sidestepping GAAP to mislead investors is quite alarming and very important to understand. We will pick up on this topic and discuss it much more thoroughly in Part Four, "Key Metric Shenanigans."

2. Improperly Capitalizing Normal Operating Costs

Recording normal operating costs as an asset rather than as an expense sounds simple, and frankly, it is quite easy to do. However, it is one of the scariest and most lethal shenanigans out there. Why? Because it is a simple sleight of hand that does more than just embellish earnings—it inflates operating cash flow as well.

It certainly is no coincidence that WorldCom, the perpetrator of one of the largest and most shocking accounting frauds in history, was a purveyor

of this brand of snake oil. By classifying billions of dollars of normal operating costs as capital equipment purchases, WorldCom not only artificially inflated its profits, but it also overstated its CFFO.

TIP

If you suspect a company of receiving an earnings benefit from improper capitalization, don't forget that there may be a boost to operating cash flow as well.

Recording Normal Operating Costs as a Capital Asset Rather Than as an Expense

Recall our discussion of how WorldCom improperly inflated its earnings by recording its line costs (a clear operating expense) as an asset rather than as an expense? This simple tactic helped the company portray itself as a profitable company rather than tell investors that trouble was stirring.

This move also allowed WorldCom to present strong operating cash flow. Purchases of capital assets ("capital expenditures") are classified on the Statement of Cash Flows as investing activities. By classifying line costs as a capital asset, WorldCom shifted a very large cash outflow from the Operating to the Investing section.

This line cost scheme artificially inflated WorldCom's CFFO by nearly $5 billion in 2000 and 2001, according to the company's restatement. Together with other improperly capitalized costs and CFFO boosts, WorldCom's operating cash flow was overstated by a whopping $8.6 billion over these two years (as shown in Table 11-2, the difference between $15.7 billion reported and the $7.1 billion restated).

Table 11-2 WorldCom's CFFO, Reported Versus Restated, 2000–2001

($ millions)	FY 2000	FY 2001	Total
Reported cash flow from operations (CFFO)	7,666	7,994	15,660
Improperly capitalized line costs	(1,827)	(2,933)	(4,760)
Other CFFO boosts	(1,612)	(2,216)	(3,828)
Restated CFFO	4,227	2,845	7,072

In Chapter 6 (EM Shenanigan No. 4), we discussed several ways to identify companies that are engaging in aggressive capitalization. Dishonest company executives may find ways to improperly capitalize any normal operating cost; however, the most common ones are generally those related to long-term arrangements, such as research and development, labor and overhead related to a long-term project, software development, and costs to win contracts or customers. Monitor these accounts for the best chance of spotting aggressive capitalization.

TIP

Rapidly increasing "soft" asset accounts (e.g., "prepaid expenses," "other assets") may be a sign of aggressive capitalization.

Pay Attention to Free Cash Flow as Well When a company improperly records costs as an asset instead of an expense, CFFO will be overstated. However, as we discussed in Chapter 1, free cash flow may not be affected because it is a measure of cash flow after capital expenditures. As shown in Table 11-3, calculating free cash flow at WorldCom reveals the extent of the company's problems—a $6.1 billion deterioration from 1999 to 2000.

Table 11-3 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)

Some very clever companies have figured out how to turn ordinary operating expenses from being a drain on free cash flow to ones that have virtually no cost, either in the present or in the future. In 2013 Salesforce.com, for example, began the unusual practice of accounting for a large multiyear software license as a "capital lease." In all prior years, these types of licenses had been treated as operating expenses, both on the Statement of Operations and within the reported Operating section of the Statement of Cash Flows.

However, by classifying the license agreement as a lease, Salesforce.com moved most of payments to the software vendor from the Operating section

of the Statement of Cash Flows to the Financing section under “Principal payments of capital lease obligations.” This line item, literally the second-to-last entry of the entire SCF, would be unlikely to draw any attention from analysts, who would have seen reported cash flow artificially inflated by tens of millions of dollars.

Accounting Capsule: Free Cash Flow

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

Cash flow from operations *minus* capital expenditures

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3. Recording the Purchase of Inventory as an Investing Outflow

Cost of goods sold (COGS) is a very apt name for the direct expenses that companies incur to acquire or produce inventory sold to customers. On the Statement of Operations, COGS are subtracted from revenue to yield a company’s gross profit, an important measure of the profitability of the company’s products.

The Statement of Cash Flows is sometimes not as straightforward. The economics of purchasing goods to be sold to customers suggests that these purchases should be classified as an operating activity on the Statement of Cash Flows. Normally, this would be the case. Curiously, some companies treat these purchases as an Investing outflow.

Purchase of DVDs: Operating or Investing?

In its early days (before streaming), Netflix Inc. was a mail-based movie-rental company. As you might imagine, one of the company’s largest expenditures was purchasing the DVDs that it rented out to customers. DVDs were essentially Netflix’s inventory, and therefore the company recorded its DVD library as an asset on its Balance Sheet. This asset was then amortized (over a period of one year for new releases and three years for back catalog), and as you would expect, the amortization cost was

presented on the Income Statement as a cost of goods sold. In 2007, Netflix's amortization of its DVD library amounted to $203 million on revenue of $1.2 billion.

While Netflix's Income Statement appropriately reflected the economics of its DVD costs, its Statement of Cash Flows did not. You would think that the purchase of DVDs would have been presented on the SCF as an operating outflow just like the purchase of any inventory (particularly the purchase of the new releases that were amortized for only one year). However, Netflix did not see it that way. Instead, it considered the purchase of DVDs to be the purchase of a capital asset, and therefore the cash outflows were presented in the Investing section. This treatment effectively moved a big cash outflow (payment for DVDs) from the Operating to the Investing section, thereby inflating CFFO.

Interestingly, Netflix's competitor at the time, Blockbuster Inc., a company that is not known for accounting conservatism, changed its accounting for DVD acquisitions at the end of 2005. Previously, Blockbuster had presented DVD purchases as an investing outflow, just like Netflix. However, after consultation with the regulators at the Securities and Exchange Commission, Blockbuster began classifying DVD purchases as an operating outflow and restated its historical numbers.

Consider Differences in Accounting Policies When Comparing Competitors Since Netflix put DVD purchases in the Investing section and Blockbuster put them in the Operating section, investors had little ability to compare the CFFO of the two companies without making an adjustment. As shown in Table 11-4, Netflix's cash flow from operations was much stronger than that of Blockbuster in 2007; however, the difference was much less pronounced after adjusting for the DVD purchases.

Table 11-4 CFFO for Netflix and Blockbuster (FY 2007), as Reported and as Adjusted to Remove DVD Purchases from Netflix's CFFO

($ millions)	Netflix	Blockbuster
Cash flow from operations (CFFO), as reported	291.8	(56.2)
SCF treatment of acquiring DVD library	Investing outflow	Operating outflow
Acquisitions of DVD library	(223.4)	(709.3)
Apples to apples (Blockbuster's treatment)	68.4	(56.2)

Question Any Investing Outflow That Sounds like a Normal Cost of Operations While many analysts claim that reading the Statement of Cash Flows is an integral part of their analysis, many of them fail to read carefully below the Operating section. Simply scanning Netflix's Investing section would have revealed that the company classified "Acquisitions of DVD library" as an investing activity. Even investors with only a basic knowledge of Netflix's business would know enough to realize that acquisition of DVDs represents a normal cost of operations for Netflix.

Purchasing Patents and Newly Developed Technologies

Some professional sports franchises fill their team rosters with players whom they scouted, drafted, and developed within their own organizations. Others rely on the "free agent" market to sign proven players (albeit normally at a much higher price). In the same way, some companies rely on their own internal research and development projects to grow their businesses organically, while others choose to grow inorganically by acquiring development-stage technologies, patents, and licenses. While these different business strategies are means to the same end, the expenditures are often treated differently on the Statement of Cash Flows. Specifically, cash paid to employees and vendors for internal research and development would be reported as an operating outflow. However, some companies report cash paid to acquire already researched and developed products as an Investing outflow.

In certain industries, acquiring development-stage technologies is considered commonplace. For example, small biotechnology research companies often develop new drugs and then sell the rights to these drugs to larger pharmaceutical companies once FDA approval is near. The larger pharmaceutical companies then, as owner of the drug, reap all the profits. When analyzing the pharmaceutical company's business, you certainly

should consider the cash paid to acquire the drug rights. However, since the payment will be classified in the Investing section, many investors will have no idea it even exists.

Consider the case of biopharmaceutical company Cephalon. Looking to continue its rapid pace of growth, Cephalon went on a $1 billion shopping spree in 2004 and 2005, snapping up patents, rights, and licenses related to several newly developed drugs. Cephalon presented these cash payments as "acquisitions" and dumped them into the Investing section of the Statement of Cash Flows. Had they been classified in the Operating section, CFFO instead would have been severely negative in both years. (See Table 11-5.)

Table 11-5 Cephalon's Cash Flow from Operations (Adjusted to Subtract Drug Purchases)

($ millions)	2003	2004	2005
Cash flow from operations, as reported	200.2	178.6	185.7
"Acquisition" of drug patents, rights, and licenses	—	(528.3)	(599.7)
Cash flow from operations, as adjusted	200.2	(349.7)	(414.0)

Similarly, Nuance Communications, a speech recognition software company, acquired a substantial amount of a development-stage technology. In 2014, Nuance showed $253 million in "payments for business and technology acquisitions" as an Investing outflow on its Statement of Cash Flows. This was a very large outflow for the company, especially in relation to the $358 million in operating cash flow generated that year. However, despite spending this large amount, Nuance deemed each of its acquired entities to be immaterial and provided little detail about what it actually bought. Certainly, the cash spent on these assets should be considered when analyzing Nuance's cash flow, as it likely relates to acquired technology and other development spending.

I'll Gladly Pay You Tuesday for a Hamburger Today

In an interesting twist, Biovail Corporation, which merged with Valeant in 2010, gained ownership of certain drugs by purchasing the rights through noncash transactions. Instead of paying cash at the time of the sale, Biovail compensated the sellers by issuing a note—essentially, a long-term IOU under which the company would pay cash in the future. Since no cash changed hands at the time of the sale, there was no impact on the Statement of Cash Flows. And as Biovail paid down the notes over time, the cash

payments were presented on the SCF as the repayment of debt—a financing outflow.

Biovail's noncash purchases of product rights can be thought of in the same light as Cephalon's patent purchases and Netflix's DVD purchases. The economics suggests that these purchases relate to normal business operations, and yet they are reflected very differently on the Statement of Cash Flows. When analyzing Biovail's ability to generate cash, these purchases should certainly not be ignored.

Look for "Supplemental Cash Flow Information" Companies frequently provide information about noncash activities in disclosures called "Supplemental Cash Flow Information." This disclosure is sometimes found immediately after the Statement of Cash Flows; however, occasionally companies will bury this disclosure deep in the footnotes. For example, Biovail provided the disclosure about its noncash purchases in a supplemental cash flow footnote that came 30 pages after the Statement of Cash Flows.

BIOVAIL'S SUPPLEMENTAL CASH FLOW DISCLOSURE

In 2003, *non-cash investing and financing activities* included the long-term obligation of $17,497,000 related to the acquisition of Ativan® and Isordil®, and the subscription to $8,929,000 Series D Preferred Units of Reliant in repayment of a portion of the loan receivable from Reliant. In 2002, non-cash investing and financing activities included long-term obligations of $99,620,000 and $69,961,000 related to the acquisitions of Vasotec® and Vaseretic®, and Wellbutrin® and Zyban®, respectively, as well as a long-term obligation of $80,656,000 related to the amendments to the Zovirax distribution agreement. [Italics added for emphasis]

4. Shifting Operating Cash Outflows off the Statement of Cash Flows

The final section of this chapter shows how creative management found ways to move the undesirable operating cash outflows far away from the

Statement of Cash Flows.

Most companies with an employee pension plan fund those plans with cash that is invested to grow and meet the company's projected long-term obligations. These contributions have the unfortunate effect of reducing reported cash flows. What if pensions could be funded without depleting precious cash flow?

In 2011 Diageo (maker of spirits including Johnnie Walker, Smirnoff, and Guinness) funded its U.K. pension scheme with GBP535 million of whiskey. As the whiskey ages, its value would increase, improving the funded status of the plan. All the while, reported cash flows remain unaffected. Similarly, in 2016 IBM contributed $295 million of U.S. Treasury securities to its defined benefit plan, saving that much in reported cash flow.

Looking Ahead

As this chapter showed, shifting operating cash outflows to the Investing section can be quite enticing for management that hopes to impress investors with stronger cash flow. Well, it seems that management cannot get enough of a good thing.

12

Cash Flow Shenanigan No. 3: Boosting Operating Cash Flow Using Unsustainable Activities

With local versions in more than 100 countries, the hit game show *Who Wants to Be a Millionaire?* has been one of the most successful television franchises of all time. The game is alluringly simple: contestants are asked up to 15 trivia questions. Answering all the questions correctly will win the grand prize; however, if the contestant gives one wrong answer, he or she goes home.

If a contestant is struggling with a question, the rules allow for the use of a "lifeline." For example, one lifeline allows the contestant to ask a friend for help, and another lets the contestant poll the studio audience for its opinion. These lifelines can prove very valuable and often keep struggling contestants afloat. However, they must be used judiciously, since there are just three of them, and once they're gone, they're gone.

Similarly, struggling companies often use valuable "lifelines" to help them keep their cash flow afloat. Just as in the game show, it is often wise and certainly legitimate for companies to use these lifelines. Unlike in the game show, however, companies may fail to disclose the use of these nonrecurring cash flow lifelines. It is up to you to spot them, because once they're gone, they're gone.

In this chapter we discuss four unsustainable lifelines that companies use to boost their cash flow from operations.

Techniques to Boost Operating Cash Flow Using Unsustainable Activities

1. Boosting CFFO by paying vendors more slowly

2. Boosting CFFO by collecting from customers more quickly
3. Boosting CFFO by purchasing less inventory
4. Boosting CFFO with one-time benefits

1. Boosting CFFO by Paying Vendors More Slowly

Want to save a little more cash this year? Use your "delay-payments" lifeline: wait until the beginning of January to pay your December bills. If you push your payments out a month, your end-of-year bank balance will be higher, and it will cosmetically seem as if you generated more cash this year. However, you certainly would not be under the delusion that you had found a recurring way to grow your cash flow each year; rather, you would realize that this was a one-time benefit. To grow your cash flow again next year, you would have to push two months' worth of payments into the following January.

Your "delay-payments lifeline may be a helpful cash management strategy, and there is certainly nothing wrong with holding your money a month longer. In the same way, it is completely appropriate for a company to take longer to pay back its vendors and reap the immediate cash management benefits. However, just like you, companies cannot continue to delay payments into eternity. The cash benefit from pushing out payments (i.e., an increase in payables) should be considered a one-time activity, not a sign that the company has found a lasting way to generate more cash. While this may seem like common sense, you would be surprised at how many companies tout their CFFO strength and forget to mention their little secret: that they increased CFFO by stringing out vendors and not paying them in a timely fashion.

Home Depot Squeezes Its Vendors

Just days after losing an internal management succession battle to replace the legendary Jack Welch at GE, Bob Nardelli earned a consolation prize: the top job at Home Depot. Appointed in December 2000, Nardelli immediately was hailed as the master operating executive that the struggling home improvement retail chain desperately needed. The board loved his GE pedigree and rewarded him right off the bat with an extremely generous compensation package. And Nardelli certainly knew how to

please. In his first year on the job, he more than doubled CFFO—from $2.8 billion to nearly $6 billion. Investors who were not too worried about the details of its climb were thrilled.

This cash flow growth, however, would prove to be unsustainable and unrelated to increasing sales at the business. In that first year, Nardelli did a masterful job of redefining the way Home Depot did business with its vendors. Specifically, the company started treating suppliers very badly by paying them much more slowly. By the end of fiscal 2001, Home Depot had successfully stretched out accounts payable to 34 days from 22 the year earlier. The company's Statement of Cash Flows (shown in Table 12-1) reveals that this seemingly minor change in accounts payable was the primary driver of the company's impressive cash flow growth. Another large component of CFFO growth was a decrease in the amount of inventory held at each store (as we will discuss later in this chapter).

Table 12-1 Home Depot Statement of Cash Flows, 2000–2002

	Fiscal Year		
($ millions)	**2000**	**2001**	**2002**
Net earnings	**2,581**	**3,044**	**3,664**
Depreciation and amortization	601	764	903
Increase in receivables, net	(246)	(119)	(38)
Increase in merchandise inventories	**(1,075)**	**(166)**	**(1,592)**
Increase in accounts payable and accrued liabilities	**268**	**1,878**	**1,394**
Increase in deferred revenue	486	200	147
Increase in income taxes payable	151	272	83
Increase (decrease) in deferred income taxes	108	(6)	173
Other	(78)	96	68
Net cash provided by operations	**2,796**	**5,963**	**4,802**

Okay, mission accomplished for 2001. The next year, Home Depot was faced with the challenge of improving upon an incredible 2001. To grow CFFO again, however, the company first would have to replicate the 2001 boost it would no longer receive in 2002. The company could stretch payables again in 2002, but not to the extent of the prior year (as payables

reached 41 days from 34 days). CFFO for 2002 fell to $4.8 billion from $6.0 billion in 2001.

Accounting Capsule: Days Payable Outstanding

Days payable outstanding (DPO) is generally calculated as follows:

DPO = accounts payable/cost of goods sold × number of days in the period
(for quarterly periods, 91.25 days is a normal approximation)

Investors should analyze payables in terms of days outstanding in much the same way that they analyze receivables (days' sales outstanding, or DSO) and inventory (days' sales of inventory, or DSI). An increase in DPO means that the company is paying off its payables over a longer period. A decrease in DPO means that the company is paying its bills more quickly.

Investors should note that Nardelli's cash management techniques certainly were not inappropriate and seemed beneficial to the company's operations. The takeaway here, however, is that the $3 billion increase in CFFO during 2001 should have been viewed as nonrecurring. Alert investors would have correctly anticipated that CFFO would shrink in 2002.

Watch for Large and Suspicious Increases in Payables An increase in payables relative to cost of goods sold tells you the company has probably stretched out its payments to vendors. Assess the extent to which CFFO growth is derived from stretching out payments to vendors and consider that amount an unsustainable boost that is unrelated to improved business activities.

Look for Large Positive Swings on the Statement of Cash Flows A quick review of Home Depot's CFFO in 2001 shows that improvements in accounts payable and inventory were the primary drivers of CFFO growth. (See Table 12-1.) In the following year, it is evident that Home Depot's inability to sustain that improvement was the primary source of CFFO deterioration.

Be Alert When Companies Use Accounts Payable "Financing" Some companies choose to "finance" their accounts payable by getting a bank

involved in their transactions with vendors. In these so-called vendor financing arrangements, a company does not pay its vendors directly; rather, a bank pays off the vendor invoice, and the company reimburses the bank at a later date. These transactions result in the creation of bank debt on the company's Balance Sheet in place of accounts payable. Since the repayment of bank debt is categorized on the Statement of Cash Flows as a financing activity, the cash paid for this inventory would never be shown as an operating outflow.

Wireless carrier T-Mobile, for example, offered vendor financing arrangements for its handset and network equipment suppliers. In 2015 alone, T-Mobile repaid $564 million in short-term debt that was used for purchases of handset inventory and network equipment. Conveniently, this cash outflow was buried on T-Mobile's Statement of Cash Flows as a financing activity.

This anecdote shows the enormous management discretion available in classifying a straightforward transaction on the Statement of Cash Flows. To properly compare cash flow generation at these competitors, investors must adjust for this difference in policy. Each company provided sufficient disclosure to understand its SCF classification. Diligent investors would have used these disclosures to reflect both sides of the loan transaction (inflows and outflows) as financing, not operating.

TIP

Accounts payable is a relatively straightforward account. If you see a discussion of accounts payable that is longer than a couple of sentences, there is probably something in there that you want to know (for example, accounts payable financing arrangements).

Watch for Swings in Other Payables Accounts Accounts payable is not the only obligation that companies can use to manage their cash flow. CFFO can be influenced by the timing of payments on many liability accounts, including tax payments, payroll or bonus payments, and pension plan contributions. Consider how Callaway Golf Company's tax situation resulted in unsustainably strong CFFO in 2005.

Callaway spent the off-season working on its long game. The dedication seemed to pay off. In 2005, Callaway drove its CFFO up to $70.3 million—

quite an improvement from the meager $8.5 million reported in 2004. A quick check of the Statement of Cash Flows reveals that CFFO growth came from an improved swing—that is, a $55.8 million “swing” in the impact of tax payables and receivables (apparently because of net tax refunds and settlements). It should not have been too rough for investors to spot this tax swing on the Statement of Cash Flows and deduce that Callaway’s strong CFFO growth would not recur.

2. Boosting CFFO by Collecting from Customers More Quickly

Another way in which companies can generate a nonrecurring CFFO boost would be to convince customers to pay them more quickly. This certainly would not be considered a bad thing, and it may even speak well of a company’s significant leverage over its customers. However, as in our discussion about stretching out payables, companies cannot continue to collect at a faster rate in perpetuity. As a result, the growth in CFFO that results from accelerated collections should be deemed unsustainable.

Watch for CFFO Boosts from Higher Prepayments

For high-end electric automaker Tesla Motors, liquidity and cash flow have been particularly important metrics for investors and lenders. Since its founding in 2003, Tesla had never posted a full year of positive free cash flow, and therefore the company had become entirely reliant on debt financing and equity issuances to continue funding its operations. In 2016, Tesla’s operating cash outflows appeared to have improved, amounting to net outflows of $124 million, down from outflows of $524 million in 2015. However, what changed most significantly in terms of cash flow that year was that the company *began accepting orders and refundable customer deposits* for its Model 3 sedan, which had been introduced only in concept. These deposits accounted for $350 million of additional inflows, or 88 percent of the reported improvement in 2016. Skeptical investors would have noted that fundamentally the business continued to burn cash at historical rates, but because of a successful marketing campaign, it was able to “borrow” from future periods and accelerate customer payments to report better results.

Watch for Elaborate Strategies to Influence the Timing of Cash Flow

Warning signs about accelerated collections could certainly have been spotted at Silicon Graphics several quarters before its May 2006 bankruptcy. The company was burdened with debt and did everything in its power to portray a stronger liquidity position to investors. Unlike companies that may use a position of power with customers to accelerate collections, Silicon Graphics' diminished health compelled it to offer discounts to induce early payments. Consider the disclosure shown here from the company's September 2005 10-Q. Also, notice another cash management trick that Silicon Graphics was playing—holding vendor payments and buying inventory at the end of the quarter—to show cash on its Balance Sheet at its highest point on the last day of the quarter. Diligent investors would have noticed these issues and known that disaster was not far away.

SILICON GRAPHICS INC. SEPTEMBER 2005 10-Q

During the first quarter of fiscal 2006, we maintained our focus on customer cash collections and *offered certain customers discounted terms for early payment*. As a result, our days' sales outstanding were 37 days at September 30, 2005, down from 49 days at June 24, 2005 and 39 days at September 24, 2004. We expect that days' sales outstanding will be more in line with historical levels in the second quarter of fiscal 2006.

We also experience significant intra-quarter fluctuations in our cash levels, with the result that *our cash balances are generally at their highest point at the end of each quarter and significantly lower at other times.* These intra-quarter fluctuations reflect our business cycle, with significant requirements for inventory purchases in the early part of the quarter and most sales closing in the last few weeks of the quarter. *To maintain adequate levels of unrestricted cash within each quarter, we offer certain customers discounted terms for early payment and hold certain vendor payments to the beginning of the following quarter.* [Italics added for emphasis]

Be Wary of Dramatic Improvements in CFFO

Chinese telecom equipment manufacturer UTStarcom reported markedly improved CFFO in early 2008. After a dismal 2007, in which it logged four consecutive quarters of negative CFFO (for a total cash burn of $218 million), the company suddenly reported positive cash flow of $97 million in March 2008. Investors could have readily noticed that the cash flow turnaround resulted from a variety of particularly aggressive working capital actions. A quick peek at the Balance Sheet revealed a $65 million drop in accounts receivable and a $66 million increase in accounts payable. The 10-Q gave more insight and mentioned one of those "management decisions" we warned you about in Chapter 10, "Cash Flow Shenanigan No. 1, Shifting Financing Cash Inflows to the Operating Section," with the infamous Computer Associates. (See the accompanying disclosure from UTStarcom's March 2008 10-Q.)

UTSTARCOM'S MARCH 2008 10-Q DISCLOSURE TOLD THE STORY

The decrease in accounts receivable was primarily due to strong customer collections in our PCD business segment. The increase in accounts payable was due to the substantial inventory purchasing activity late into the first quarter of 2008, as well as a *management decision to forgo early payment discounts with a significant vendor*. [Italics added for emphasis]

UTStarcom proceeded to report negative operating cash flow throughout the rest of 2008. Despite the $97 million in positive CFFO during the first quarter, the company ended the year in a hole, having burned through $55 million in operating cash flow.

TIP

While many investors are pleased when management says that it is "aggressively managing working capital," you should take this as a warning sign that recent CFFO growth may not be sustainable.

3. Boosting CFFO by Purchasing Less Inventory

Home Depot, as you recall, received an unsustainable CFFO boost in 2001 from stretching out payments to vendors. Well, the company had another CFFO-improving trick up its sleeve: purchasing less inventory.

Earlier in this chapter, we discussed how Bob Nardelli doubled Home Depot's operating cash flow in his first year on the job by stretching out vendor payables and reducing the amount of inventory at each store. Home Depot lowered its inventory levels simply by not restocking shelves after goods had been sold. In other words, the company just did not purchase as much inventory from vendors as in previous years.

In much the same way that Nardelli's Home Depot "cosmetically" improved CFFO (by paying vendors more slowly), a company choosing to purchase less inventory would also provide an artificial and unsustainable boost to CFFO. Let's revisit Home Depot's Statement of Cash Flows in Table 12-1 to see the inventory swing from an outflow of $1.1 billion in 2000 to an outflow of only $166 million in 2001 (and then back to an outflow of $1.6 billion in 2002 as the benefit reversed).

To be fair, Home Depot was very clear in its disclosure under the Liquidity and Capital Resources section of its 10-K filing, stating that CFFO growth primarily had been driven by an extension of payables and a decrease in inventory per store (see the disclosure in the accompanying box). Investors would be well served by reading through the entire document, because such important nuggets of information can be found deep inside the filing.

HOME DEPOT 2002 10-K

For fiscal 2001, cash provided by operations increased to $6.0 billion from $2.8 billion in fiscal 2000. The increase was primarily due to significant growth in days payable outstanding from 23 days at the end of fiscal 2000 to 34 days at the end of fiscal 2001, a 12.7% decrease in average inventory per store as of the end of fiscal 2001 and increased operating income.

In the next year, Home Depot did not benefit from a decrease in inventory. However, it provided a good spin on this in the Liquidity and

Capital Resources section, suggesting that it had pared back inventory too much in the previous year.

HOME DEPOT 2003 10-K

For fiscal 2002, cash provided by operations decreased to $4.8 billion from $6.0 billion in fiscal 2001. The decrease was primarily due to a *7.9% increase in average inventory per store resulting from our focus on improving our in-stock position in fiscal 2002.* [Italics added for emphasis]

TIP

Buried in the 10-Qs and 10-Ks is some extra insight about the drivers of cash flow. It is one of the most important sections of the filing, but many investors don't know it exists. To find it, turn to the Management Discussion and Analysis (MD&A)—in a section often called "Liquidity and Capital Resources." This section is a must-read for every company you analyze.

Watch for Disclosure About Timing of Inventory Purchases Within Each Quarter

Silicon Graphics purchased inventory at the very beginning of each quarter and then worked it down as much as possible by the end of the period, only to purchase more once the quarter closed. (See the 10-Q disclosure in our earlier discussion on Silicon Graphics.) As with its receivables and payables management schemes, the company used this strategy to manipulate investor perceptions that its liquidity was adequate while it was teetering on the brink of bankruptcy.

4. Boosting CFFO with One-Time Benefits

Microsoft doled out billions of dollars to settle antitrust litigation between 2004 and 2007. One of the largest recipients, Sun Microsystems, pocketed nearly $2 billion from Microsoft in 2004 ($1.6 billion of which was immediately recognized as income). Sun presented this large one-time item in plain view on its Statement of Operations, listing it separately as

“settlement income.” Sun’s disclosure made it very easy for investors to understand that the income from this settlement was nonrecurring and unrelated to its normal operations; it was reported “below the line” as nonoperating income.

Sun’s Statement of Cash Flows, however, was less clear. The company recorded the $2 billion in cash as an operating inflow (as is appropriate under the indirect method), but it was not listed separately on the SCF; rather, it was simply bundled with net income. As you would imagine, a $2 billion settlement was quite material to Sun’s results—CFFO for all of 2004 was $2.2 billion, up from $1.0 billion in 2003. Diligent investors would have noticed this settlement reflected on the Statement of Operations and immediately realized that it was an unsustainable source of CFFO.

TIP

Nonrecurring boosts to CFFO often are not plainly disclosed on the Statement of Cash Flows. Whenever you spot any kind of one-time earnings benefit, ask yourself, “How does this boost affect the Statement of Cash Flows?”

Looking Ahead

This completes our unit on Cash Flow Shenanigans—techniques used to inflate operating cash flows. In aggregate, Parts Two and Three focused on gimmicks that impress investors with either higher reported earnings or operating cash flows. In Part Four, we show how accounting tricks may also contaminate management’s non-GAAP metrics and key performance indicators.

PART FOUR
KEY METRIC SHENANIGANS

We have climbed the first two mountains in our quest to conquer financial shenanigans, with two still to come. Until now, we have focused on assessing the performance of companies using two separate metrics: earnings and cash flow.

Part Two, "Earnings Manipulation Shenanigans," discussed techniques for manipulating accrual-based performance numbers by playing around with revenue and expenses or shifting them to the wrong section or the wrong financial statement entirely. We pointed out the limitations of accrual-based performance metrics like net income, and we suggested that investors should expand their analysis to evaluate cash flow performance metrics such as cash flow from operations and free cash flow.

Part Three, "Cash Flow Shenanigans," addressed a relatively new and troubling phenomenon: management's propensity to use Cash Flow Shenanigans to give a company the misleading appearance of having strong operating and free cash flow. We also presented strategies that investors can use to detect Cash Flow Shenanigans and to adjust the reported numbers to remove these unsustainable boosts.

At this point, you can take a deep breath and feel good about your ability to evaluate a company's "economic" performance through accrual-based (Income Statement) and cash-based (Statement of Cash Flows) models, even when management employs shenanigans to hide the true story from investors. You have also learned how to uncover dozens of tricks used by management.

However, your quest is only half over. In Part Four, "Key Metric Shenanigans," we discuss the importance of using other "key metrics" to evaluate a company's performance and economic health, and we expose tricks that companies could use to cloud the picture and mislead investors.

Two Key Metric Shenanigans

KEY METRIC SHENANIGANS

KM No. 1: Showcasing misleading metrics that overstate performance (Chapter 13)

KM No. 2: Distorting Balance Sheet metrics to avoid showing deterioration (Chapter 14)

Successful investing requires a rigorous analysis of a broad array of financial performance and economic health metrics for a company. Some pertinent information can be found easily by reading the Income Statement, the Statement of Cash Flows, and the Balance Sheet. Other vital information may be gleaned from supplementary documents (company press releases, Earnings Releases, footnotes, and Management Discussion and Analysis included with the financial reports). In addition, investors should study the financial reporting of competitors, not only to compare performance and health measures, but also to assess the application of accounting standards and disclosure.

Now you have reams of data to read and analyze. Great, but before digging in, remember to ask these two important questions:

1. What are the *best metrics of that specific company's performance*, and does management highlight, ignore, distort, or even make up its own version of these metrics?
2. What are the *best metrics that would reveal a specific company's deteriorating economic health*, and does management highlight, ignore, distort, or even make up its own version of these metrics?

Investors are increasingly evaluating companies using both performance-related and economic health–related metrics. Not surprisingly, with so much riding on pleasing investors, management is providing much more information, but it often tries to camouflage any deterioration in the business. We label this group of tricks Key Metric (KM) Shenanigans. They can be grouped as (1) performance metrics and (2) economic health metrics.

Evaluation of Financial Performance and Economic Health Metrics

For a given industry or company, start out by learning the very best metrics for evaluating economic performance and health—both past and expected in the near term. (Longer-term performance predictions tend to be woefully inaccurate and provide little value for investors.)

Let's consider a subscription-based business. Start with the traditional performance metrics reported on the Income Statement (revenue, operating earnings, net income, and earnings per share [EPS]) and on the Statement of Cash Flows (cash flow from operations and free cash flow). Nothing would be wrong with any of these—provided that *no* Earnings Manipulation or

Cash Flow Shenanigans exist. But this list would lack at least one enormously important piece of information—recent developments in the business. Have recent subscriber counts been falling? Has the amount of revenue earned from each subscriber declined over the last few quarters? Since both accrual-based revenue and cash flow–based CFFO focus on *past, not expected, revenue or cash flows*, investors should be keen on receiving and evaluating subscriber-based metrics. This information would be extraordinarily valuable.

Categories of Performance Metrics

Think of our traditional financial performance metrics (e.g., revenue, net income, and cash flow) as being like the *box score* of yesterday's baseball game. While the information reflects past performance, it can often provide very relevant indicators about the strength of the team, and in many cases, it can shed light on what to expect tomorrow. However, other supplementary pieces of information exist or can be derived that are excluded from the box score, yet would be essential for an analysis of the team. As baseball historian Bill James realized when he pioneered a new form of baseball statistical analysis (and as Michael Lewis illustrated beautifully in his book *Moneyball*), many unconventional baseball statistics can be more revealing than the traditional metrics listed in the box score.

The best supplementary financial performance metrics should provide additional insight into a company's recent operational performance (good or bad) to go with that conveyed by traditional financial statement metrics based on generally accepted accounting principles. We highlight ways in which management presents (1) surrogates for revenue, (2) surrogates for earnings, and (3) surrogates for cash flow.

Surrogates for Revenue

Management often tries to clarify and expand its disclosures on customer sales and provide insight into future demand and pricing power. A broadcast cable operator, for example, may disclose its subscriber count, an airline its "load factor" (the percentage of total seats filled), an Internet portal its number of "paid clicks," and a hotel operator its "revenue per available room." Industries and companies often produce their own unique metrics to help investors get a better grasp of a company's performance. Some common metrics that would be considered revenue surrogates include

same-store sales, backlog, bookings, subscriber count, average revenue per customer, and organic revenue growth.

Surrogates for Earnings

Management sometimes tries to present a "cleaner" version of earnings to convey the true operating performance of the business. A chemical manufacturer, for example, may remove a large one-time gain from selling real estate when presenting earnings to convey its performance in a way that is comparable with that used in past and future periods. Companies often have similar names for these non-GAAP earnings surrogates, even though each company may define them differently. Some common metrics used include pro forma earnings, EBITDA, non-GAAP earnings, constant-currency earnings, and organic earnings growth.

Surrogates for Cash Flow

As with earnings surrogates, management may also try to present a "cleaner" version of its cash flow, although this may be a bit trickier and is often more controversial. For example, a retail chain may present cash flow excluding a substantial one-time cash payment for a legal settlement. Some common metrics used include pro forma operating cash flow, non-GAAP operating cash flow, free cash flow, cash earnings, cash revenue, and funds from operations.

Accounting Capsule: Pro Forma Numbers—Apples-to-Apples Comparison

Whenever management makes significant accounting or classification changes, or even makes an acquisition, comparisons with earlier-period results may become difficult, if not impossible, for investors to make. Thus, to provide an apples-to-apples comparison for investors, companies include pro forma ("as if") adjusted financial statements as supplementary information. For example, let's assume that a company changes its revenue recognition policy. The GAAP-based numbers would naturally show current-period results with the new accounting policy but would still report alongside them the earlier-period results using the old accounting policy, no doubt creating confusion. To help investors make a sensible

comparison, a pro forma presentation would include the results of both periods under the new revenue recognition policy.

Categories of Economic Health Metrics

Continuing our baseball analogy, if analyzing performance metrics can be considered akin to reviewing yesterday's *box score*, then analyzing economic health metrics would be like reviewing today's baseball *standings* that show a team's cumulative performance (wins and losses for the season). The Balance Sheet can be thought of as a company's present, up-to-the-minute record that reflects its cumulative performance since its inception. (For some longstanding companies, that could be a very long "season.") While the Balance Sheet reflects the accumulation of all past performance, it can shed light on what to expect tomorrow. A baseball team that is at the top of the win-loss standings and is leading the league in runs scored for the season is usually in excellent health. On the opposite side of the spectrum, a team that is near the bottom of the standings, has a miserable cumulative batting average, and is letting more runs score than any other team can be in poor health and relatively unstable.

As with the approach described for performance, for a given industry, start out by learning the very best metrics for evaluating economic health and stability—both past and expected in the near term. The best supplementary economic health metrics should provide added insight into the strength of a company's Balance Sheet, including how well the company (1) manages customer collections, (2) maintains prudent inventory levels, (3) maintains financial assets at their appropriate value, and (4) keeps liquidity and solvency risks in check to prevent a devastating cash crunch.

Evaluation of Accounts Receivable Management

Investors worry if collection of customer receivables begins stretching out. Analysts use a days' sales outstanding (DSO) metric to catch signs of collection problems. Higher DSO (as discussed earlier) typically suggests that customers have been paying more slowly. Or worse, perhaps management has used Earnings Manipulation Shenanigans to inflate revenue and profits. Now if management wants to hide these problems from investors, it may distort the true accounts receivable balance. Investors should evaluate accounts receivable to gauge whether the DSO metric

provided by management fairly presents the underlying economics of the business. Remember, distorting accounts receivable metrics could indeed be an attempt to hide revenue problems.

Evaluation of Inventory Management

A healthy and prudent level of inventory is essential for a well-run business. Holding an inventory of undesirable products leads to write-downs, and not having enough of the "hot" ones will lead to missed sales opportunities. Naturally, investors monitor inventory levels closely and use a metric called days' sales of inventory (DSI). Management may create misleading inventory metrics to hide profitability problems. Or it may simply classify inventory incorrectly on the Balance Sheet to trick investors into using the wrong input when computing DSI.

Evaluation of Asset Impairments for Financial Companies

Financial institutions provide metrics that give investors insight into the quality or strength of their financial assets. Companies may disclose, for example, delinquency rates on mortgage loans or the fair value of their investments. Investors must monitor this supplementary data to ensure that proper reserves and impairments are being recorded. With the 2008 financial crisis, investors unable to spot lax impairment decisions took big hits.

Evaluation of Liquidity and Solvency Risks

Investors can face devastating losses, often with little warning, if they fail to monitor imminent threats of a massive cash crunch. Enron's demise came very rapidly when credit rating agencies swiftly downgraded its bonds to "junk" status and the company's liquidity sources immediately dried up. Similarly, any company that fell out of compliance with its debt covenants could face unpleasant consequences. If a company fails to provide data on such threats (or worse, if it intentionally covers up them up), investors will be in serious jeopardy.

The next two chapters cover two Key Metric Shenanigans. Investors should be delighted if management provides additional useful information to help them better assess the company's performance and economic health. Unfortunately, management might provide information that not only adds no value, but might be misleading. Chapter 13 highlights metrics that hide

revenue, earnings, or cash flow problems or simply put an overly positive spin on modest achievements. Chapter 14 describes misleading economic health metrics that hide problems.

13

Key Metric Shenanigan No. 1: Showcasing Misleading Metrics That Overstate Performance

Above all, do no harm.

—HIPPOCRATES, THE FATHER OF WESTERN MEDICINE

Newly minted doctors are required to take the Hippocratic oath and pledge their commitment to practice medicine ethically. This oath is widely attributed to Hippocrates, the father of Western medicine, in the fourth century BC, and the gist of it can be boiled down to "Above all, do no harm."

Perhaps corporate managers should be made to study this solemn oath taken by physicians and apply it in earnest when they communicate with investors. In so doing, they would pledge to never knowingly harm investors and always refrain from showcasing metrics that misrepresent performance. Based on what you have already seen in this book, that day seems way off in the horizon. Well, we can only dream that such a day will eventually come! Until it arrives, however, investors must be alert to the following three techniques that management can use to obfuscate company performance.

Techniques to Showcase Misleading Metrics That Overstate Performance

1. Highlighting a misleading metric as a surrogate for revenue
2. Highlighting a misleading metric as a surrogate for earnings
3. Highlighting a misleading metric as a surrogate for cash flow

1. Highlighting a Misleading Metric as a Surrogate for Revenue

Many people consider revenue growth to be an important and straightforward measure of the overall growth of a business. Companies also frequently provide additional data points to supplement revenue, providing investors with more insight into product demand and pricing power. As discussed in the previous chapter, investors should welcome this additional information and analyze these supplemental non-GAAP revenue metrics to better assess the sustainable business performance. However, sometimes these revenue surrogates provided by management can be misleading and can harm investors if they have not put appropriate safeguards in place. In this first section, we highlight ways in which companies can be less than honest using common revenue surrogates and how careful investors can protect themselves.

Same-Store Sales

Revenue growth at retailers and restaurants is often fueled by the opening of additional stores. Logically, companies that are in the middle of a rapid store expansion show tremendous revenue growth, since they have many more stores this year than they had the prior one. While total company revenue growth may give some perspective on a company's size, it gives little information on whether the individual stores are performing well. Investors should therefore focus more closely on a metric that measures how the company's stores have been performing.

To provide investors with that insight, management often reports a metric called *same-store sales* (SSS) or *comparable-store sales*. This metric establishes a comparable base of stores ("comp base" for short) with which to calculate revenue growth, allowing for more relevant analysis of true operating performance. For example, a company may present its revenue growth for stores that have been open for at least one year. Companies often prominently disclose SSS in their Earnings Releases, and investors use it as a key indicator of company performance. Many consider same-store sales to be the most important metric in analyzing a retailer or restaurant. We agree that if it is reported in a logical and consistent manner, SSS is extremely valuable for investors.

However, because same-store sales (and the other metrics discussed in Part Four) fall outside of GAAP coverage, no universally accepted definition exists, and calculations may vary from company to company. Worse, a company's own calculation of SSS in one quarter may differ from the one used in the previous period. While most companies compute their same-store sales honestly and disclose them consistently, "bad apples" try to dress up their results by routinely adjusting their definition of SSS. Investors, therefore, should always be alert to the presentation of same-store sales to ensure that it fairly represents a company's operating performance.

Compare Same-Store Sales to the Change in Revenue per Store When a company experiences consistent growth, same-store sales should be trending up consistently with the average revenue at each store. By comparing SSS with the change in revenue per store (i.e., total revenue divided by average total stores), investors can quickly spot positive or negative changes in the business. For example, assume that a company's SSS growth has been consistently tracking well with its revenue per store growth. If a material divergence in this trend suddenly appeared, with SSS accelerating and revenue per store shrinking, investors should be concerned. This divergence indicates one of two problems: (1) the company's new stores are beginning to struggle (driving down revenue per store, but not affecting SSS because they are not yet in the comp base), or (2) the company has changed its definition of same-store sales (which affects the SSS calculation but not total revenue per store).

Watch for Changes in the Definition of Same-Store Sales Companies usually disclose how they define same-store sales. Once the definition is disclosed, investors should have little difficulty tracking it from period to period. Companies can manipulate same-store sales by adjusting the comp base in two possible ways. The first involves simply changing the length of time before a store enters the comp base (for example, requiring a store to be open for 18 months, versus 12 months previously). The second trick involves changing the types of stores included in the comp base (for example, excluding certain stores based on geography, size, businesses, remodeling, and so on).

Coach Inc., the New York City–based fashion company, made such a change in 2013. Historically, when Coach expanded a store's square footage by at least 15 percent, it excluded these stores' sales from the comp base

until one year after completing the expansion. This made sense since larger stores generally have higher sales, and any growth related to a large store expansion should not really be considered same-store sales. Yet Coach decided that beginning in 2014 it would no longer exclude these store expansions from its comp base, meaning its same-store sales metric would include an unsustainable benefit related to growth in store size. Not surprisingly, this change came just as same-store sales was slowing and the company was embarking on a multiyear plan to expand some of its most productive stores.

Pay Close Attention to Which Parts of the Business Reported Growth Reflects In 2013, Thomson Reuters, the Toronto-based media juggernaut, reported "revenue growth before currency" of 2 percent. This figure stood in contrast to the more standard rate of change in reported sales versus the prior year, which was *negative* 3 percent. Which measure was more accurate? It turns out that not only did the headline figure adjust for the effects of currency, but it also only considered "ongoing businesses"; this was not a legal or accounting distinction the way that a "discontinued operation" is, but rather one that management made subjectively. The curious thing about this methodology was that in the 2013 Annual Report, the revenue from "ongoing businesses" in 2012 had fallen by almost $500 million compared with the revenue from "ongoing businesses" originally reported in 2012. It was only the retroactive recategorizing of certain businesses as non-"ongoing" that allowed Thomson Reuters to report positive sales growth in 2013, a period where by all objective measures the company declined. This clever scheme provided similar benefits in 2011 and 2012.

Average Revenue per User

When comparing key non-GAAP metrics across a peer group, it is important to ensure that these metrics are being calculated in the same way. For example, in the broadcast industry, a common metric analyzed is average revenue per user (ARPU), calculated as total subscription revenue divided by average subscribers. Calculating the average revenue per subscriber sounds like it should be simple; however, varying definitions of ARPU abound. Consider, for example, the different definitions at competitors Sirius Satellite Radio Inc. and XM Satellite Radio Holdings Inc. (before they merged in 2008). Sirius's calculation of ARPU included

revenue from subscriptions, advertising, and activation fees. XM Radio, on the other hand, calculated ARPU using only revenue from subscriptions; advertising revenue and activation fees were excluded. (See the accompanying box.) To compare ARPU at the two companies on an apples-to-apples basis, investors would have had to either adjust Sirius's ARPU calculation to exclude advertising revenue and activation fees or adjust XM's ARPU calculation to include these revenue sources.

AVERAGE REVENUE PER USER (ARPU) DIFFERENCES AT SIRIUS AND XM RADIO

Sirius's ARPU calculation: Subscriber (including offset for sales rebates) *activation and advertising revenue* divided by the daily weighted average number of subscribers for the period. [Italics added for emphasis]

XM Radio's ARPU calculation: Total monthly earned subscription revenue net of promotions and rebates divided by monthly weighted average number of subscribers for the period reported.

Subscriber Additions and Churn

Let's go back to our discussion of subscription-based businesses from earlier in this chapter. Since these types of companies (e.g., research providers, telephone companies, newspapers, fitness clubs, and so on) rely on new subscribers for growth, it is helpful for investors to monitor subscriber levels to get a sense of the latest trends in the business. Logically, the number of new subscriber additions each quarter is often a good leading indicator of upcoming revenue. Similarly, the level of cancellations (called "churn") is important to know when assessing the business. If a company shows a healthy subscriber base with growth in new subscribers and shrinking churn, investors can expect strong revenue growth ahead. That is, unless the company is manipulating these metrics.

In the late 1990s, AOL, for example, found a clever way to inflate the number of subscribers to its online Internet service. One of the ways in which AOL sold subscriptions was to sell "bulk subscriptions" to corporations, which would then distribute these subscriptions to employees as a perk. AOL did not include these bulk subscription sales in its

subscriber count because it knew that many of these subscriptions would never actually be activated. When employees did sign up, however, they rightfully entered the subscriber count.

In 2001, AOL was struggling to meet its subscriber targets. So the company began including the number of bulk subscriber sales in its subscriber count, even though most of these subscriptions were never activated. Moreover, AOL would ship these bulk subscription membership kits to customers immediately before the quarter end to meet targets for subscriber count.

Bookings and Backlog

Many companies disclose their quarterly "bookings" or "orders," which are supposed to represent the amount of new business *booked during the period*. Companies may also disclose their backlog, which essentially represents their outstanding book of business or, in other words, all past orders that have yet to be filled (and recognized as revenue). "Book to bill" is also a common disclosure that compares current-period bookings to current-period revenue and is calculated as bookings divided by revenue.

If they are presented accurately, bookings and backlog are important indicators, as they provide investors with extra insight into upcoming revenue trends. However, since they are non-GAAP metrics, companies have plenty of leeway in how they define and disclose bookings and backlog. You would think the calculations would be straightforward, but indeed there are plenty of nuances in what should and should not be included. For example, different companies include the following types of orders differently in their presentation of bookings and backlog: cancelable orders, orders in which the quantity purchased is not defined, bookings for longer-term service or construction contracts, contracts with contingencies or extension clauses, bookings on noncore operations, and so on.

The varying definitions of bookings and backlog across companies make it extremely important for investors to understand exactly what the metric represents before putting any faith in it. Moreover, if the metric is a key performance indicator, investors should use extra diligence to ensure that the company does not change its own definition of bookings in a way that flatters the metric.

Accounting Capsule: Bookings and Backlog

The following formula shows the general relationship between bookings, backlog, and revenue (for all revenue streams that run through backlog). This formula is very helpful when analyzing companies, as it can be used to test the veracity or consistency of these non-GAAP metrics. It can also be used to calculate bookings when only backlog is given.

Beginning backlog + net bookings – revenue = ending backlog

where net bookings are total bookings minus cancellations.

Some companies will present booking and backlog metrics that do not seem to accurately represent the underlying business economics. For example, First Solar, whose percentage-of-completion shenanigans you may remember from Chapter 3, played tricks with its bookings presentation as well. In its March 2014 earnings presentation, First Solar presented a "quarterly" bookings figure that included much more than a quarter's worth of bookings. A close read of the fine print revealed that the bookings metric included all new bookings from the beginning of the quarter all the way through the date of the Earnings Release—a full 36 days after the quarter ended.

Consider also the unusual definition of backlog employed by electronic payments company ACI Worldwide. ACI presents a 60-month backlog metric in which all nonrecurring license arrangements are assumed to renew as recurring revenue streams. A better name for this metric would be "wishful thinking backlog."

2. Highlighting a Misleading Metric as a Surrogate for Earnings

Warren Buffett has long poked fun at management teams that create dishonest pro forma metrics. He memorably compared this practice to an archer who shoots an arrow into a blank canvas and *then* draws a bull's-eye around the implanted arrow.

EBITDA and Its Variations

Consider the bull's-eye drawn by the archers at Global Crossing. The company reported a net loss of $120 million in the March 2007 quarter. Desperate to show a profit, however, management removed expenses using

a pro forma concoction reminiscent of its misdeeds during the dot-com bubble. First, management removed $97 million in expenses for interest, taxes, depreciation, and some other items to get to a metric it called *adjusted EBITDA* (earnings before interest, taxes, depreciation, and amortization). Then, it removed $15 million in noncash stock compensation expense, bringing the company to an adjusted cash EBITDA of *negative* $8 million. Close, but not all the way to profitability, management then removed a host of charges that it deemed one-time in nature, propelling the company to a positive $4 million in what it called *adjusted cash EBITDA less one-time items*. Bull's-eye!

It is easy to be skeptical about Global Crossing's three levels of pro forma, and it is hard not to laugh when looking at some of the "one-time" charges that the company removed. (See Table 13-1.) Last time we checked, expenses for "maintenance" were a normal cost of doing business and therefore should never be excluded from a pro forma calculation. Ditto for customer defaults (bad debts), employee retention bonuses, and routine regulatory charges. Do not be fooled into thinking these items will not recur just because management decides to present them as one-time in nature.

Table 13-1 Global Crossing's Adjusted Cash EBITDA Less One-Time Items

($ millions)	Q1, 3/07
Net income	**(120)**
Provision for income taxes	12
Other expense	6
Interest expense	29
Depreciation and amortization	50
Adjusted EBITDA	**(23)**
Noncash stock compensation	15
Adjusted cash EBITDA	**(8)**
One-time item: regulatory charges	5
One-time item: Asian earthquake	1
One-time item: customer defaults	2
One-time item: severance	1
One-time item: cash portion of retention bonus	3
One-time item: utility credit	(2)
One-time item: maintenance charge	2
Adjusted cash EBITDA less one-time items	**4**

Now You See It, Now You Don't

On its June 2007 earnings call, flash memory manufacturer Spansion proudly stated that EBITDA grew to $72 million from $61 million the quarter before. The following quarter, Spansion reported that EBITDA fell to $71 million; however, the company soothed concerned investors by claiming that EBITDA increased by $8 million if you exclude a one-time real estate gain received in the previous quarter. Conveniently, this one-time gain was not excluded from EBITDA when earnings were reported the previous quarter. So Spansion essentially included the one-time gain to help show strong EBITDA growth in June, and then excluded the gain the next quarter to show strong EBITDA growth in September. You can't have it both ways!

Watch for Clever Games to Inflate EBITDA

Travel technology company Sabre Corporation found a clever way to inflate its reported EBITDA by excluding an important component of its cost

structure. Sabre often makes up-front payments to travel agencies in order to induce them to use the company's travel reservation system; in 2016, these payments totaled $71 million. Because these up-front disbursements relate to multiyear contracts, the payments are capitalized and then amortized over the contract period. Since the costs hit the Income as an amortization expense, they are added back in the calculation of EBITDA. If EBITDA is meant to be a shorthand proxy for cash profitability, it's hard to think of a justification for permanently excluding this type of cost that is paid in cash each and every period.

SEC Cracks Down on Groupon's Misleading Operating Earnings Metrics

While Global Crossing, Spansion, and Sabre used interesting variations of EBITDA to make profits look more plentiful, other companies take it one step further—they create their own profitability metric. And that is exactly what Groupon did.

Recall in Chapter 4 that Groupon's much-anticipated 2011 IPO ran into some early headwinds when the SEC forced the company to restate revenues. That restatement resulted in a massive cut in revenue previously reported in every period from 2009 through June 2011 by over 50 percent. Separately, the SEC also forced Groupon to stop reporting what the agency considered a very misleading non-GAAP metric, consolidated segment reporting operating income (CSOI). In Table 13-2, we show that Groupon tried to trick investors into believing the company was profitable by eliminating several items from income from operations: (1) online marketing expenses, (2) stock-based compensation, and (3) acquisition-related expenses. The non-GAAP metric that Groupon used, adjusted CSOI, transformed the GAAP-based losses to gains.

Table 13-2. Groupon's Misleading Non-GAAP Metric

($ thousands)	Year Dec-09	Year Dec-10	Three Months Mar-10	Three Months Mar-11	27 Month Cumulative
Oper. income	**(1,077)**	**(420,344)**	**8,571**	**(117,148)**	**(538,569)**
Adjustments					
Marketing	4,446	241,546	3,904	179,903	
Stock comp	115	36,168	116	18,864	
Acquis. costs	–	203,183	–	–	
Total adjust	4,561	480,897	4,020	198,767	
Adj. CSOI	**3,484**	**60,553**	**12,591**	**81,619**	**145,656**

During the 27 months starting in January 2009, Groupon reported a cumulative GAAP-based operating loss totaling $536 million. However, the company wanted investors to instead use the misleading non-GAAP metric, adjusted CSOI, showing a cumulative profit of over $145 million. Fortunately, the SEC notified Groupon to stop using this misleading metric.

Pro Forma Earnings/Adjusted Earnings/Non-GAAP Earnings

What's in a name? That which companies call earnings, by any other name would smell as sweet … or so management would like you to think. Sometimes management insists that a foul-smelling "pro forma" or "adjusted" earnings metric (or any other earnings metric with a qualifying name) is a sweet and pure measure of earnings.

Pretending That Recurring Charges Are One-Time in Nature You may recall that Peregrine Systems recorded bogus revenue and then tried to cover it up by fraudulently faking the sale of accounts receivable. Well, the company had so many bogus receivables that it also used pro forma tactics to hide the evidence of its chicanery. In addition to pretending to sell these receivables, Peregrine also took charges for these receivables, but it inappropriately classified those charges as nonrecurring and related to acquisitions. This classification gave Peregrine the cover to exclude these charges from its pro forma earnings presentation so investors would not be concerned (or at least those investors that always took the company at its word).

Whirlpool, one of the global leaders in large home appliances, reports a profitability metric called *ongoing earnings* that is meant to exclude the

effects of nonrecurring and nonoperating items. One of the most common adjustments from GAAP earnings to “ongoing earnings” is restructuring charges that relate to a wide range of costs associated with the company’s M&A, plant closures, layoffs, and asset impairments, among others. However, restructuring charges have been on Whirlpool’s Income Statement in 23 of the past 27 years, hardly a “nonrecurring” cost! In October 2016, the SEC finally questioned the company’s perennial exclusion of these costs.

3. Highlighting a Misleading Metric as a Surrogate for Cash Flow

Non-GAAP cash flow metrics are less common than non-GAAP revenue and earnings disclosures; however, they do exist. Sometimes companies create a pro forma cash flow metric to exclude a nonrecurring activity, such as a large litigation settlement. However, other times, companies may look to artificially enhance their cash-generation profile.

“Cash Earnings” and EBITDA Are Not Cash Flow Metrics

Companies sometimes present metrics like “cash earnings” or “cash EBITDA” (as we just saw with Global Crossing). Do not confuse these metrics with substitutes for cash flow! Many companies and investors alike believe that these metrics (as well as plain old EBITDA) are good surrogates for cash flow simply because the calculation includes the adding back of noncash expenses such as depreciation. As you surely know by now, a company’s cash flow consists of much more than just net income plus noncash expenses. Calculating it in this way is just an abuse of using the indirect method of developing the Statement of Cash Flows (SCF) (refer to our discussion of cash flow presentation in the Part Three introduction). Ignoring working capital changes when calculating cash flow will provide you with a fictional portrait of a company’s cash-generation abilities, in the same way that ignoring accruals for expenses such as bad debts, impairments, and warranty expenses will give you an illusory sense of profitability. In truth, metrics such as EBITDA and cash earnings are poor representations of performance.

Moreover, for capital-intensive businesses, EBITDA is often a misleading measure of performance and profitability because all the major capital costs

run through the Income Statement as depreciation, and therefore they are excluded from EBITDA. Some companies abuse the investment community's acceptance of EBITDA and use the metric even though it is completely unwarranted.

Take, for example, the non-GAAP reporting at Gogo Inc., provider of in-flight Internet access. Gogo's non-GAAP adjusted EBITDA metric ignores some basic costs of delivering its in-flight services including the production and installation of network equipment and system software. Gogo treats these costs appropriately for GAAP purposes: they are capitalized on the Balance Sheet and depreciated through the P&L. However, since these expenses are categorized as "depreciation and amortization," they are eliminated from Gogo's non-GAAP adjusted EBITDA. No surprise that Gogo has been able to show positive adjusted EBITDA every year since its 2013 IPO despite deeply negative GAAP net income.

Non-GAAP Cash Flow Metrics May Be Put There to Confuse

In Chapter 10, "Cash Flow Shenanigan No. 1: Shifting Financing Cash Inflows to the Operating Section," we discussed how in 2000 Delphi Corp. improperly recorded a loan from the bank as the sale of inventory and in doing so boosted cash flow from operations by $200 million. Well, management at Delphi also liked to mislead investors by presenting tricky cash flow metrics. For example, Delphi routinely headlined its "Operating Cash Flow" in its Earnings Releases. No doubt, many people thought that Delphi was discussing its CFFO; however, this was not the case. "Operating Cash Flow" was actually Delphi's deceptively named surrogate for GAAP cash flow from operations. Since the name is so close to its GAAP compadre, you can imagine how many investors were confused into thinking that this pro forma metric was Delphi's actual CFFO. In truth, this surrogate barely resembled GAAP cash flow from operations. As shown in Table 13-3, it was calculated as net income *plus* depreciation and other noncash charges *minus* capital expenditures *plus* some huge mystery item labeled "other."

Table 13-3 Delphi's GAAP Cash Flow Versus Pro Forma Cash Flow, 2000

($ millions)	2000
Net income (GAAP)	1,062
One-time charge for in-process R&D	32
Depreciation and amortization	936
Capital expenditures	(1,272)
Other, net	878
"Operating Cash Flow" (non-GAAP)	**1,636**
Cash flow from operations (GAAP)	**268**
Free cash flow (GAAP CFFO less GAAP capital expenditures)	**(1,004)**

We mentioned earlier that Delphi's actual CFFO (as reported on the SCF) was $268 million, but its self-defined "Operating Cash Flow" (as presented in the Earnings Release) was $1.6 billion—an astonishing differential of almost $1.4 billion. Since this cash flow surrogate includes the impact of capital expenditures, it may be more relevant to compare it with Delphi's free cash flow (CFFO less capital expenditures) of *negative* $1.0 billion—bringing our differential to an outrageous $2.6 billion. (Oh, by the way, that $268 million in CFFO reported on the SCF was only $68 million if you exclude the sham sale of inventory that we discussed in Chapter 10.)

In 2003, Delphi was still up to the same tricks, but the company was now showing a reconciliation between its "Operating Cash Flow" and CFFO as reported on the Statement of Cash Flows. Delphi's "Operating Cash Flow" was $1.2 billion in 2003, versus $737 million in CFFO and *negative* $268 million in free cash flow. As shown in Table 13-4, the primary differences included routine operating uses of cash flow, including pension plan contributions, payments to employees, and a decline in the sales of accounts receivable.

Any serious investor who looked at this presentation would be aghast at seeing such normal operating expenditures excluded from the calculation of "Operating Cash Flow." The adage "Where there's smoke, there's fire" is very applicable when searching for shenanigans. Delphi's ridiculous cash flow surrogate deception was the smoke. The fraudulent revenue and cash flow was the fire.

Table 13-4 Delphi's GAAP Cash Flow Versus Pro Forma Cash Flow, 2003

($ millions)	2003
"Operating Cash Flow" (non-GAAP)	**1,220**
Pension contributions	(990)
Cash paid for employee and product line charges	(229)
Cash paid for lump-sum contract signing bonuses	(125)
Decrease in sales of accounts receivable	(144)
Capital expenditures	1,005
Cash flow from operations (GAAP)	***737***
Free cash flow (GAAP CFFO less GAAP capital expenditures)	**(268)**

Similarly, IBM showcased a free cash flow metric with an unusual and opportunistic definition. Free cash flow is a non-GAAP metric that is widely used and traditionally calculated as cash flow from operations minus capital expenditures. IBM adjusted this definition to also exclude changes in its financing receivables. This is problematic, since IBM's financing receivables are really just *long-term loans to its own customers*, in other words, accounts receivable. From 2010 to 2013, higher levels of financing to customers created a large drag on CFFO; however, IBM's tricky free cash flow metric made it seem as if these payments had been collected. In 2012 alone, the increase in financing receivables was nearly $3 billion, representing 16 percent of IBM's self-defined free cash flow.

What to Do When Non-GAAP Metrics Become Pervasive in an Industry?

Sometimes certain industries use non-GAAP metrics as the standard way to value companies or to calculate an appropriate dividend distribution to investors. Energy companies, structured as master limited partnerships (MLPs), stand out in eschewing GAAP-based numbers for non-GAAP ones.

With historically low interest rates since the 2008 financial crisis, investors have searched far and wide for securities offering an annual yield higher than the miserly interest on bonds. Wall Street took notice and began singing the praises of the high yields and tax-advantaged status of MLPs.

Houston-based Linn Energy quickly became a darling MLP for its ability to consistently grow its dividend payments. In 2012 the company paid investors $680 million in dividends, an increase of 15 percent from 2011.

While impressive, these figures seem strange alongside the company's free cash flow, which fell by more than half a billion dollars to *negative* $694 million in 2012. How could the board have approved such a rich dividend payment when business required so much of Linn's available cash? The company actually had to borrow money in order to fund these payments. The answer lies in the way that Linn (and many other MLPs) reported their cash flow. The company emphasized "distributable cash flow"—this is a metric that has no standardized definition, but for Linn Energy it was derived from adjusted EBITDA, and it only took into account a portion of the company's capital expenditures. The methodology resulted in a much more favorable metric that was used to justify a higher dividend payment.

Table 13-5 shows Linn's GAAP and non-GAAP earnings and cash flow metrics, and Table 13-6 shows how Linn calculated "distributable cash flow" and the many costs that are not included.

Table 13-5 Linn Energy GAAP-Based and Non-GAAP-Based Earnings and Cash Flow

($ thousands)	Fiscal 2010	Fiscal 2011	Fiscal 2012
GAAP-based metrics			
Net income	(114,290)	438,440	(386,616)
Calculate free cash flow			
CFFO	270,920	518,710	350,907
Capital expenditures	(223,033)	(629,864)	(1,045,079)
Free cash flows (FCF)	47,887	(111,154)	(694,172)
Acquisitions	(1,351,033)	(1,500,193)	(2,640,475)
FCF after acquisitions	(1,303,146)	(1,611,347)	(3,334,647)
Company's non-GAAP metrics			
Adjusted EBITDA	732,000	995,000	1,400,000
Distributable cash flow	450,400	570,600	663,757
Cash dividends paid	457,476	590,224	679,275
Coverage ratio	0.985%	0.967%	0.977%

Table 13-6 Linn Energy Non-GAAP Metrics Used to Determine Dividend Payout

($ thousands)	Fiscal 2010	Fiscal 2011	Fiscal 2012
Net income	(114,288)	438,439	(386,616)
Plus:			
Acquisition/divestiture	42,846	57,966	80,502
Interest expense	193,510	259,725	379,937
Depreciation/amortization	238,532	334,084	606,150
Impairments and losses	48,046	97,011	432,104
Losses (gains) on derivatives	300,284	(219,703)	256,379
Unit-based stock-comp	13,792	22,243	29,533
Exploration costs	5,168	2,390	1,915
Income tax expense	4,241	5,466	2,790
Adjusted EBITDA	**732,131**	**997,621**	**1,402,694**
Minus:			
Interest expense	(193,510)	(259,725)	(379,937)
Maintenance capital expenditures	(88,000)	(167,300)	(362,000)
Distributable cash flow (DCF)	**450,621**	**570,596**	**660,757**

You'll notice that Linn Energy deducted maintenance capital expenditures in arriving at distributable cash flow, while total capital expenditures on a GAAP basis were nearly double that amount. This follows an approach that some companies (and investors) take to consider capital expenditures in two distinct buckets: (1) *maintenance*—capital spent on existing facilities that do not increase capacity—and (2) *growth*—capital spent to expand the business at either existing facilities or new ones. Clearly, management has quite a bit of discretion in what it includes in each grouping. Table 13-7 shows how much Linn allocated to maintenance and growth. Naturally, the more Linn classifies as growth, the higher the DCF—as growth capital expenditures *are excluded in the calculation*.

Table 13-7 Linn Energy Allocation to Maintenance and Growth Capital Expenditures

($ thousands)	Fiscal 2010	Fiscal 2011	Fiscal 2012
Total capital expenditures	223,013	629,864	1,045,079
Maintenance capital expenditures	88,000	167,300	362,000
Growth capital expenditure	135,013	462,564	683,079
Percent of total expenditures classified as "growth"	60.5	73.4	65.3

The subsequent years proved to be quite challenging for Linn. First, the SEC raised questions about the company's calculations of the distributable cash flow. By the following year, the energy market had collapsed, causing Linn's business to fall on tough times. But following years of imprudently high dividends (paid largely with borrowing), Linn faced a severe cash crunch, leading to its 2016 bankruptcy filing. And with its $8.3 billion debt load, Linn earned the dubious distinction as the largest energy MLP bankruptcy.

Could investors have avoided suffering big losses from Linn's demise? We think so. Paying out enormous dividends while generating *negative* free cash flows was simply not a sustainable strategy—and should have been a strong warning sign. The fact that most shareholders were paying attention to a non-GAAP surrogate for free cash flow that didn't include many of the most significant costs of the business explained why the market had valued the company so richly, while more careful (and skeptical) investors would have stayed away.

Looking Ahead

In Chapter 14, we shift from key metrics that present an overly optimistic view of a company's performance to those metrics that mislead investors about a potentially imminent deterioration in the Balance Sheet and the company's economic health.

14

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

As well as writing books, we also love reading them. We always make it a point to step into bookstores as often as possible, whether they're part of a mega chain like Barnes & Noble or the literary jewel of Portland, Oregon—Powell's Books. Once we're inside one of these places, it's hard not to notice the scores of self-help and diet books. They are everywhere. No doubt, we all yearn to look, feel, and be better at work, play, and all the other stuff. It's certainly a big business teaching people to feel better about their lives and to look fabulous.

Who knows if any of these plans really make us healthier or make us look any better? We do know, however, that upper management spends a great deal of time trying to make its Balance Sheets look great, even if they are loaded up with junk. This chapter highlights four techniques that struggling companies might use to convince investors that the company not only looks great but is in excellent health. Our hope is that these folks won't be as effective in fooling investors as the diet book authors are in persuading readers to trust their advice.

Techniques to Distort Balance Sheet Metrics to Avoid Showing Deterioration

1. Distorting accounts receivable metrics to hide revenue problems
2. Distorting inventory metrics to hide profitability problems
3. Distorting financial asset metrics to hide impairment problems
4. Distorting debt metrics to hide liquidity problems

1. Distorting Accounts Receivable Metrics to Hide Revenue Problems

Corporate executives understand that many investors review working capital trends carefully for signs of poor earnings quality or operational deterioration. They realize that a surge in receivables that is out of line with sales will lead investors to question the sustainability of recent revenue growth. To keep these kinds of questions at bay, companies may seek to distort the receivables numbers by (1) selling receivables or (2) converting them into notes receivable (both of which are discussed in this section) or (3) moving them somewhere else on the Balance Sheet (we address this later in the chapter).

Selling Accounts Receivable

In Chapter 10, "Cash Flow Shenanigan No. 1: Shifting Financing Cash Inflows to the Operating Section," we discussed how selling accounts receivable may be considered a useful cash management strategy, but an unsustainable longer-term driver of cash flow growth. Selling accounts receivable also serves another useful purpose: it lowers the days' sales outstanding (DSO) reported to investors (making it appear that customers have been paying more quickly). Dishonest management can conceal a jump in DSO simply by selling more accounts receivable.

Let's refer to our discussion in Chapter 10 of Sanmina-SCI's stealth sales of receivables. After selling these receivables, the company highlighted a decline in DSO and an increase in cash flow from operations in its September 2005 quarterly results. Astute investors would have understood that it was the sale of receivables, not operational improvements, that drove DSO lower and CFFO higher. Such investors understand that the sale of receivables, in substance, represents a financing decision (that is, collecting cash due on customer accounts earlier). Therefore, the now lower accounts receivable balance naturally also results in a smaller DSO figure.

TIP

Whenever you spot a CFFO boost from the sale of receivables, also realize that by definition, the company's *DSO will have been lowered as well.*

Also recall how Peregrine recorded bogus revenue and then shamelessly faked the sale of the related bogus accounts receivable in order not to raise any alarms. Those receivables, obviously, went uncollected, and management became concerned that the bulging account balance would drive up DSO indefinitely—a clear warning for investors. By faking the sale of these receivables, Peregrine inflated its CFFO and removed the potential DSO red flag from investors' sights in one fell swoop.

The first examples of lowering receivables to improve DSO involved either selling them outright or faking the sale. Another way to hide accounts receivables is simply to reclassify them elsewhere on the Balance Sheet.

TIP

To calculate DSO on an apples-to-apples basis, simply add back sold receivables that remain outstanding at quarter-end for all periods.

Turning Accounts Receivable into Notes Receivable

Symbol Technologies' receivables had been growing rapidly because of aggressive revenue recognition and channel stuffing, surging to 119 days in June 2001 (up from 94 in March 2001 and 80 in June 2000). To avoid investor concerns, management engineered a cosmetic reduction in accounts receivable.

It was a pretty dirty trick, in our view. Symbol simply asked some of its closest customers to sign paperwork that would convert these trade accounts receivable into promissory notes or loans. Apparently, the customers acquiesced, since it made no difference to them; they owed the money either way. However, the new paperwork gave Symbol a convenient cover to move these accounts receivable to the notes receivable section of the Balance Sheet. In effect, Symbol waved a magic wand and, with the help of some compliant customers, "reclassified" these trade receivables to an account that was not as closely monitored by investors. It seems that Symbol's primary purpose for this reclassification was to lower its DSO and fool investors into believing that sales had been kosher and that customers had paid on time. And according to plan, DSO fell from the 119 days in June 2001 to 90 days the following period.

TIP

Investors should be as concerned when they see a *large decrease in DSO* (particularly following a period of rapidly rising DSO) as they are when they see a substantial increase in DSO.

Watch for Increases in Receivables Other Than Accounts Receivable

UTStarcom pulled a similar switcheroo in 2004 by taking more payment in the form of "bank notes" and "commercial notes." Since UTStarcom chose not to classify these notes receivable as accounts receivable on the Balance Sheet (in fact, the bank notes were considered to be a subset of cash!), the company presented a more palatable DSO to investors, despite a severe deterioration in the business. Diligent investors could have spotted this improper account classification by reading UTStarcom's footnotes. As shown in the box, the company disclosed clearly that it had accepted a substantial amount of bank and commercial notes in place of accounts receivable.

UTSTARCOM'S JUNE 2004 FORM 10-Q

From Footnote 6 (Cash, Cash Equivalents and Short-Term Investments)

The Company *accepts bank notes receivable* with maturity dates between three and six months *from its customers in China* in the normal course of business. *Bank notes receivable were $100.0 million and $11.5 million at June 30, 2004 and December 31, 2003,* respectively, and have been included in cash and cash equivalents and short-term investments. [Italics added for emphasis.]

From Footnote 8 (Accounts and Notes Receivable)

The Company *accepts commercial notes receivable* with maturity dates between three and six months *from its customers in China* in the normal course of business. Notes receivable available for sale were *$42.9 million and $11.4 million at June 30, 2004 and December 31, 2003,* respectively. [Italics added for emphasis.]

Investors received another warning on UTStarcom's Balance Sheet: notes receivable surged, from $11 million in December 2003 to $43 million the following quarter. By now, it should be abundantly clear that identifying the reason for such a change is extremely important. If management cannot provide you with a plausible reason, assume that the company may be playing a game with accounts receivable and trying to hide otherwise bulging DSO.

Watch Out for Varying Company DSO Calculations For the purposes of identifying aggressive revenue recognition practices, we suggest that investors use the ending (not the average) receivables balance when calculating DSO. Using average receivables works well for assessing cash management trends, but it works less well for trying to detect financial shenanigans. End-of-period balances are more representative of the revenue transactions that took place later in the period, which are more relevant in assessing revenue quality.

Accounting Capsule: Days' Sales Outstanding

Days' sales outstanding is generally calculated as follows:

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

While we recommend using this calculation for DSO, you may encounter different calculations suggested by companies or texts. For example, some people believe that DSO should be calculated using average receivables over the period, as opposed to the ending balance of receivables that we suggest.

Since DSO is not a GAAP metric, there is no absolute definition for it. It is important, however, that the calculation reflect the analysis that you are trying to perform. For example, if you are assessing the likelihood that a company has accelerated revenue by booking a significant amount of revenue on the last day of the quarter, (i.e., stuffing the channel), it makes sense to calculate DSO using the ending balance of receivables rather than the average one. Similarly, if you are worried about the collectibility of receivables and you are evaluating a company's exposure, it is best to use the ending balance. However, if you wish to calculate the average time

over which a company collects its receivables, you may want to use the average balance of receivables.

The bottom line is that for financial shenanigan detection purposes, we advise calculating DSO using ending balances, even if a company tells you otherwise.

Watch for Changes in a Company's DSO Calculation Be especially wary if a company *changes its own DSO calculation* in a way that conceals deterioration, as Tellabs Inc. apparently tried to do in December 2006. Tellabs had been calculating DSO based on the ending receivables balance, but it then changed to using its quarterly average receivables balance. Since receivables surged in the quarter in which the change was made, the average receivables balance was naturally much lower than the ending one, allowing for a more favorable presentation of DSO on an earnings conference call with investors. As a result, Tellabs disclosed that DSO in December 2006 had increased by only 5 days sequentially (to 59 days from 54 days in the previous quarter). Had management made no changes in its calculation, Tellabs would have reported an increase in DSO of 16 days (to 82 days from 66 days the previous quarter). The change in the DSO calculation was mentioned in the same conference call. In this case, being aware of the change in calculation was the easy part; knowing it was a big deal was key for alert investors to realize that management was playing games and trying to hide its bulging receivables.

TIP

Astute investors should note a change in the calculation of DSO; when management changes how it computes operational metrics it is often attempting to hide some deterioration from investors.

2. Distorting Inventory Metrics to Hide Profitability Problems

Investors typically view an unexpected rise in inventory as a sign of upcoming margin pressure (through markdowns or write-offs) or falling product demand. Some companies with inventory problems seek to avoid this negative perception by toying with inventory metrics.

Covering Up a Cover-Up

You may recall from Chapter 4 that Symbol Technologies had overstated sales by offering customers very generous return rights. Moreover, some sales turned out to be completely bogus because customers had sent back products they never wanted, and based on a side agreement with Symbol, they could return them at any time and pay nothing. These returns became more than a minor nuisance, as they increased Symbol's inventory levels, a potential warning sign for investors. So as one cover-up often leads to another, Symbol created an "inventory reduction plan" designed to reduce inventory levels. The plan (as described by the Securities and Exchange Commission) included recording fictitious accounting entries to reduce inventory, leaving product deliveries on the receiving docks without recording them as inventory, and selling inventory to a third party but agreeing to repurchase it.

Watch for Inventory That Moves to Another Part of the Balance Sheet Companies will sometimes reclassify inventory to a different account on the Balance Sheet. Pharmaceutical giant Merck & Co., for example, in 2003 began reporting part of its inventory as a long-term asset, included in the "other assets" line on the Balance Sheet. A footnote revealed that these oddly classified inventories related to products that were not expected to be sold within one year. In December 2003, the long-term portion of Merck's inventory represented 13 percent of the total, and the next year, it jumped to 25 percent. Investors should certainly have included these long-term inventory totals when analyzing Merck's inventory trends. A sudden spike in long-term inventory warrants concern by investors.

Be Cautious About New Company-Created Metrics Inventory balances at mall retailer Tween Brands Inc. had been bloated in late 2006 and early 2007, and management correctly assumed that investors would be less than overjoyed. Specifically, days' sales of inventory jumped to 60 days in the May 2007 quarter from 52 days the preceding year, marking the third consecutive quarter of increase. Moreover, inventory per square foot (a non-GAAP metric often cited by Tween) increased by 18 percent.

To divert potential investor concerns about inventory, management began highlighting a new metric: "in-store" inventory per square foot. In May 2007, Tween management claimed that the surge in inventory should not be

a source of worry because “in-store” inventory had increased only a modest 8 percent ($27 per square foot versus $25 last year). Despite the absurdity of this new metric, Wall Street bulls were pleased; all they needed was an explanation, no matter how weak.

Tween’s explanation should have given astute investors pause on two grounds. First, it would be completely inappropriate for Tween to simply ignore inventory that it owned and included on its Balance Sheet but that was not on store shelves. “Out-of-store” inventory qualifies as inventory and has no less markdown risk than “in-store” inventory. Second, and even more troubling, Tween tricked investors by providing an “apples-to-oranges” comparison of its inventory growth. Specifically, the $25 cited by management as the prior year’s *in-store* inventory per square foot reflected *total* inventory per square foot. By definition, comparing the current year’s in-store number with the prior year’s total number would understate inventory growth; of course, it was up only 8 percent! Since the in-store metric was new, the prior year’s number was not previously disclosed, which made it difficult for investors to notice the inconsistency. However, diligent investors would have been *skeptical enough about the creation of a new inventory metric* at a time when inventory was increasing, and they would have questioned its usefulness as a measure of the company’s health.

3. Distorting Financial Asset Metrics to Hide Impairment Problems

Financial assets (such as loans, investments, and securities) are significant sources of income for banks and other financial institutions. Therefore, assessing the “quality” or strength of these assets should be a key part of understanding the future operating performance of such companies. For example, it is crucial for investors to understand whether a bank’s investment portfolio consists of risky, illiquid securities and to know if its loan portfolio is weighted toward dicey subprime borrowers.

Consider two banks that are identical in every way, except for the composition of their loan portfolios. One bank’s loan portfolio consists entirely of loans to subprime borrowers, 20 percent of which have failed to pay their bills on time. The other bank’s loan portfolio consists mainly of loans to prime borrowers, only 2 percent of which have failed to pay on time. It does not take a banking expert to realize that the second bank’s

operating performance will be steadier and that the first one will be more volatile.

Financial institutions will often present extremely helpful metrics that allow investors to understand the strength and performance of their assets. For example, a bank might report delinquency rates, nonperforming loans, and loan loss reserve levels. However, sometimes management dresses up or conceals important metrics that would show a deterioration in order to present itself in a more favorable light.

Watch for Changes in Financial Reporting Presentation

Consider the case of New Century Financial Corp., once the largest U.S. independent nonprime lender, whose risky mortgage lending culminated in its April 2007 bankruptcy. New Century kept its earnings afloat in September 2006 by *reducing* its loan loss reserve, instead of increasing it, despite facing higher delinquencies and bad loans. However, when it released its September 2006 earnings, the company was less than completely honest with investors about its reserve level. Most investors reading the Earnings Release came away thinking that New Century had raised its loan loss reserve.

Here's why. New Century realized that investors would be seriously spooked if they knew that the company had reduced its reserves while its subprime loan portfolio was souring and that this reduction was the primary driver of earnings. Indeed, analysts who followed New Century were monitoring the company's allowance for loan losses closely as the subprime market started to crack. So when the company released its September 2006 results, management quietly changed its reserve presentation.

Previously, New Century's Earnings Release had presented the loan loss reserve on a stand-alone basis. However, in September 2006, the company grouped the loan loss reserve with another reserve (allowance for real estate owned) and presented the two together as one unit (see the accompanying disclosure in the box). By combining the two reserves, New Century could say in its release that reserves increased from $236.5 million in June to $239.4 million in September. However, the number on which investors had previously been focused—the loan loss reserve—declined from $209.9 million to $191.6 million. The loan loss reserve fell because bad loans that had been written off (called *charge-offs*) had accelerated and New Century had failed to record a sufficient expense to refill the reserve; if it had done

so, EPS in September 2006 would have been sliced to $0.47 from the $1.12 as reported.

By simply changing the presentation of a key metric, New Century was able to avoid signaling that asset quality had deteriorated, while also reporting higher earnings. This charade probably bought the company some time before its bankruptcy several months later. Astute investors who were monitoring not only the level of the loan loss reserve, but also the presentation, would have had a warning of the company's demise. Investors who missed the presentation change in New Century's Earnings Release, but read the 10-Q released several days later, would have seen the disaggregated loan loss reserve and had fair warning as well.

NEW CENTURY'S LOAN LOSS RESERVE DISCLOSURE

June 2006 Earnings Release

At June 30, 2006, the balance of the mortgage loan portfolio was $16.0 billion. *The allowance for losses on loans held for investment* was $209.9 million, representing 1.31 percent of the unpaid principal balance of the portfolio. This compares with 0.79 percent of the unpaid principal balance of the portfolio at June 30, 2005 and 1.30 percent of the portfolio at March 31, 2006. [Italics added for emphasis.] September 2006 Earnings Release

At September 30, 2006, *the allowance for losses on mortgage loans held for investment and real estate owned* was $239.4 million compared with $236.5 million at June 30, 2006. These amounts represent 1.68 percent and 1.47 percent of the unpaid principal balance of the mortgage loan portfolio, respectively. [Italics added for emphasis.]

Executives at New Century eventually got into trouble for their tactics. In 2009, the SEC charged New Century's former CEO, CFO, and Controller with securities fraud for misleading investors, alleging the company sought to assure investors that its business was not at risk and was performing better than its peers.

4. Distorting Debt Metrics to Hide Liquidity Problems

A company's cash obligations, such as debt payments, may have an impact on future operating performance as well. Large near-term debt obligations may prevent a company from funding its desired growth initiatives or, at worst, send it spiraling toward bankruptcy.

Europe's Enron

Parmalat Finanziaria SpA, the Italian-based dairy producer and one of the world's largest packaged-food companies, grew its business rapidly in the 1990s by aggressively acquiring food service companies around the world. Parmalat relied heavily on the debt markets to fund its shopping spree, borrowing at least $7 billion in various offerings between 1998 and 2003. As its business ran into serious problems, Parmalat began having trouble generating sufficient cash to pay down this debt. Moreover, top executives of this family-owned and family-dominated company began funneling hundreds of millions of dollars to other family businesses. Therefore, when bonds came due, Parmalat had a desperate need to issue new bonds and float equity offerings to raise enough cash to pay off the older debt.

Normally, investors would be reluctant to purchase new bonds and equity from a poorly performing company that was strapped with heavy debt obligations and had no cash. So to attract investors, Parmalat concocted a widespread scheme to fraudulently hide its debt and conceal bad assets. By dressing up its Balance Sheet, Parmalat fraudulently portrayed itself to investors as a company that was in robust economic health. In September 2003 (the quarter before the fraud was revealed), Parmalat's unreported debt amounted to an astonishing €7.9 billion. The company's net worth, reported to be €2.1 billion, was negative €11.2 billion—an inconceivable €13.3 billion overstatement!

The centerpiece of Parmalat's fraud seems to have been the company's use of offshore entities to hide fictitious or impaired assets, fabricate the reduction of debt, and create fake income. The scope of the fraudulent activities that Parmalat is alleged to have engaged in is quite amazing. SEC litigation against the company names a few, including forging the repurchase of its debt, faking the sale of bogus or uncollectible receivables, falsifying the payment of payables, recording fictional revenue,

mischaracterizing debt as equity, disguising intercompany loans as income, and diverting company cash to various businesses owned by members of the CEO's family.

As usual, there were warning signs for perceptive investors to find. One key warning occurred in late October 2003 when Parmalat's auditors (Deloitte & Touche) wrote in an audit report that they were unable to certify certain transactions involving an investment fund called Epicurum, which later turned out to be one of these fraudulent offshore entities. These transactions were quite significant. Parmalat had recorded gains on a derivative contract just signed with Epicurum that *accounted for more than all Parmalat's €119.9 million in pretax earnings* in the first half of 2003. Moreover, these gains were revealed because of Parmalat's commenting on Deloitte's review report, but they had not previously been disclosed by Parmalat in its June 2003 Earnings Release.

Less than two weeks later, in early November 2003, Parmalat decided to formally respond to Deloitte's report in a very public manner. It issued four press releases over a span of three days seeking to clarify Deloitte's reasons for not signing off on its financial statements and also to explain its Epicurum investment in further detail. To be clear, Parmalat decided to refute its auditor in a public forum over a transaction with an obscure offshore entity that had accounted for all its recent earnings.

The late 2003 series of events at Parmalat is perhaps the reddest of red flags. As an investor, you should cringe when you see a company having a public disagreement with its auditor, particularly on a shady transaction of significant magnitude. Surprisingly, many investors in Parmalat did not feel that way. It was not until several weeks later that Parmalat's stock price plunged as the company defaulted on its debt.

Looking Ahead

This chapter completes the section on Key Metric Shenanigans. The next section of the book, Part Five, "Acquisition Accounting Shenanigans," introduces readers to the most complex companies to analyze—acquisitive ones—and how to navigate the many accounting tricks used by companies favoring an acquisition-driven strategy.

PART FIVE

ACQUISITION ACCOUNTING SHENANIGANS

> More value is destroyed by acquisitions than any other single action taken by companies.
>
> —ASWATH DAMODARAN, NYU FINANCE PROFESSOR

Finding new growth engines at a mature company can be challenging, and management generally takes one of two approaches: (1) develop new categories of products, services, or customers organically or (2) make acquisitions. In other words, “make or buy.”

Success stories abound following either strategy, or combinations of both. Consider the smartphone market. Apple developed its megahit iPhone product internally. Since its release a decade ago, over a billion iPhones have been sold. Today, the smartphone generates about 60 percent of Apple’s revenue. In contrast, Google became a formidable player in the smartphone space by acquiring Android for $50 million in 2005. According to information from a 2016 court deposition, since 2008, Android’s software had generated well over $30 billion in revenue and $22 billion in profit for Google. So using different approaches, one an organic grower and the other through M&A, both Apple and Google scored big in the smartphone market.

Clearly, one big advantage of following the M&A path is timing. Unlike Apple, which spent many years developing the Apple iPhone, Google found a “plug-and-play” solution for its platform, getting its phone to market much more quickly than if it had built a comparable product internally.

But perhaps the biggest difference in outcomes between the organic growers and the acquirers relates to failure. As you might imagine, the failure rate for companies trying to discover, build, and market a new product is quite high. Think of it like oil drillers who know that the probability of hitting a gusher is low. So their thinking is generally to not “bet the farm” on a single drilling expedition, which could imperil the company. However, even if they fail to hit a wet well most of the time, spending to drill around an entire field can be quite profitable over the long run.

Acquisitions, by contrast, appear to provide a more attractive risk profile. After all, the acquired company presumably already has a track record in the marketplace and a base of business that can be measured. However, in some respects this is an illusion—in reality, the long-term success rate of

acquisitions is quite low. Shareholders of AOL and Time Warner would agree. They learned this all too well in the megamerger of “new media” with “old media” in the $164 billion deal, with AOL shareholders owning 55 percent of the new company. The combined business crashed and burned over the next 18 months, reporting a hard-to-imagine $99 billion loss.

There are many reasons that acquisitions fail to live up to the hype. In our experience, three of them seem particularly resonant:

1. Widespread overconfidence in the magic of “synergies”
2. Reckless transactions motivated by intense fear or greed
3. Deals driven by artificial accounting and reporting benefits rather than business logic

1. Widespread Overconfidence in the Magic of “Synergies”

M&A deals often are pitched to investors with highly optimistic projections of cross-selling and cost-cutting opportunities. Consider the grand plan of United Airlines’ parent, UAL, which in the 1980s sought to create a one-stop fly-drive-sleep behemoth that would take care of the most important needs of travelers. In just a two-year period, UAL CEO Richard Ferris spent $2.3 billion acquiring Hertz Car Rental and Westin and Hilton hotel chains. In 1987, Ferris changed the company name to Allegis to “reflect the broadened scope of the travel experience.” Investors hated the new name (some mockingly calling it Egregious Corp.) and questioned the business strategy. The share price collapsed, and its CEO began looking for a new job.

Just as at UAL, Sears, the biggest retailer before Walmart, loved the concept of “cross-selling.” So with its millions of customers, management believed that by creating a “financial supermarket,” they could sell stocks, insurance, and homes after they acquired Dean Witter brokerage, Allstate insurance, and Coldwell Banker realty. Again, investors were baffled and unhappy with these confusing and costly acquisitions. One critic at Merrill Lynch mockingly asked, “Did consumers really want to buy socks and stocks under the same roof?” With investors giving an emphatic thumbs-down, Sears quickly began to sell off these companies.

2. Reckless Transactions Motivated by Intense Fear or Greed

We believe that many deals are driven by the human emotions of fear or greed. In the case of Valeant, for instance, CEO Michael Pearson's stock-based compensation (topping out if Valeant's share price appreciated an insane 60 percent annually) created huge incentives to grow the company at breakneck speed, making serial acquisitions the only logical strategy.

At Mattel in the late 1990s, CEO Jill Barad, fearful that her traditional toy business failed to provide sufficient growth opportunities, searched for a deal in the faster-growing software industry. At the same time, software entrepreneur Kevin O'Leary, founder of The Learning Company (TLC), was searching for a buyer of his business. TLC's business included a mishmash of around 60 mostly unprofitable educational software companies, all acquired in rapid succession over a few years, using its inflated stock or enormous amounts of debt. (Yes, this is the same Kevin O'Leary affectionately known as "Mr. Wonderful" on ABC's hit TV series *Shark Tank*.)

So when Mattel came knocking, O'Leary was eager to cash out. Mattel agreed to pay $3.7 billion in May 1999. Big mistake! Really big mistake! No sooner had the ink dried on the contract than Mattel started reporting disappointing results, largely from the TLC business. (In fact, on the day the deal was announced, Mattel's stock was pummeled, dropping $2 billion in market value in a single day.) The news kept getting worse as TLC reported losses totaling $206 million for the year, including $183 million in the fourth quarter alone. This caused Mattel to suffer an $86 million loss for the year and CEO Jill Barad to lose her job in February 2000. And less than one year after this ill-fated deal, Mattel had seen enough and basically gave TLC away for nothing, selling it to the Gores Group at a fire-sale price of $27 million! To add insult to injury, Mattel later wound up paying $122 million in class-action lawsuits filed by Mattel shareholders. Ouch!

3. Deals Driven by Artificial Accounting and Reporting Benefits Rather Than Business Logic

Part Five of this book focuses on artificial accounting and reporting used around the time of an acquisition and intended to inflate the performance

and operating metrics of the acquiring company.

Comparing Acquisition Accounting Shenanigans to All Other Ones

Think about all the shenanigans we discussed earlier (Earnings Manipulation, Cash Flow, and Key Metric) as tricks designed to cover up some problem in the underlying business. Sometimes another layer of deception may help nefarious management teams to hide the original cover-up. That's where Acquisition Accounting (AA) Shenanigans can be used and can make detection of the underlying business problem that much more difficult. Consider the case of Olympus Corp., starting with management's decision to use an Earnings Manipulation (EM) Shenanigan to hide a business problem, only to later use an egregious AA Shenanigan to cover up the first accounting game.

Olympus ran a decades-long loss-hiding scheme in which it failed to record impairment charges for bad investments. Over the years, Olympus had invested in many enterprises, many of which turned out to be big money-losing investments. Rather than record disappointing impairment charges against income for these losses, management decided to maintain these investments at inflated values on the Balance Sheet. It was a textbook example of a technique described in Chapter 6, *failing to write down assets with impaired value*. As the oversized investment account on Olympus's Balance Sheet would likely raise questions by investors, management essentially made these losses disappear by shifting them into goodwill, under cover of an acquisition, then later shifting these losses to bogus nonconsolidated entities created by management.

In addition to serving as a cover-up of a typical accounting shenanigan, some AA tricks can be used to provide earnings benefits directly. Part Five, "Acquisition Accounting Shenanigans," shows various techniques often used to cover up business problems and other newly created schemes to trick investors.

Three Acquisition Accounting Shenanigans

ACQUISITION ACCOUNTING SHENANIGANS

AA Shenanigan No. 1: Artificially boosting revenue and earnings (Chapter 15)

AA Shenanigan No. 2: Inflating reported cash flow (Chapter 16)

AA Shenanigan No. 3: Manipulating key metrics (Chapter 17)

15
Acquisition Accounting Shenanigan No. 1: Artificially Boosting Revenue and Earnings

Acquisition Accounting Creates Distortions on the Financial Statements

One reason investors have difficulty in interpreting financial statements of acquisitive companies is because certain costs that typically should be reflected as expenses on the Income Statement are instead found on the Balance Sheet in *goodwill* or *intangibles*. Moreover, some cash outflows typically reflected as reductions in cash flow from operations are classified as *investing outflows* on the Statement of Cash Flows.

Thus, the first two manifestations of distortion (shifting operating costs *to* the Balance Sheet and shifting cash outflows *from* the Operations section to the Investing section) should be considered the *consequence* of the acquisition process, rather than an overt action by management to mislead. As such, we are not criticizing management; rather we are alerting investors to the inherently misleading information resulting from acquisition accounting conventions.

Shifting Operating Costs to the Balance Sheet

Consider two different companies in the drug industry. Company O grows organically, while Company A grows through acquisitions. Company O spends 15 percent of its $1 billion sales on R&D and charges to expense $150 million annually; in contrast, Company A spends only 3 percent of its $1 billion revenue on R&D, or a $30 million expense, as it acquires most of its new drugs through acquisitions. In comparing the results for the two companies, Company O will report a much smaller profit, as it must recognize $150 million as an expense. Company A, in contrast, would

expense just the $30 million for the modest R&D spent, plus a relatively small amortization expense on the acquired intangible assets. However, over a five-year period, Company A will likely have *spent much more* than Company O to gain access to new drugs and to acquire entire companies. But under GAAP-based acquisition accounting conventions, most acquisition-related costs would not be expensed but rather would reside on the Balance Sheet, often with the lion's share shown as *goodwill* or *intangible assets*.

The key point is that acquisitive companies should logically report higher profits than organic growers, simply because certain necessary costs of growing their business (like R&D) have already been incurred by someone else and thus are not be charged as an expense against revenue.

Shifting Operating Cash Outflows to the Investing Section

As we will discuss in the next chapter, the same benefit received by the acquiring company on the Income Statement can also be seen on the Statement of Cash Flows. Specifically, cash paid to access products by acquisition would be reflected as a cash outflow in the Investing (and not Operating) section of the Statement of Cash Flows. This convention under acquisition accounting rules would make M&A-driven companies appear to generate much more operating cash flow than their organic peers. Again though, the M&A-driven companies will have a much larger cash outflow because of the much higher cost they pay to acquire an entire company.

Another important anomaly relates to the cash flow generated by an M&A-driven company. Recall that increases in working capital (i.e., rising inventory or receivables) would ordinarily be reflected as a reduction in cash flow from operations. However, if that working capital came from an acquisition, rather than organically, it would be reflected as a reduction in cash flow from investing activities (and not operations). Again, the acquisition accounting conventions would allow M&A-driven companies to appear to be bigger generators of operating cash flow, but this may be a mirage. (Chapter 16 shows a variety of tricks to inflate cash flow from operations during the acquisition process.)

The Sun Will Come Out Tomorrow

One of our favorite Broadway musicals, *Annie*, has a memorable song, "Tomorrow," sung by little Annie. The statement "The sun will come out

tomorrow" expresses her hope for a very bright future. In much the same way, serial acquirers have mastered the art of convincing investors of a sunny future after a deal closes—no matter how cloudy the past. To increase the odds that the sun will indeed shine very brightly tomorrow on the newly merged company, the following Acquisition Accounting Shenanigans come in very handy.

The main objective in using AA Shenanigan No.1: Artificially Boosting Revenue and Earnings is to inflate the acquirer's revenue and profits after the deal closes.

Acquisition Accounting Techniques to Artificially Boost Revenue and Earnings

1. Inflating profits through tricks at a target company before a deal closes
2. Inflating profits by hiding losses at deal closing
3. Creating dubious new revenue streams after closing
4. Inflating profits by releasing suspicious reserves either before or just after closing

1. Inflating Profits Through Tricks at a Target Company Before a Deal Closes

Think back to the important themes we discussed in Part Two, "Earnings Manipulation Shenanigans." Unlike the first five EM shenanigans, which inflate current profits, EM Nos. 6 and 7 represent tricks to make *future periods* look sunny. And that's exactly the goal of the target and acquirer: to make the postclosing period beautiful. One way to accomplish this goal is to depress earnings in the period just before the deal—called the *stub period*.

Watch for a Slowdown in Revenue at the Target Prior to the Acquisition Close

Investors in Valeant would have found a very puzzling pattern if they had paid close attention to the revenues of the company's acquisition targets just prior to consolidation. In many of these cases, reported revenue at the target slowed down dramatically before the deal closed when compared with prior periods. No example, however, was more extreme than at Salix. Table 15-1 shows Salix's quarterly sales from 2013, 2014, and 2015. Notice a few interesting patterns in the numbers: (1) during the last three quarters of 2013, sales were virtually unchanged; (2) during the first quarters in 2014 (when Salix management was actively shopping the company), sales grew rapidly when compared with the same prior-year periods; (3) during the last quarter of 2014 and first one of 2015 (when Valeant was in the process of closing the acquisition), sales completely dried up; and (4) the last three quarters of 2015 (after Valeant acquired Salix), sales grew dramatically.

Table 15-1 Salix Quarterly Revenue, 2013 to 2015

	Quarter ending ($ million)			
Year	March	June	September	December
2013	203	235	239	238
2014	403	376	342	**13**
2015	**0**	313	461	497

Let's dig a bit deeper to make sense of these strange numbers and trends. Starting in 2014, Salix made a strong push to report terrific sales growth to maximize the price an acquirer would pay. Trying to spruce up the financial statements before a deal might be fairly common. But stuffing inventory to distributors that have no customers to buy those products goes a bit too far. Indeed, this aggressive channel stuffing caught the attention of the regulators and eventually cost the CEO and CFO their jobs.

But the accounting games were far from over. In the fourth quarter of 2014, for example, Salix reported almost no sales at all—a mere $13 million. So compared with the same quarter in 2013, sales declined an unbelievable 95 percent. How is that even possible? We can think of only two possible explanations: (1) the numbers are correct and Salix's business had completed imploded—very unlikely, as Valeant chose not to abort the deal—or (2) the numbers are rigged and Salix had intentionally refrained

from booking any business during Q4 2014 to allow Valeant to include that revenue in the periods after the deal closed on April 1.

After the deal closed, Valeant booked a whopping $1.3 billion (or $424 million per quarter) in Salix product sales over the remaining three quarters of 2015. While we claim no "smoking-gun" evidence to prove inflated revenue at Valeant from spring-loading sales, the numbers in Table 15-1 look convincing.

Watch for Unusual Sources of Revenue at the Time of an Acquisition

Agreements between two parties just before they merge clearly lack an "arm's-length" element. Consider Krispy Kreme's nifty scheme to inflate revenue when it was about to reacquire one of its franchises in 2003.

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

Target Company Takes Large Expense Write-off During Stub Period

With the goal of deflating earnings during the stub period, companies not only refrain from reporting all their sales, but can also take big write-offs during the period. Specifically, a company might write off assets causing the stub period to be burdened with expenses that otherwise would have been charged to the newly merged company. It is simple to execute. The target company simply announces a write-off to streamline its operation in advance of the two companies merging.

2. Inflating Profits by Hiding Losses at Deal Closing

As we discussed in Chapter 6, Olympus Corporation pumped billions into money-losing investments to accelerate sluggish growth at the company.

The company chose to keep the assets at full cost on the Balance Sheet, against the wishes of its auditor. As the amounts grew to an uncomfortably large amount, Olympus knew it had to find another trick to make the balance in its investment account disappear.

In October 2011 when Olympus fired its newly appointed CEO, Michael Woodford, it was revealed that the company had been operating a *tobashi* scheme (a scheme that makes problems "fly away," in Japanese) in which $2 billion was said to have been siphoned off to cover bad investments made up to 20 years before.

Around 2008, Olympus had bought three companies and paid far more than they were worth, according to Woodford. This inflated price (totaling 30 percent of the deal value) was labeled "fees to a middleman." Woodford pointed out that the cut for investment bankers typically would be 1 to 2 percent, so the $674 million paid on the $2 billion deals likely was a payment to cover losses and move the investments off the Balance Sheet to an unconsolidated related-party entity.

When Woodford, who was responsible for considerable business across Europe, noticed this shenanigan in 2008, he attempted to tender his resignation over the "strange" European acquisitions. He was given plausible reassurances and promoted to run Olympus's entire European business. Over the next few years, Woodford was promoted to COO and eventually became the chief executive officer. As he then became aware of the true nature of these and other accounting tricks at the company, he made the board aware of his deep concerns. Unfortunately, rather than investigate the prior executives, the board fired Woodford. Shortly thereafter, the fraud was revealed.

3. Creating Dubious New Revenue Streams After Closing

Both buyers and sellers of businesses have great flexibility in structuring a deal to create dubious future revenue streams. For example, assume Buyer Ben wants to purchase Seller Sam's business, and they come to terms on a price of $5 million, which is the fair market value of the company. Buyer Ben then says to Seller Sam, "I will instead pay you $6 million (rather than the $5 million), provided you also agree to pay me a $1 million licensing fee next year." This change has no real economic impact to either Buyer

Ben or Seller Sam, but the change in structure allows Ben to show $1 million more in revenue in the year following the acquisition. Seriously, this type of nonsense actually does happen.

Watch for Either a Buyer or Seller Creating an Unrelated Nonrecurring Revenue Stream

Occasionally, we see either a buyer or seller of a business cleverly create a recurring revenue stream by bundling a seemingly unrelated agreement into the acquisition accounting.

One clever scheme to create revenue out of thin air, using the cover of an acquisition, was employed by FPA Medical (FPAM). In 1996, FPAM paid $197 million to nursing home operator Foundation Health to purchase a group of medical practices. As part of the acquisition, however, FPAM guaranteed that Foundation's patients would receive continued and uninterrupted access for the next 30 years. In exchange, Foundation (the seller) agreed to pay FPAM $55 million in rebates over two years. As FPAM received the $27.5 million payment each year, it recorded these amounts as sales revenue. As we thought through the essence of this transaction, we considered it quite aggressive to record any revenue for the transaction. In real economic terms, FPAM paid $197 million and received $55 million rebate over two years, resulting in a net acquisition cost of $142 million and zero revenue on this deal.

Turning the Sale of a Business into a Recurring Revenue Stream

Some companies will sell a manufacturing plant or a business unit to another company and, at the same time, enter into an agreement to buy back product from that sold business unit. Like the FPAM-Foundation deal, when cash is flowing in two directions, opportunities abound for playing games regarding how the flows are classified.

Consider the November 2006 deal between semiconductor giant Intel and fellow chip manufacturer Marvell Technology Group. Intel agreed to sell certain assets to Marvell. At the same time, Marvell agreed to purchase a minimum number of semiconductor wafers from Intel over the next two years.

In studying the footnotes to the financial statements of both companies, we learned that Intel priced this business below market value (presumably booking a smaller gain on that sale), but it was made whole as Marvell

agreed to later purchase wafers at *above market prices* (thereby creating a new and inflated recurring revenue stream). In short, Intel used a shenanigan that resulted in shifting some of the one-time gain related to an asset sale to increase its recurring revenue from selling a product to a customer.

Question the Management of the Acquirer When Changing Accounting Practices of a Target Inflate Profits While the first AA Shenanigan showed how the target company could play games to aid the acquirer, the acquiring company still has a lot of cards it can play to inflate profits *after* the deal closes. Recall that in Chapter 3 we discussed the accounting change made just after Valeant acquired Medicis. In the first quarter after the deal closed, Valeant changed the revenue recognition policy for Medicis so that sales would be recognized sooner, thereby inflating Valeant's revenue and profits. Medicis sold through its distributor, McKesson, which then sold to its customer, the physicians. Medicis historically used the more conservative "sell-through" approach, that is, 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 more aggressive "sell-in" approach and started recognizing sales much earlier—when product was sent to the distributor. Not surprisingly, this brazen change in revenue recognition caught the attention of the SEC, which notified the company in a formal letter and asked it to explain any reasons for this change.

4. Inflating Profits by Releasing Suspicious Reserves Either Before or Just After Closing

During the closing process of a deal, a variety of new opportunities are created for management to provide an artificial boost to income at a later point. Management can include taking a charge for layoffs or projected legal payments and later releasing part of these reserves back into income as management deems such payments will be much less than first anticipated (the quintessential example of this shenanigan is CUC, profiled in Chapter 1). The acquirer can also set up a bigger-than-necessary reserve for contingent consideration payments that might be paid to the owners of

the target company, then later release some of the reserves back into income when they are deemed unnecessary.

Releasing Deal-Related Reserves When Contingency Payments May Be Payable

Let's assume you buy a business paying $60 million and later might have to pay an "earn-out" for as much as another $40 million if the acquired business achieves certain agreed-upon targets. That $40 million would be recorded as a "contingent consideration liability" on the Balance Sheet. Say, one year later, the business performs *below* expectations and the expected payout drops to $30 million. You must make an accounting entry reducing (debiting) the contingent consideration reserve and reducing (crediting) operating expenses, which results in a $10 million increase to earnings. On the face of it, the outcome seems illogical. You *increase* your profits when the business you bought *underperforms*. From an accounting perspective, however, the reduction of the future earn-out is considered a gain.

If a company wants to play games with its contingent consideration reserve, it is quite easy to do. Both inflating the initial fair market value of the total estimated payments to be made and later asserting that the acquired business is performing poorly (and little or no future payments will be made), management, like a master magician, can take out its wand and create profits out of thin air.

Watch for Big Gains from Reductions of Contingent Consideration Liability Apparel manufacturing giant Li & Fung materially boosted its operating income during the first six months of 2012 by lowering an acquisition-related contingent consideration liability from potential earn-out payments. This simple management decision resulted in a $198 million gain (51 percent of its operating profit) during the six-month period. Investors should have raised concerns about the disappointing performance of the acquired businesses, because the reduction in the contingent liability indicated that certain of the acquired businesses must have missed performance targets set by Li & Fung as of the acquisition date.

Looking Forward

Chapter 15 demonstrated how managers, under the cover of an acquisition, can cleverly inflate profits and trick investors. The following chapter shows

how managers can use the acquisition structure and flexibility to inflate reported cash flow from operations.

16
Acquisition Accounting Shenanigan No. 2: Inflating Reported Cash Flow

The Friday after Thanksgiving is generally considered the unofficial start of the holiday shopping season. Traditionally, it is one of the biggest shopping days of the year, if not *the* biggest. The day has long been called “Black Friday” since many people are hopeful that it will be the day when retailers move “into the black” (accounting slang for “turning a profit”) for the year. Every time Black Friday approaches, retailers are quick to remind us of all the holiday shopping we need to do. They offer huge sales and fill the airwaves and newsprint with “Shop ’til You Drop” advertisements trying to lure us into their stores.

Tyco and WorldCom seemed to adhere to the “Shop ’til You Drop” mantra quite literally; however, they were buying entire businesses, and their holiday season ran all year long for many years. In the late 1990s and early 2000s, both companies went on lavish shopping sprees, acquiring business after business to fuel impressive performance. Organic growth at Tyco and WorldCom was much weaker than investors realized, though, as the companies hid their problems by acquiring oodles of companies and futzing with the accounting to show impressive results. They shopped and shopped—until the exposure of their massive accounting frauds caused them to drop like a ton of bricks.

Throughout their shopping sprees, both companies satiated investors and quashed naysayers by consistently reporting strong cash flow from operations. However, this cash flow was not a sign of operational strength at all. Rather, it came mainly from a liberal use of AA Shananigan No. 2: Inflating Reported Cash Flow.

In this chapter, we will discuss three techniques by which Tyco, WorldCom, and other companies use acquisitions and disposals to enhance

and flatter CFFO.

Acquisition Accounting Techniques to Artificially Boost Cash Flow from Operations

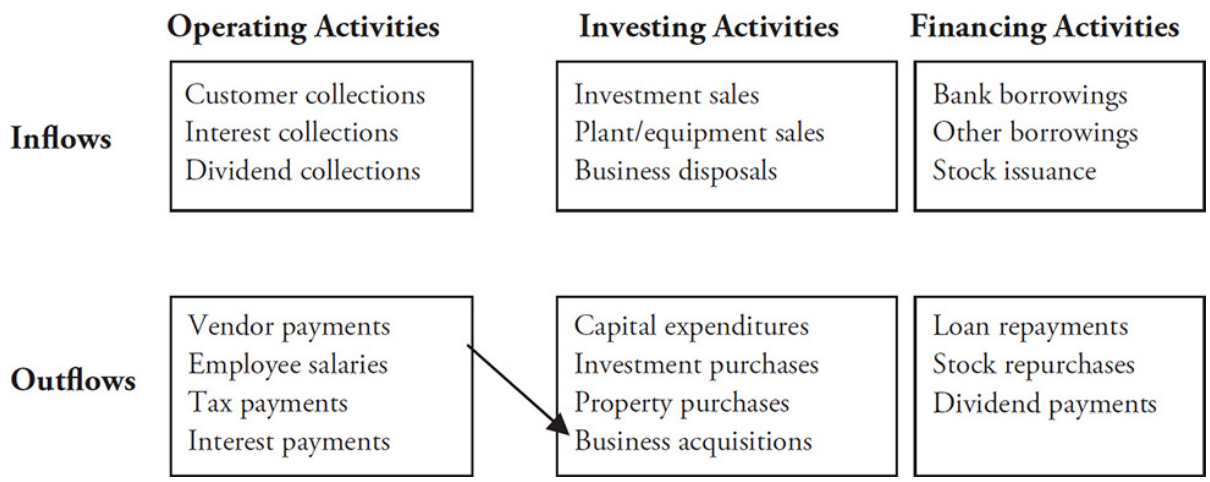
1. Inheriting operating inflows in a normal business acquisition
2. Acquiring contracts or customers rather than developing them internally
3. Boosting CFFO by creatively structuring the sale of a business

1. Inheriting Operating Inflows in a Normal Business Acquisition

The cash flow shifting tricks in this chapter have many similarities to the ones we discussed in Chapter 11; they represent shifts between the Operating section and other sections. However, in this chapter, we focus solely on shifts that are related to acquisitions and disposals. The first two techniques in this chapter involve shifting cash outflows from the Operating section to the Investing section, as shown in Figure 16-1.

Rabidly acquisitive companies such as Tyco and WorldCom often report impressive CFFO quarter after quarter. Faced with the opacity that is inherent whenever multiple sets of financial statements are suddenly combined, investors in these types of companies often rely more heavily on CFFO generation as a sign of business strength and earnings quality. Unfortunately, heavy reliance on CFFO for acquisitive companies is ill-advised because of a deep, dark secret that companies want to hide from investors.

Figure 16-1 Shifting Cash Outflows from Operating Activities to Investing Activities



This secret concerns an accounting quirk (read "loophole") that enables acquisitive companies to show strong CFFO every quarter *simply because they are acquiring other businesses*. In other words, the mere act of acquiring a company provides a benefit to CFFO. How can this be true? Well, it's a peculiar side effect from the accounting rules that segregate cash flows into three sections. The quirk is quite simple and easy to understand.

Imagine you are a company that is getting ready to make a business acquisition. When you pay for the acquisition, you do so without affecting CFFO. If you buy the company with cash, the payment is recorded as an *investing outflow*. If you offer stock instead, there is, of course, no cash outflow.

As soon as you gain control of the company, all the ins and outs of the acquired business become a part of the combined company's operations. For example, when the newly acquired company makes a sale, you record that sale on your Income Statement as revenue. Similarly, when the newly acquired company collects cash from a customer, you record that collection on your Statement of Cash Flows (SCF) as an operating inflow. Think about the cash flow implications of this situation. For one, you could generate a new cash flow stream (the acquired business) without any initial CFFO outflow. In contrast, companies that seek to grow their business *organically* would generally first incur CFFO outflows to build the new business.

Additionally, now that you have inherited the receivables and inventory of the acquired business, you can generate an unsustainable CFFO benefit by rapidly liquidating these assets (that is, by collecting the receivables and selling the inventory). Normally, accounts receivable result from past cash expenditures (e.g., cash paid to purchase or manufacture the inventory

sold). In other words, a cash inflow from collecting a receivable comes only after you have had a cash outflow to generate that receivable. When you acquire a company, however, and inherit its accounts receivable, the cash outflows involved in generating those receivables were recorded on the acquired company's books prior to the acquisition. This means that when you collect these receivables, you will be receiving an *operating cash inflow* without ever having recorded a corresponding *operating cash outflow*. The same is true with inventory. The proceeds received from selling inventory inherited in an acquisition will be recorded as an operating inflow even though no operating outflow ever occurred.

Think of it this way: cash spent to purchase inventory and other costs related to the sale *occurred before the acquisition*, and when you close on the deal, you obviously must pay the seller for inventory, receivables, and so on, but those outflows are reflected in the Investing section. Then, after the deal closes, you collect all that delicious cash from customers and show it as inflows in the Operating section. By liquidating and not replenishing these assets (i.e.., keeping the acquired business's inventories at a lower level), you can show an unsustainable benefit to cash flow. Brilliant! In an acquisition context, cash outflows never hit the Operating section, yet all the inflows do.

To be fair, when companies inherit working capital liabilities (such as accounts payable), then the acquirer will be on the hook for paying off the seller's vendors and the cash paid will be an operating cash outflow. However, most acquisitions involve companies that *have positive net working capital* (more receivables and inventory than accounts payable).

Accounting Capsule: The Impact of Acquisition Accounting on CFFO

A quirk in the accounting rules gives many companies a benefit to CFFO just for acquiring a company. When a company grows organically, naturally, it incurs CFFO outflows (payments for creating and marketing products) to create CFFO inflows (receipts from customers). However, a company that grows by acquiring other businesses would classify some CFFO outflows regarding working capital differently on the SCF. In short, since the entire acquisition price (including working capital of the target company acquired) would be included in the CFFI (cash flow from

investing) section of the SCF, naturally, CFFO would be artificially inflated.

To understand why, realize that cash spent to acquire another business runs through the Investing section of the Statement of Cash Flows (of course, stock issued for an acquisition does not impact the SCF at all). As a result, when buying another business, companies inherit a new stream of cash flows without having to incur a CFFO outflow. Moreover, by liquidating the working capital of the acquired business, a company can provide itself with an unsustainable CFFO boost. These accounting nuances are why companies that grow through acquisitions often appear to have stronger CFFO than companies that grow organically.

It is important to realize that because this CFFO boost is simply an artifact of required acquisition accounting, even the most honest companies will benefit from inflated CFFO after an acquisition. Moreover, this boost may cause "quality of earnings" measures (such as comparisons of CFFO to net income) to improve, particularly if a company does not engage in any Earnings Manipulation Shenanigans at the time of the acquisition.

Serial Acquirers Receive This CFFO Boost Repeatedly

So far, we have established that by their very nature, acquisitions serve to boost CFFO. Consider the impact at companies that make numerous acquisitions every year, serial acquirers like Tyco and WorldCom. Many investors criticize serial acquirers for being able to produce revenue and earnings growth only inorganically by "rolling up" acquisitions.

These "roll-ups" often reject this criticism and point to their CFFO as proof that they are running the acquired businesses well and exploiting synergies. Many investors believe this hype because they fail to understand the lesson you just learned: stronger reported CFFO is merely an accounting side effect from acquiring numerous companies each year.

Putting the "Con" in Conglomerate

For some companies, these pure boosts to cash flow are seemingly not enough. They want to squeeze even more juice out of these acquisitions. Consider the following scenario, based on allegations in legal proceedings of Tyco's behavior during the acquisition process.

Imagine that you work in the accounting department of a company that just announced that it was being bought by a serial acquirer. The acquisition has not officially happened yet, but it is a friendly takeover with lucrative terms, and the deal is likely to close before the end of the month. The new owners want to start coordinating operations.

In walks one of the finance executives from the acquirer. He calls a meeting with the team and discusses some logistics that he says will help the transition go more smoothly. He points to a pile of checks—payments from customers that you had planned to deposit later that day. “You see all those checks? I know you normally deposit them at the end of the day, but let’s hold off on that for now. Put them in the drawer, and we’ll deposit them in a few weeks. And let’s call up our biggest customers and tell them that they can hold off on paying us for a few weeks. I know that sounds odd, but this will score us some points and ensure that they stay loyal through the transition.

“And you see that pile of bills? I know you normally wait until the deadline approaches to pay them; however, let’s pay them down ASAP. In fact, see if you can prepay any vendors or suppliers—I’m sure those folks would be willing to take our money and perhaps even give us a discount. We certainly have enough cash in the bank; let’s put it to good use.”

The day after the acquisition closes, the executive returns. “Now that we are one company, it’s time to go back to normal business procedure. Deposit those checks immediately and start collecting from customers. And stop paying those bills early—let’s wait until we get closer to the deadline.”

Think about the cash flow implications of this scenario. The target company’s CFFO was abnormally low in the weeks leading up to the acquisition because of abandoning collection efforts and paying down bills rapidly. However, once the acquisition closed, there were an unusually large number of receivables to collect and an unusually small number of bills to pay. This causes CFFO for your division to be abnormally high in the period immediately after the acquisition.

The finance executive had a trick up his sleeve. His reasons for abandoning collection efforts and prepaying vendors had little to do with engendering goodwill. He concocted this scheme to boost the CFFO of the combined company in the first quarter after the acquisition. Granted, the effect of this benefit would be short-lived; however, the executive knew that

the scheme could continue if the company kept rolling up more and more acquisitions each quarter.

Tyco: The Mother of All Roll-Ups

This scenario is similar to allegations of what happened behind the scenes when Tyco made its acquisitions. And Tyco made *a lot* of acquisitions. From 1999 to 2002, Tyco bought more than 700 companies (not a typo) for a total of approximately $29 billion. Some of these acquisitions were large companies; however, most of the businesses acquired were small enough that Tyco considered them "immaterial" and chose to disclose nothing at all about them. Imagine the impact that this game could have with 700 companies worth a combined $29 billion! It should come as no surprise, then, that Tyco was able to generate strong CFFO over these years, as shown in Table 16-1. But it certainly was not from a booming business!

Table 16-1 Tyco's Cash Flow from Operations (from Continuing Operations)

($ millions)	FY 1999	FY 2000	FY 2001	FY 2002
Cash flow from operations	3,550	5,275	6,926	5,696

Treat CFFO Differently for Acquisitive Companies Since acquisitions create an unsustainable boost to CFFO, investors should not blindly rely on CFFO as a barometer of performance. Use free cash flow *after* acquisitions to assess cash generation at acquisitive companies. Table 16-2 shows that Tyco recorded negative free cash flow after acquisitions each year, despite reporting positive CFFO; this was a warning that operating cash flow was not what it appeared to be.

Table 16-2 Tyco's Free Cash Flow After Acquisitions (from Continuing Operations)

($ millions)	1999	2000	2001	2002
Reported cash flow from operations	**3,550**	**5,275**	**6,926**	**5,696**
Subtract: Capital expenditures	(1,632)	(1,704)	(1,798)	(1,709)
Subtract: Construction in Progress	—	(111)	(2,248)	(1,146)
Free cash flow	**1,918**	**3,460**	**2,880**	**2,841**
Subtract: Acquisitions	(5,135)	(4,791)	(11,851)	(3,709)
Free cash flow after acquisitions	**(3,217)**	**(1,331)**	**(8,971)**	**(868)**

TIP

"Free cash flow after acquisitions" is a useful measure of cash flow when analyzing serial acquirers. This metric can easily be calculated from the Statement of Cash Flows: CFFO *minus* capital expenditures *minus* cash paid for acquisitions.

Review the Balance Sheets of Acquired Companies If these documents are available, then absolutely review them. Doing so should help you gauge the potential inherent working capital benefits. It may be difficult to be precise in this analysis; however, you often will be able to make an assessment that is within the "ballpark" of the benefit. Companies often disclose the Balance Sheets of larger acquisitions and sometimes an aggregate Balance Sheet for smaller ones in their footnotes. If the acquired company had publicly traded stock or bonds, you can probably obtain a Balance Sheet from public records.

2. Acquiring Contracts or Customers Rather Than Developing Them Internally

In the previous section, we discussed how acquisitions, by their very nature, provide a boost to CFFO. This benefit results not from illegitimate accounting maneuvers, but rather from quirky accounting rules. We witnessed Tyco abusing the rules by quietly snapping up hundreds of small companies and finding ways to squeeze even more CFFO out of these acquisitions.

In this section, we take a step into more nefarious terrain and explore how companies use the acquisition accounting loophole for nonacquisition situations to shift normal operating cash flows to the Investing section.

Among the hundreds of businesses Tyco owned was an electronic security monitoring provider. Home security monitoring was a fast-growing industry in the 1990s, and Tyco's ADT division proved to be among the most popular brand names. Tyco generated new security systems contracts in two ways: through its own direct sales force and through an external network of dealerships. The dealers allowed Tyco to outsource a portion of its sales force. They were not on Tyco's payroll, but they sold security contracts, and Tyco paid them about $800 for every new customer.

Oddly, Tyco executives did not view these $800 payments to dealers to be normal customer solicitation costs, as the economics would suggest. Instead, they deemed these payments to be a purchase price for the "acquisition" of contracts. Thus, after the dealer presented Tyco with many contracts and received payment, Tyco curiously accounted for these "contract acquisitions" in the same way that it accounted for normal business acquisitions: as investing outflows.

Given how deeply the acquisition mentality was engrained in Tyco's culture and DNA, you can almost picture the confusion among its executives. Almost. These customer solicitation costs resemble normal operating expenditures much more closely than they resemble business acquisitions. As a result, it makes more sense for them to be recorded on the Statement of Cash Flows in the same way that Tyco's internal sales force commissions are recorded: as operating outflows. By classifying these operating outflows in the "acquisitions" line in the Investing section, Tyco found a convenient way to overstate CFFO. *And the company didn't stop there!*

From Aggressive Accounting to Fraud

By turning the Investing section into a hidden dumping ground for customer solicitation costs, Tyco aggressively and creatively twisted the accounting rules. But the company still wanted more. So it concocted a new scheme to inflate CFFO (and earnings) even further, and in so doing, it crossed the line from aggressive accounting to fraud. The SEC charged that from 1998 to 2002, Tyco used a "Dealer Connection Fee Sham Transaction" to fraudulently generate $719 million in CFFO. Here's how it worked:

For every contract Tyco purchased from a dealer, the dealer would be required to pay an up-front $200 "dealer connection fee." Of course, the dealers would not be happy about this new fee, so Tyco raised the price at which it would purchase new contracts by the same $200—from $800 to $1,000. The net result caused no change in the economics of the transaction—Tyco was still paying a net of $800 to purchase these contracts from dealers.

However, Tyco did not see it that way. After all, the company would not have created the ruse unless management felt the tactic would be beneficial in the end. Tyco now recorded a $1,000 investing outflow for the purchase of these contracts and an offsetting $200 as an operating inflow. Essentially,

Tyco created a bogus $200 CFFO inflow by depressing its investing cash flow. (See Table 16-3.) Over the course of five years and hundreds of thousands of contracts, this was quite a contribution to CFFO!

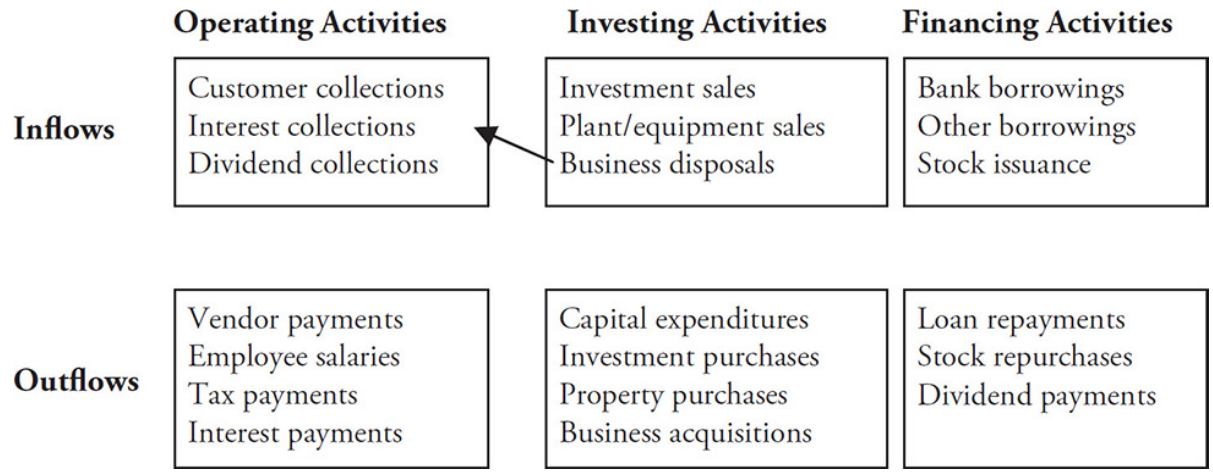
Table 16-3 Tyco's Creative Classification of Net Payments to Dealers

	Original	Sham	Tyco's SCF
Tyco purchases contract from dealer	$800	$1,000	Investing outflow
Dealer pays "connection fee" to Tyco	—	($200)	Operating inflow
Net payment by Tyco to dealer	$800	$800	—

3. Boosting CFFO by Creatively Structuring the Sale of a Business

In the previous two sections, we showed how companies use acquisitions to shift cash *outflows* from the Operating section to the Investing section of the SCF. In this next section, we discuss the flip side of that coin: how companies use disposals to shift cash *inflows* from the Investing section to the Operating section, as shown in Figure 16-2.

Figure 16-2 Shifting Cash Inflows from Investing Activities to Operating Activities



Recording CFFO for Proceeds from the Sale of a Business

In 2005, Softbank structured an interesting two-way arrangement with fellow Japanese telecom company Gemini BB. Softbank sold its modem rental business to Gemini, and simultaneously, the companies entered into a "service agreement" in which Gemini would pay Softbank royalties based

on the modem rental business's future revenue. At the time of the sale, Softbank received ¥85 billion in cash from Gemini, but Softbank did not consider the entire amount to be related to the sale price of the business. Instead, Softbank decided to split the cash received into two categories: ¥45 billion was allocated to the sale of the business, and ¥40 billion was deemed to be an "advance" on the future royalty revenue stream. (You may recall the earnings boost that this transaction provided, as discussed in EM Shenanigan No. 3 in Chapter 5.)

The economic reality of this situation seems to be that Softbank sold its modem rental business for ¥85 billion. However, the way it structured the transaction seemingly allowed Softbank to exercise discretion in its presentation of cash flow. Rather than recording an ¥85 billion *investing* inflow from the sale of the business, Softbank recorded (1) a ¥45 billion *investing* inflow from the sale of the business and (2) a ¥40 billion *operating* inflow from the "advance" on future revenue. This ¥40 billion boost to CFFO represented 69 percent of Softbank's ¥57.8 billion in CFFO for the full year.

Watch for New Categories on the Statement of Cash Flows Investors could easily have spotted Softbank's CFFO boost just by looking at the Statement of Cash Flows. Look at Table 16-4, and note that a new line item surfaced in 2006—a ¥40 billion "increase in deferred revenue." This Statement of Cash Flows disclosure (together with the magnitude of its impact on CFFO) would be reason enough for astute investors to dig deeper.

Table 16-4 Softbank's Statement of Cash Flows, 2005–2006

(¥ millions)	2005	2006
Pretax earnings	(9,549)	129,484
Depreciation and amortization	66,417	80,418
Other noncash gains, net	(115,659)	(136,455)
Increase in trade receivables	(15,854)	(23,333)
Increase in trade payables	2,373	4,331
Increase in deferred revenue	—	**40,000**
Increase in other receivables	(70,813)	(9,865)
Increase (decrease) in other payables	97,096	(26,774)
Cash flow from operating activities	(45,989)	57,806

Sell the Business, but Keep Some of the Good Stuff

Tenet Healthcare is a company that owns and operates hospitals and medical centers. In recent years, Tenet has sold some of its hospitals to improve its liquidity and profitability. It often played a neat little CFFO-enhancing trick when structuring the sale of these hospitals—it sold *everything but the receivables*.

Let's discuss how this works. Think of each hospital as being its own little business, with revenue, expenses, cash, receivables, payables, and so on, just like any other company. Before putting a hospital up for sale, Tenet strips the receivables out of the business. In other words, if a hospital has, say, $10 million in receivables, Tenet keeps the rights to those receivables and puts the rest of the business up for sale. This, of course, lowers the eventual sale price of the hospital by about $10 million, but Tenet couldn't care less, as it recoups that amount when it collects the receivables.

What are the implications about cash flow? Well, normally all proceeds from selling a hospital would be recorded as an investing inflow (just like the sale of any business or fixed assets). But by stripping out the receivables prior to the sale, Tenet lowers the sale price (and the investing inflow) by $10 million. However, the company will soon collect the $10 million from its former customers, and here's the nice part: all the proceeds will be reported as an operating inflow, since it is related to the collection of receivables. This trick allowed Tenet to shift the $10 million inflow from the Investing to the Operating section.

This game would have been spotted by those diligent investors who read Tenet's financial reports. As presented below, the company clearly disclosed in its March 2004 10-Q that it planned to keep $394 million in receivables related to the sale of 27 hospitals.

TENET'S DISCLOSURE ABOUT THE SALE OF HOSPITALS, 3/04 10-Q

Because *we do not intend to sell the accounts receivable* of the asset group, except for one hospital, these receivables, less the related allowance for doubtful accounts, have been included in our consolidated net accounts receivable in the accompanying condensed consolidated Balance Sheets. At March 31, 2004, *the net accounts receivable for the hospitals to be divested aggregated $394 million*. [Italics added for emphasis]

Buy the Business, but Not Any of the Bad Stuff

In the last section, we showed how Tenet inflated its future operating cash flows by cleverly structuring a sale of a business—by selling everything *except* the receivables. Well, a buyer of a business can also inflate its cash flows in much the same way; that is, by buying everything *except* the payables. And that is exactly the ploy used by Treehouse Foods in early 2016 when it bought Private Brands for $2.7 billion. Ordinarily in this type of acquisition, Treehouse would have assumed the assets and liabilities of Private Brands on the day the deal closed. However, in this case, the acquisition *specifically excluded accounts payable* for nine of Private Brands' manufacturing facilities. These obligations were essentially carved out of the acquisition, resulting in a higher purchase price corresponding with higher net assets. Following the consolidation, Treehouse's operating cash flow benefited from cash collections of the working capital assets that had been acquired, and conveniently did not incur the natural offset of these benefits, as it didn't hold the associated accounts payable. Very clever, indeed.

Buy Controlling Interest in a Business, but Use Restricted Cash to Hide Outflows

When Whirlpool acquired a controlling interest in Chinese appliance manufacturer Hefei Sanyo, the company segregated cash into a restricted account to cover the working capital and ongoing research and development needs of that business. Over the next few years the liquidity needs of Hefei Sanyo (renamed Whirlpool China) were funded from the restricted cash account. Like most companies, Whirlpool's Statement of Cash Flows provided a reconciliation to the beginning and ending balances of ordinary (unrestricted) cash, so the payments from the separate account had no adverse impact on reported operating or free cash flow.

Fuzzy Line Between Operating and Investing Outflows

Sometimes acquisitions create a murky situation making it difficult to distinguish between investment activities and operating activities. This is particularly true when the acquired business was previously owned by partners/employees who are to remain involved in operations on an ongoing basis. MDC Partners provides a good example. This New York City–based advertising agency grew in large part by acquiring smaller agencies, closing several deals each year. Typically, only part of the acquisition price would be paid up front, with significant portions structured as earn-outs and paid over time. Since the company mainly acquired partnerships, the ongoing earn-out payments were directed to existing workers and likely represented a big portion of their annual income. Whether such payments are strictly "capital payments" or in some part more like compensation is hard to determine and can be quite subjective. In all cases, though, the payments are reflected as a reduction of cash flow from financing activities, and they enrich employees without having any adverse effect on reported operating or free cash flow.

Looking Ahead

The next chapter covers AA Shenanigan No. 3: Manipulating Key Metrics and completes our discussion on acquisition accounting tricks.

17
Acquisition Accounting Shenanigan No. 3: Manipulating Key Metrics

Academic research has long supported the claim that most acquisitions destroy shareholder value. Management must therefore work very hard to convince investors of the merits of a deal. That's where AA Shenanigan No. 3: Manipulating Key Metrics comes in handy to portray a business combination in a very favorable light. As Key Metric Shenanigans have become much more pervasive in recent years, there has been an uptick in misleading non-GAAP metrics used by the most acquisitive companies.

Inflating Sales Growth at the Core Business

When analyzing acquisitive companies, investors often have a difficult time separating organic revenue growth in the legacy business from revenue growth in the acquired company. A major obstacle is that organic revenue growth is not a measure defined by GAAP, thereby allowing management to come up with its own calculation (or not disclose organic growth at all). Naturally, management would like investors to believe that its core business is strong, so investors must be extra vigilant when interpreting company-defined measures of organic growth.

Determining Representative Sales Growth Rates Following an Acquisition

When evaluating a company that completes an acquisition, it's important to recognize the impact of the deal on reported revenue, and assess what the growth rate would have been absent the transaction. The results of the acquired business are included on a GAAP basis from the moment the transaction closes, so naturally reported sales growth will be artificially boosted. There are several ways that investors can correct for this distortion

and arrive at a more accurate understanding of the real underlying growth rate of the business.

In many cases the acquirer will provide a footnote disclosure that shows sales on a "pro-forma" basis, which includes the results from recently acquired businesses, along with the legacy businesses, from the beginning of the prior-year period. This can be a very useful disclosure, as it provides the year-over-year growth rate of the business units that now comprise the company. In other cases, the acquirer may disclose the contribution of the target company to overall revenue post-consolidation. This too is a useful disclosure, as it provides the reader with enough information to calculate what reported results would likely have been absent the transaction.

In the presence of a significant acquisition we recommend reading through each of the available disclosures, and crunching the numbers, in order to parse out the underlying growth rates of the legacy business, the acquired business, and the combined business.

Look for Strange Definitions of Organic or Pro Forma Sales Growth

Affiliated Computer Systems (ACS) had an odd way of presenting its organic growth, or what it called "internal growth." Rather than simply excluding all revenue from acquired businesses when calculating internal growth, ACS calculated a fixed amount to remove based on the acquired business's revenue for the previous year. (See ACS's disclosure below.) This meant ACS could include in its own internal growth any large deals that the acquired company booked just before the acquisition.

ACS'S INTERNAL REVENUE GROWTH DEFINITION, MARCH 2005 EARNINGS RELEASE

Internal revenue growth is measured as total revenue growth less acquired revenue from acquisitions and revenues from divested operations. Acquired revenue from acquisitions *is based on pre-acquisition normalized revenue of acquired companies*. [Italics added for emphasis]

To illustrate, let's hypothetically assume that ACS acquired a company on January 1, 2005. In 2004, that target company had generated $120 million in revenue ($30 million per quarter). In the weeks before the acquisition, the target company also closed a large deal that would bring in an additional $10 million in revenue each quarter beginning in 2005.

Now assume that in March 2005 (the first quarter after the acquisition), the target company generates $40 million in revenue as expected (the normal $30 million plus $10 million from the new contract). ACS, when calculating its own March 2005 internal revenue growth, logically should exclude this entire $40 million because none of it would have been included in ACS's revenue absent the acquisition. However, ACS's calculation allows the company to treat the new $10 million contract as part of its own "internal" growth. As a result, ACS's internal revenue growth would improperly benefit from revenue that came from the acquired company's business. Clearly, this is not an apples-to-apples comparison.

TIP

Scrutinize the organic growth calculation of acquisitive companies, as it may include revenue that spilled over from the target company.

Raise Your Antennae When Key Metrics Include Acquired Revenue Streams

Usually same-store sales metrics exclude the effects of new stores; however, when Starbucks went about acquiring regional licensees beginning in 2004, it brought existing stores into the comp base immediately. As a result, Starbucks calculated same-store sales using a different universe each quarter—hardly a comparable metric. If Starbucks had been purchasing its strongest licensees, this acquisition activity would have had a positive impact on same-store sales performance, thereby misleading investors about the company's underlying sales growth.

As discussed in Chapter 13, comparing same-store sales with average revenue per store is a helpful way to identify inorganic changes in the same-store sales metric. In 2006, Starbucks's same-store sales trend began diverging from its revenue per store trend. The gap widened in 2007, and in September 2007, Starbucks reported that U.S. traffic had fallen for the first time ever. When same-store sales in the United States turned negative in

December, Starbucks announced it would no longer disclose same-store sales, stating that it would "not be an effective indicator of the Company's performance."

Look Out for Acquisitions of Companies with Competing Products

Sometimes a company will acquire a competitor in order to wind down a competing product and move the target's customers onto the acquirer's platform. This may be a good business strategy, but it could wreak havoc with organic growth metrics. For example, 3D printer manufacturer 3D Systems acquired competitor Z-Corp in 2012 and quickly announced that it would discontinue some of Z-Corp's products. Naturally, Z-Corp's revenue fell after being acquired, and 3D Systems reported strong organic growth. Any revenue growth that 3D Systems derived from legacy Z-Corp customers should not be considered organic.

Highlighting Inflated Earnings

Acquirers often incur substantial deal-related costs (legal, investment banking, integration, etc.) and have much leeway regarding classification of these costs as one-time in nature and segregating them below the line. That is, management might guide investors to ignore such costs and only consider normal recurring operating costs. In theory, it may sound sensible to ignore one-time costs, as by definition, they should not be there next year.

However, for companies that do deal after deal, such costs are absolutely *recurring* and a regular part of the cost structure. Additionally, companies doing many deals and incurring many write-offs often cross the proverbial line and improperly shift some normal recurring operating costs (selling, R&D, administration, etc.) below the line into the nonrecurring category.

Be Skeptical When GAAP Earnings Materially Lag "Adjusted Earnings"

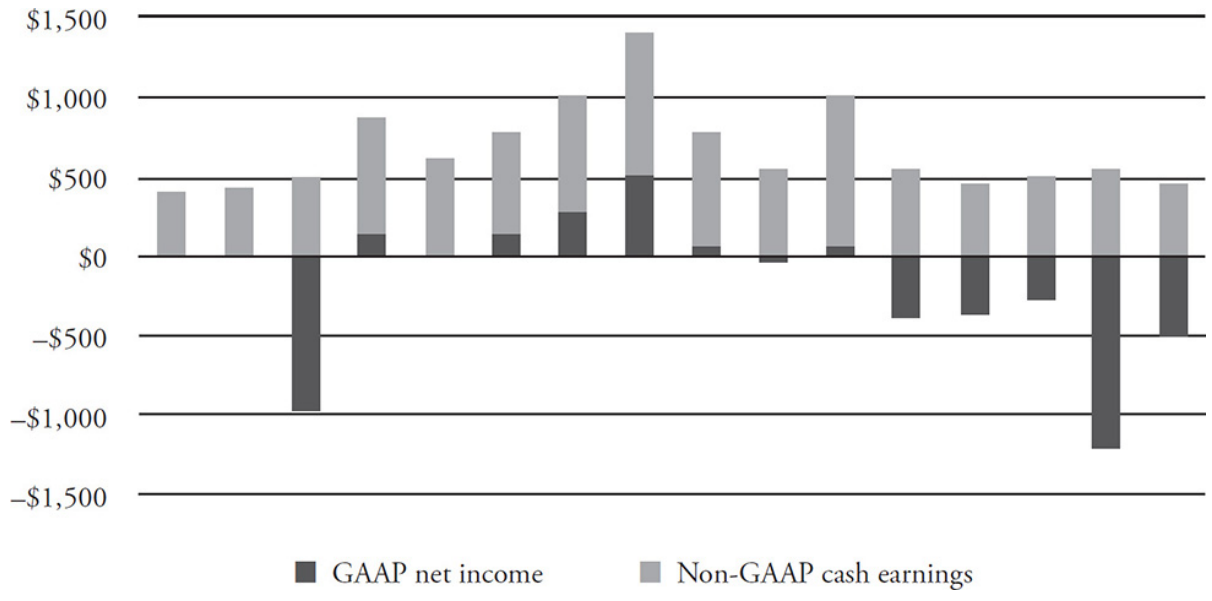
A good rule of thumb to assess legitimacy of a non-GAAP metric is to compare it with the corresponding GAAP-based metric. So if the non-GAAP "adjusted earnings" tracked closely to GAAP-based net income, we consider the non-GAAP equivalent as legitimate. Of course, if the non-GAAP metric continually produced "A-plus" results and the GAAP-based

equivalent produced “D-minus” results, investors should reject the non-GAAP metric.

Consider the metrics posited by Valeant highlighting its “stellar” performance under the metric “cash earnings.” Valeant generated a three-year total (2013–2016) GAAP-based net income of *negative* $2.7 billion, but the company boasted a cumulative non-GAAP “cash earnings” of *positive* $9.6 billion—a staggering differential of over $12 billion. With the non-GAAP metric lagging the GAAP-based equivalent by such a large amount (and one a profit and the other a loss), investors should reject the non-GAAP metric as woefully misleading.

In Figure 17-1, we show Valeant’s reported GAAP versus non-GAAP profits for the 16 quarters covering 2013 through 2016. Notice that in most quarters, GAAP-based net income was either negative or very close to zero. One exception, however, was Q4 2014, shown as the highest bar right in the middle of the chart, with GAAP-based net income approaching $500 million. That figure, however, should have a big asterisk, since it includes the one-time $287 million pretax gain on the sale of its stake in another business (Allergan). Clearly, Valeant’s gain should be considered one-time in nature, so the chasm between GAAP and non-GAAP earnings would be even greater than the $12 billion differential.

Figure 17-1 VRX NI Versus Cash Earnings, 2013–2016, by Quarter



TIP

Be extremely skeptical when management purveys a non-GAAP metric that always looks far better than its GAAP counterpart.

Looking Forward

Part Six includes two chapters that tie everything together. Chapter 18 shows the unraveling of three prominent companies, each of which used a variety of shenanigans to fool investors. Chapter 19 discusses key elements of the forensic mindset and offers 10 takeaway lessons that will help you become a better investor.

PART SIX
PUTTING IT ALL TOGETHER

Congratulations! You have scaled the fourth and final shenanigan mountain. In Chapter 18, we look at three storied companies whose accounting shenanigans turned them into some of the largest corporate debacles in recent years. Then in our closing chapter, “The Forensic Mindset,” we reflect on the most important issues and questions to keep in mind as you voyage through financial statements.

18
The Unraveling

Until now, *Financial Shenanigans* has mainly focused on describing a variety of accounting tricks and how investors could have spotted them. Companies using such tricks to hide business problems sometimes collapse in a spectacular fashion, creating large losses for investors. We refer to this meltdown as the unraveling.

This chapter highlights three companies that employed a variety of shenanigans to hide business problems from investors but eventually imploded as the accounting scandals were revealed. The first two companies profiled have had a long history of success (Hertz Global Holdings and Toshiba Corporation). The third company profiled is a relative newcomer, but had a spectacular rise and fall in less than a decade (Valeant Pharmaceuticals).

Hertz

Background and History

Founded in 1918, Hertz has been a leader in the car rental business for a century. For many years, it was owned by large publicly traded companies including RCA, UAL, and until late 2005, Ford Motor Company. In June of 2005, Ford announced plans to spin out Hertz in an IPO, but several months later, a trio of private equity firms (Carlyle, Clayton Dubilier & Rice, and Merrill Lynch Private Equity) made an offer to buy the entire company. In December of 2005, the trio paid $15 billion for Hertz in a heavily leveraged transaction. In this fast-moving drama, not even seven months later, the trio filed to take Hertz public, which resulted in a November 2016 IPO. As a "last hurrah" before the IPO, the private equity sponsors took a new $1 billion loan to pay themselves a special dividend in the same amount. After the public offering, the trio continued to hold a controlling interest in Hertz.

The Years as a Public Company

Hertz was hit severely during the 2008 financial crisis, and its stock price plummeted to $1.56 during its darkest days. Over the subsequent years, its business slowly recovered, and revenue began rising in 2010 and each year through 2013. With the company seemingly in fine shape, the trio sold their remaining stake in early 2013.

By early autumn, the first signs of possible trouble for investors blew in with the September 23 announcement that Hertz's longtime CFO, Elyse Douglas, would leave just one week later for "personal reasons." A few things about Ms. Douglas's decision seemed odd: the *timing* and the *reason*. No doubt, seasoned executives regularly leave jobs for better ones or even to spend more time with family. But they almost never give just a single week's notice. Also, late in the year just when the finance team should be getting the year-end results ready for the auditors is a terribly troublesome time to leave a company—particularly on such short notice. More warning signs followed in quick succession.

When the new CFO, Thomas Kennedy, arrived, he must have found the accounting to be a mess. The first evidence of his concerns appeared when Hertz filed a Non-Timely (NT) 10-K on March 3, 2014, requesting an extension to file its Annual Report. As reason for the delay, Hertz cited that certain adjustments were needed to correct previously issued financial statements—but indicated that *no material impact was expected*. Indeed, Hertz was able to file its 2013 10-K on March 19, but ominously, it contained a footnote titled "Correction of Errors," indicating that wholesale errors had been found in its financial statements for 2011, 2012, and 2013.

TIP

When first signs point to accounting problems, don't take management's assurances at face value. Initial disclosures by management usually "sugarcoat" the problem.

The warnings grew louder and more ominous with the May 13 announcement of another late filing (the first quarter of 2014) with these disclosures:

> Errors were identified relating to Hertz's conclusions regarding the capitalization and timing of depreciation for certain non-fleet assets,

> allowances for doubtful accounts in Brazil, as well as other items. Hertz continued its review and recently identified additional errors related to allowances for uncollectible amounts with respect to renter obligations for damaged vehicles and restoration obligations at the end of lease facilities.

But amazingly, just six days later, Hertz felt comfortable enough to release its Q1 2014 financial statements. But then, on June 3, 2014, Hertz reversed itself again and told investors that its 2011–2013 financial statements could no longer be relied upon. Hertz also announced that its auditor, PwC, would be amending its internal control report and most likely rendering an adverse opinion on Hertz's internal controls as of December 31, 2013.

Perhaps just to calm the frayed nerves of investors (who understandably were quite concerned), Hertz management released some preliminary restatements, shaving pretax profits from 2011 by $19 million and from 2012 by just $9 million. At that point, some value-oriented investors, no doubt, became interested in acquiring a stake in Hertz, as it looked dirt cheap and the reported restatements *appeared not to be material*—just 1.9 percent lower than first reported numbers, across the three years. (The $28 million haircut reduced only minimally the reported pretax profits of $1.4 billion reported.) Moreover, respected and influential investor Carl Icahn had acquired a 12 percent stake in Hertz and received three seats on the board of directors.

While some investors began scooping up shares at seemingly bargain prices, prudent investors would have been concerned that initial management estimates of restatements tend to be woefully wrong and almost always turn out to be much worse than first reported. Indeed, the actual results at Hertz would be much worse than management first suggested, as the *revised* error was not the originally reported $28 million—not even close.

Investors had to wait in limbo for over a year before receiving the corrected financial statements. It was not a good period for Hertz as the stock price continued to dive and longtime chairman and CEO Mark Frissora was ousted from the company. Finally, in July 2015, Hertz completed its restatement and provided details of its accounting

transgressions. The restatement cut a whopping $349 million from pretax profits, including $235 million for the years 2011 through 2013.

The restatement revealed that Hertz had used a variety of accounting gimmicks to conceal its deteriorating underlying performance. Most shenanigans used by Hertz fit into three Earnings Manipulation groupings: (1) EM Shenanigan No. 1: Recording Revenue Too Soon; (2) EM Shenanigan No. 4: Shifting Current Expenses to a Later Period; or (3) EM Shenanigan No. 5: Employing Other Techniques to Hide Expenses or Losses. As you recall, when management uses EM No. 1, revenue would be inflated; and when it uses EM No. 4 or No. 5, expenses would be deflated. In all cases, however, profits would be inflated.

Hertz's unraveling continued even after its large restatement as persistent business problems drove down revenue and profits. The restatement provided investors with a brand-new picture of the business. After years of analyzing false numbers, investors were now able to see Hertz's true economic reality. And they became aghast at what they saw. Hertz's stock price continued to tank, and by February 2016, it was down nearly 75 percent from its peak just a year and a half earlier.

TIP

When a company is in the process of correcting past accounting errors, smart investors will stay away until they have the chance to analyze the company's true performance. There is a good chance that the corrected numbers and underlying business performance will be worse than expected.

Toshiba

Background and History

Toshiba traces its roots to the founding of Tanaka Engineering in 1875. In 1939, through an earlier merger, the company took on the name Toshiba. It grew into an impressive conglomerate, with diverse businesses including Energy and Infrastructure, Community Solutions (elevators, lighting, and HVAC), Healthcare Systems and Services, Lifestyle Products and Services, and others. Toshiba encompasses over 600 consolidated subsidiaries and generates annual sales exceeding $44 billion in fiscal 2017.

Recent History of Problems and Accounting

The year 2015 was a nightmare for Toshiba, as news of a long-term accounting scandal cut the share price in half. The first shoe to drop came on April 3, 2015, when the company disclosed it would convene a “Special Investigation Committee” to conduct an internal investigation into certain accounting matters. In particular, the investigation would focus on the company’s use of percentage-of-completion revenue recognition accounting on past infrastructure contracts. This was an incredibly scary announcement, yet the market showed only mild concern. Shares fell just 5 percent from ¥512 to ¥487 and actually began to rebound by the end of the month.

Astute investors would have seen this announcement as a major warning sign. News of an internal accounting investigation, particularly one focused on revenue recognition, should never be taken lightly. It is a sign that accounting problems exist and likely are significant. While the scope and magnitude of the issues may be unknown, it is wise to assume they will be worse than imagined. Rather than hoping for the best, investors would be better off sitting on the sidelines.

As we just learned with Hertz, management often sugarcoats its initial disclosures about accounting problems. The onset of an internal investigation likely means there will be more bad news. If the accounting issue being investigated was minor, it would have been settled without need for a major investigation.

On May 8, 2015, one month after the special committee was formed, Toshiba disclosed that the revenue recognition issues were even worse than initially thought. Given the seriousness of the situation, Toshiba changed the composition of its committee members to be solely composed of “fair and impartial outside experts, who do not have any interests in the company.” This troubling news sent the stock down another 17 percent to ¥403.

On July 20, 2015, Toshiba’s investigation committee announced preliminary findings that shocked investors: Toshiba would be forced to lower its previously reported profits going back seven years to fiscal year 2008, by a staggering $1.2 billion (¥ billion). The following day, its president, Hisao Tanaka, resigned in disgrace, as he called the scandal “the most damaging event to our brand in the company’s 140-year history.”

Toshiba's stock price continued to tank, and by September, the committee released its complete report and the numbers were even worse than the preliminary findings. Amazingly, the restatements in profits covered all years from 2008 to 2014, which spanned the reign of three separate CEOs. The cumulative overstatement of pretax profits approached $1.9 billion (¥225 billion). The largest restatements occurred in 2011 and 2012, and the most substantial amounts related to (1) inflating revenue by improperly applying percentage-of-completion accounting, (2) stuffing inventory channels on transactions in the PC business, and (3) failing to take charges for impairment and depreciation. By December 2015, Toshiba's stock had fallen to ¥215, down 60 percent from its March 2015 peak.

Valeant Pharmaceuticals

Background and History

Although founded in 1960, the story of Valeant's meteoric rise and fall began in 2007, when Valeant hired the management consultancy McKinsey & Company to help jump-start growth in the business. The McKinsey team, led by Michael Pearson, advised a radical strategy—cutting internal R&D and pursuing growth through acquisitions and price increases. Apparently, Pearson impressed Valeant's board, and in early 2008 he was recruited to serve as the company's CEO. Over the next seven years, Valeant made scores of acquisitions, taking on an enormous amount of debt to finance the deals. All the while, Valeant's core business registered only tepid organic growth, and the company regularly posted GAAP-based net *losses*. But Valeant used a variety of misleading non-GAAP metrics to convince investors that Pearson's strategy was going well.

Unlike the more infamous and widely known accounting frauds, the Valeant story really is that of a relatively small company that a decade ago had delusions of grandeur and set out to become one of the five largest pharmaceutical companies in the United States. And Pearson's plan to do so was very unorthodox; it would shun the drug discovery and other R&D spending that was commonplace in the industry and instead rely on buying established companies with proven drugs and existing customers. Once part of Valeant's drug portfolio, the company could then materially increase prices as an additional driver of sales growth. Investors cheered them on as Pearson watched the value of his personal stock holdings rise to an

astounding $3 billion by the summer of 2015. When the stock peaked in August 2015, Valeant's market value hit $90 billion (an almost unimaginable climb from around $2 billion when Pearson became CEO in February 2008). By the spring of 2017, Valeant's market value crash-landed back to around $3 billion, wiping out $87 billion in equity value.

While many investors were caught flat-footed when the market value began to collapse, warning signs were everywhere. Perhaps most obviously, to execute on its strategy Valeant would need to secure a steady supply of attractive acquisition targets at reasonable prices. Moreover, the volume of deals would have to expand each year to supply meaningful growth to its increasing revenue base. In the best of circumstances, this would have been an unsustainable strategy; however, Valeant's unusual choice of targets made perpetual growth through M&A even less likely.

Merger with Biovail

In 2010, after several previous failed overtures to consummate a deal, Valeant and Canadian-based Biovail agreed to merge, enabling U.S.-based Valeant to be taxed at a very low 5 percent Canadian rate (rather than the U.S. rate of 35 percent) and move its headquarters to Quebec, Canada.

Biovail had been founded by Eugene Melnyk, and both Biovail and Melnyk had scrapes with regulators and the courts. For example, in March 2008 the SEC sued Biovail and some of its former officers, charging that they were "*obsessed with meeting quarterly earnings guidance, repeatedly overstated earnings and hid losses to deceive investors and create the appearance of achieving earnings goals*." Biovail settled the litigation by paying $10 million. Its problems continued, and in February 2009, Biovail settled with the Ontario Securities Commission after representatives admitted to making false statements and engaging in illegal conduct. Melnyk was subsequently banned from senior roles at public companies in Canada for five years and penalized $565,000 by the Canadian authorities. He also settled with the SEC and agreed to pay over $1 million in fines.

RED FLAG

Valeant certainly was aware of the sordid history of Biovail before it closed on the deal in September 2010, when it still had time to walk away. Unfortunately, when management is driven to constantly do deals to grow (and to drive up the share price), "trivial details" like the

unethical culture at Biovail and its history of unethical and illegal behavior may be overlooked by management. Thoughtful investors, however, should never overlook a culture of unethical business or financial reporting practices.

Also, as discussed in Chapter 11, Biovail inflated its cash flow from operations (in the period before the Valeant merger) by acquiring certain drug rights through noncash transactions. Specifically, rather than paying cash at the time of the sale, Biovail compensated the sellers by issuing a note—essentially, a long-term IOU under which the company would pay cash *in the future*. Since no cash changed hands at the time of the sale, there was no impact on the Statement of Cash Flows. And as Biovail paid down the notes over time, the cash payments were presented on the SCF as the repayment of debt—that is, a financing outflow. Thus, using this clever two-step technique, the normal reduction in cash flow from operations for acquiring the drug rights was shifted to cash flow from financing—thereby inflating Biovail's CFFO.

Sure enough, investors, either unaware or unconcerned with Biovail's history, cheered on news of the merger as the share price spiked and continued rising in the months following the deal.

Acquisition of Medicis

Two years after merging with Biovail, in December 2012, Valeant closed on its next major deal, Medicis. Like Biovail, Medicis also had a well-known history of accounting problems, particularly overstating revenue by improper recording of sales returns. The company had been sanctioned, and its auditor Ernst & Young had been charged with conducting ineffective audits that failed to surface and correct those issues. During the period just before the acquisition, Medicis' sales slowed—seemingly so that they could be booked under Valeant ownership and help show additional growth. As detailed in Chapter 3, Valeant then changed Medicis' accounting policies to recognize more revenue earlier in the selling process to increase reported sales even further.

In addition to these accounting issues, several other warning signs emerged, including (1) former Medicis CEO Jonah Shacknai complaining about substantial friction with Valeant executives and low morale of his

team; and (2) Valeant announcing a $100 million charge-off related to its decision to fire hundreds of sales personnel at the Medicis unit.

Acquisition of Bausch & Lomb

In early 2013, just a few months after the Medicis deal, Pearson was ready to do a much bigger one. An intriguing opportunity arose when the private equity firm Warburg Pincus (WP) filed registration documents with the SEC to take Bausch & Lomb (B&L) public. Pearson pounced on this opportunity to buy B&L outright, and WP decided to pull the offering and instead sell the company to Valeant. Following what had become a pattern, Bausch & Lomb too had serious accounting scandals in its recent history.

Investors were giddy when news of Valeant's offer to buy B&L came out, as Valeant's share price shot up over 20 percent over two days on volume more than 15 times the normal daily trading volume. Warburg Pincus had acquired a controlling stake of B&L through a leveraged buyout in 2007, putting up $1.7 billion in equity. So, when Valeant offered $8.7 billion to acquire the business, it was a windfall for Warburg and its limited partners. Less obvious was why it would be a good deal for Valeant investors, since the business had anemic growth, poor profitability, and mountains of debt; however, by focusing on non-GAAP results Pearson was able to excite shareholders and the share price.

CONCERNS OF A COMPANY SOLD BY A PRIVATE EQUITY FIRM

As you know by now, we are no big fans of an M&A-driven approach because so much can (and often does) go wrong. But when the seller has been a longtime owner (and ideally, the founder), we can breathe a sigh of relief knowing that the business probably was built carefully, with a solid foundation, and often with a goal of being built to last.

Things get more complicated when the seller has a very short-term horizon, like a leveraged buyout firm. The goals of such firms are to benefit themselves and their limited partners by flipping the acquisition and maximizing their gain. They often do so by (1) putting little equity into the investment, using mainly debt; (2) paying themselves special dividends, even if it means loading more debt on the Balance Sheet of a portfolio company; (3) making further acquisitions adding yet more debt;

and (4) cutting "discretionary" costs, such as R&D, which may help short-term earnings but make long-term success more uncertain.

The substantial borrowing by B&L during the Warburg Pincus reign left the company heavily leveraged. Just two months before Valeant acquired B&L in August 2013, studious analysts might have been aghast seeing the debt level swell to $4.2 billion, up 26 percent in just the prior six months. During that period, the shareholders' equity plummeted from around $800 million to only $8.4 million, and the cash flow from operations sank from *positive* $78.8 million in the 2012 period to *negative* $114.5 million in 2013. Clearly, the suddenly exploding debt coupled with sinking cash flow should have given pause to any potential prudent acquirer. But, of course, Valeant certainly would not be considered a prudent acquirer and *had to* continue doing deals to create the illusion of being a successful company.

Failed Hostile Deals Leave a Bitter Taste for Investors

In addition to acquisitions that closed, Valeant faced several unsuccessful campaigns; these episodes were damaging to the company and perhaps put it on a faster course for its eventual collapse.

In 2011, Valeant made an aggressive play for Cephalon, a U.S. biopharmaceutical company, offering $5.7 billion. When Cephalon pushed back to say, "not interested," Valeant became much more aggressive, threatening to go to Cephalon's board and nominate its own slate of board members.

Commentary: This should have been viewed by investors as an important warning sign as Valeant had turned from doing only "friendly" deals to occasional "hostile" ones. Pearson was beginning to show his cards. He seemingly became more desperate to do another large deal and refused to take no for an answer. A second reason for concern was the apparent indifference toward employees of the target company, since Valeant planned to fire many and appeared interested only in obtaining the new drugs and customers from the target company. We sense that executives at Valeant cared little about maintaining culture and values fostered at newly acquired companies; that should be a flashing red flag for investors.

The second, and more consequential hostile offer took place in 2014, involving both Allergan and an activist hedge fund manager, Bill Ackman.

Six Months That Changed Everything for Valeant—for the Worse

After years of successfully maintaining a low profile, in 2014 Valeant became a household name and constantly found itself the subject of both financial and mainstream media reports. The company had formed an unorthodox "partnership" with Bill Ackman to facilitate another hostile acquisition, and for its largest target yet, Allergan. Ackman's fund, Pershing Square Capital ("PSC") accumulated a significant equity stake in Allergan and used its influence to try to convince the target's board and institutional investors to agree to Valeant's offer. Ackman even launched its own public marketing campaign for the deal to help push it through. As this went on, more media outlets began questioning the ethics of the Ackman partnership and whether it violated insider trading rules, and lawsuits ensued. In late December 2017 the lawsuit with Allergan was settled, mandating Ackman's Pershing Square hedge fund to pay $194 million and Valeant an additional $96 million, subject to court approval. This negative attention, alongside an already contentious hostile campaign, began to cast Valeant as desperate for a large acquisition at any cost.

Things only got worse when Allergan definitively rebuffed Valeant's final, mostly stock offer, raising fundamental questions about Valeant's unorthodox business model. Not only did the upward momentum in Valeant's share price come to a screeching halt during the six months of battling for Allergan, but more important, rumblings about its reputation, unusual business model, and aggressive accounting practices grew louder. And journalists who had hardly covered Valeant a year prior began probing the company's business practices looking for a bigger story.

Acquisition of Salix Pharmaceuticals, Valeant's Biggest and Most Flawed Acquisition

Valeant was badly bruised in its failed hostile takeover of Allergan in 2014, but ultimately found another big target in early 2015, and acquired Salix Pharmaceuticals on April 1. Not surprisingly, this was another troubled company, just working its way through a major accounting scandal.

Salix Pharmaceuticals was founded in 1989, and in more recent years has been headquartered in Raleigh, North Carolina. The company develops and

sells drugs and medical devices to prevent and treat gastrointestinal disorders. The year 2014 was a busy one for Salix on the M&A front, starting with its January acquisition of Santarus for $2.6 billion. During much of the year, Salix was in talks with several suitors to sell itself, but that came to a screeching halt when disclosures about its own accounting problems were revealed in the autumn. The end of the year proved quite tumultuous, with both Salix's CEO and CFO leaving under a dark cloud and a new suitor (Valeant) entering the bidding.

Beginning on November 7, 2014, three class action lawsuits were filed against Salix, alleging accounting fraud. The company had *already* restated its audited financial statements for 2013 and its unaudited quarterly reports for each of the three quarters in 2014. It was abundantly clear that the company had played fast and loose with its accounting to dress up the business for sale. For some strange reason, these aggressive accounting practices seemed to be of little concern for Valeant.

Let's think about this for a moment. Why would someone be interested in buying this company when the acquirer likely would be responsible for a potential huge legal liability? Even if you could get comfortable with the legal exposure, concerns about the culture and ethics loomed large. Putting aside both the legal exposure and the culture/ethical issues at Salix, you still would have no clue of the real health and performance at the company because the *numbers were rigged*.

Others Had a Look, but Walked Away

About six months before Valeant approached Salix about a deal, several other suitors had been sniffing around, and at least one put a substantial offer on the table. That was until the accounting issues became known. Ironically, it was Allergan that had offered Salix as much as $205 per share in cash, valued at $13 billion. But when its management found serious accounting issues in October 2014, Allergan reportedly withdrew its offer and walked away from the negotiating table.

The fallout from the accounting problems cost both CEO Carolyn Logan and CFO Adam Derbyshire their jobs, as shareholders took a 35 percent haircut in value when the fraud was revealed.

Without much regard for these issues, on April 1, 2015, Pearson completed the $11 billion transaction, and just as in the case of prior

mergers, the news was welcomed by investors and Valeant's share price surged again.

Restatements and Warning from the Auditor of Internal Control Weakness

On March 2, 2015, almost a month before Valeant closed on the deal, Salix filed its 10-K for 2014, along with the restated financial statements for 2013 and each of the three quarters of 2014. Included in the filing was the auditor's assessment of the internal controls at Salix:

> Management has identified material weaknesses in controls related to product returns and communications between trade relations and accounting/finance to record agreed-upon returns by trade personnel; controls for recognition of revenue for sales to customers with FOB destination shipping terms; controls to comply with established policies and procedures to obtain, evaluate, review, and approve agreements with customers; and controls around classification of balances within the consolidated financial statements.

Translating to plain English: the controls to ensure accurate financial reporting stunk and a lot of things could go wrong. Indeed, they already had! In Q4 2013, Salix improperly booked $14.4 million of sales that should have been recorded in Q1 2014. Additionally, Q1 profits were inflated as the company had underreported its "reserve for product returns" by reporting $8.7 million when it should have been $16.9 million—again inflating sales. In Q2 2014, Salix made a suspicious $7.5 million payment to a wholesaler (that is a customer) and treated that payment as a marketing expense, rather than as a reduction to gross revenues. Then in Q3 2014, Salix had just one final quarter to "juice" its revenue before inking a deal, so it tried not to miss that opportunity by posting $15.2 million in sales that really belonged in Q4. Again, none of this information seemed to dampen Valeant's desire to close the deal.

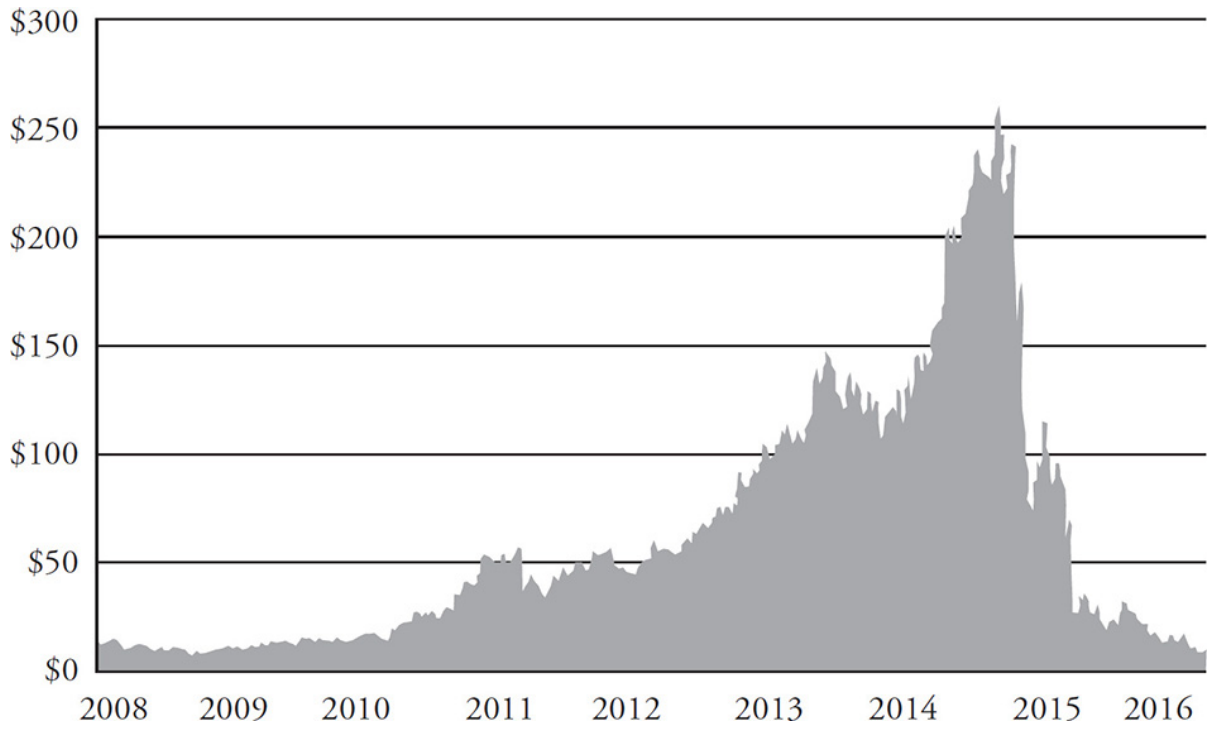
The Valeant Balloon Bursts

When Valeant announced its offer to acquire Salix in February 2015, its investors were elated. The share price immediately jumped $25 in a single day from $173 to $199. Over the next five months, Valeant's share price

continued shooting straight up, hitting its all-time peak of $263 on August 5, valuing the company at $90 billion. With each acquisition, its GAAP-based losses intensified, but the profitability metric that management focused on, “cash earnings,” grew and compounded.

The tide began to turn against Valeant by late August, as allegations of price gouging were leveled against several pharmaceutical companies. The following month, Democratic presidential candidate Hillary Clinton spooked the pharmaceuticals industry with an ominous tweet saying, “Price gouging like this in the specialty drug market is outrageous. Tomorrow I’ll lay out a plan to take it on.” As a result, investors started worrying about the government broadly cracking down on pricing at drug companies and depressing profits. Clinton’s tweet helped push Valeant’s share price back down to $229 (Figure 18-1).

Figure 18-1 Valeant Share Price, 2/1/2008 to 12/31/2016



Date	Market Cap (in millions)	Price	Event
2/1/2008	$2,132	$13.24	Pearson becomes CEO
9/30/2010	$7,395	$25.05	Biovail merger closes
12/11/2012	$17,654	$59.23	Medicis acquisition closes
8/7/2013	$32,549	$97.59	Bausch & Lomb acquisition closes
4/24/2014	$44,833	$134.42	Ackman stake in AGN revealed
4/1/2015	$67,903	$197.39	Salix acquisition closes
8/5/2015	$89,989	$262.52	Valeant hits peak price/market value
9/21/2015	$78,498	$229.00	Hillary Clinton tweets about pharma price gouging
10//19/2015	$57,074	$163.83	Initial reports exposing Philidor
10/30/2015	$32,172	$93.77	Valeant announces it will cut ties with Philidor
2/29/2016	$22,450	$65.80	Valeant announces it is under SEC investigation
3/15/2016	$11,433	$33.51	Valeant cuts revenue forecast and delays filing
3/21/2016	$9,888	$28.98	Pearson steps down as CEO
3/13/2017	$4,212	$12.11	Ackman sells VRX position
4/12/2017	$3,298	$8.51	Decline of 96 percent from peak

Over the next three months, Valeant had a giant target on its back, and criticism came from all directions. In October, a group of investigative journalists published an exposé revealing a shady and fraudulent relationship with a mail-order pharmacy named Philidor Rx. Valeant's share price went into a free fall, dropping to under $90 by late November. Many "believers" who thought the sell-off was overdone tried to make a quick buck on a "depressed" situation, but only succeeded in catching a falling knife.

In March 2016, Pearson was ousted as CEO and the board accused former CFO (and current board member) Howard Schiller of engaging in "improper conduct." The SEC was investigating the company for fraud, and investors continued to lose faith. The unraveling accelerated throughout 2016 and early 2017 as Valeant's business fell apart and all the debt raised

to finance its bad acquisitions came back to haunt the company. By April 2017, with former executives under criminal investigation for fraud, Valeant's share price crash-landed below $9, an incredible decline of 96 percent from its summer 2015 peak.

Important Lessons from the Valeant Story

Valeant was destined to collapse because its financial representations falsely portrayed a fast-growing, prosperous company, when in reality, its numbers were embellished by accounting gimmickry. Astute investors understood that while it was impossible to know the exact catalyst that would spark the unraveling, they knew the downfall would be inevitable, no matter how big the balloon inflated. The Clinton tweet and Philidor findings were the incendiary events that ignited the unraveling. While there was no way to predict that these specific events would be the proverbial "straws that broke the camel's back," without them, something else surely would have sparked Valeant's ultimate unraveling.

Looking Ahead

In our concluding chapter, we weave through the many lessons in this book (and our experience from the last quarter century) and present 10 of the most important lessons to help you detect shenanigans and dramatically improve your investment performance.

19
The Forensic Mindset

In the quarter-century since publishing the first edition of *Financial Shenanigans*, we have identified many accounting tricks hidden in corporate filings and shared our analysis with thousands of professionals and students. In discussing our findings (and what led us to them), we often are asked how we spotted these shenanigans when others, evaluating the same documents, failed to see them. Is it that we work so much harder or are more clever than other analysts? We think not. Rather, we believe our success stems from starting with a very different mindset—a forensic one. This approach incorporates qualities of skepticism, curiosity, and humility and mixes them with a deep understanding of human behavior and principles of fair play.

In the following pages, we summarize key elements of the forensic mindset that will keep you focused on key issues and questions and help you to detect accounting gimmicks and fraud in financial statements.

1. Skepticism Is a Competitive Advantage

In many ways, capital markets are designed to circulate good news. Financial services firms on the buy side and sell side, and corporate issuers themselves, typically make more money when share prices rise. Corporate issuers are incentivized to announce good news, sell-side firms to spread such news, and investors to believe it. This dynamic is part of what occasionally creates asset bubbles and boom/bust cycles. Investors who can remain objective and skeptical, while the herds echo and amplify each other's excitement, have a better chance of profiting from the more blatant disconnects from reality.

APPLYING THE FORENSIC MINDSET

1. Skepticism is a competitive advantage.
2. Pay close attention to changes—always ask "why?" and "why now?"

3. Look past “accounting problems” to see if business problems are being covered up.
4. Pay attention to corporate culture and watch for breeding grounds of bad behavior.
5. Never blindly adopt the company’s profitability framework.
6. Incentives matter: pay close attention to how executives are compensated.
7. Even in financial disclosures: location, location, location.
8. Like in golf, every shot counts.
9. Patterns of behavior provide a reliable signal.
10. Be humble and curious, and never stop learning.

Between 1995 and 2000, Enron’s revenue had grown from under $10 billion to over $100 billion, a feat never achieved so quickly before at an American company. Management had become deified as some of the smartest people in commerce. Yet, Enron operated in a mature and heavily regulated industry, and hardly generated any accounting income or cash flow at all. The few skeptics who noticed and questioned the improbable sales-growth pattern were able to see that the business was a house of cards.

2. Pay Close Attention to Changes—Always Ask “Why?” and “Why Now?”

Many of the insights highlighted in this book came from noticing some important *change* (changes in accounting practices, policy disclosures, Balance Sheet trends, key metrics, customer payment terms, executive departures, auditors, etc.). In most cases involving a change, management, wearing rose-colored glasses, dreamt up flattering and seemingly rational explanations to convince investors not to be concerned. All too often, however, we find these explanations to be irrelevant, boilerplate, or beside the point. For example, accounting policy changes are often attributed to a desire to follow the practices of peers, higher inventory is explained by the need to build product ahead of sales, and executive departures are explained by a wish to spend more time with their families, and so on. Asking “why” the change happened is an important question, but an even more insightful

one is “why now?” What prompted the change to be made at that particular point in time? Asking “why now?” often leads investors to probe deeper into how results would have looked absent the change.

In Chapter 3, we discussed a very consequential change in revenue recognition at Ulvac, a Japanese semiconductor manufacturer. The company’s choice to begin using percentage-of-completion accounting was an unusual and aggressive move; however, the “why now?” factor is what makes interpreting the change so powerful. Absent the change in accounting, the financial statements would have revealed that Ulvac’s business actually was imploding, not improving as the reported numbers misleadingly showed.

3. Look Past “Accounting Problems” to See if Business Problems Are Being Covered Up

When questions arise about a company using inappropriate accounting practices, investors tend to view those issues solely as “accounting problems” that need to be investigated and eventually remediated (usually with the help of a big-four accounting firm). The financial press reinforces this by focusing on technical rules that have been violated, the significance of the violations, and who within the organization is believed to be responsible. While these are all important issues, we believe it more important for investors to focus on this question: “To what extent have these incorrect applications of accounting served to hide problems in the business?”

When Hertz announced that it would restate several years of financial statements to correct for inappropriate accounting, the press asked these predictable questions: What was the nature of the problems? Who was responsible? This shaped discussions common among investors who talked about the company’s “accounting issues overhang.” Remarkably little attention was paid to why Hertz had been fast and loose with its accounting, and what it meant about the real health of the business. As a result, investors were surprised when after the restatement dust finally cleared, the business was significantly less profitable than was previously understood.

4. Pay Attention to Corporate Culture and Watch for Breeding Grounds of Bad Behavior

The shenanigans profiled in this book are not representative of normal corporate behavior; rather, they reflect outlier actions of more aggressive and dishonest executives. They are also typically not just discrete choices of bad actors, but rather, the result of an environment and context that made those choices more probable. As we discussed in Chapter 2, certain characteristics at a company provide the breeding grounds for bad behavior. Weak checks and balances, an autocratic CEO, and a culture of meeting targets at all costs are among the elements that increase the risk of shenanigans.

The missive of Joe Nacchio, former CEO of Qwest Communications, to his sales team serves as a prime example of a win-at-all-costs culture that comes from the top: “The most important thing we do is meet our numbers. It’s more important than any individual product.... We stop everything else when we don’t make the numbers.” This culture pushed Qwest employees to cut corners whenever necessary to make the numbers, and even engage in outright fraud.

5. Never Blindly Adopt the Company’s Profitability Framework

In press releases, earnings calls, and investor presentations, company executives often take advantage of opportunities to report results in the most impressive and flattering light. In addition to reporting the required GAAP profits, management often discusses such non-GAAP metrics as its “EBITDA,” “underlying business profit,” “adjusted earnings,” or many other variants. In some cases, these alternative metrics provide a valuable supplement to the GAAP-based figures; however, in many cases they leave out important aspects of the business’s cost structure. Even if certain metrics become industry standards, investors must consider how well they actually reflect the full economics of the business.

Linn Energy, for example, focused investors on its “distributable cash flow” in order to justify ever-increasing dividend payouts. That metric was based on a vague management distinction between “growth-oriented” capital expenditures and other payments considered to be “maintenance-

oriented.” In many cases, such distinctions are arbitrary or intentionally misleading, resulting in inflated headline figures being presented by management.

When evaluating a non-GAAP profitability metric, we recommend stopping to consider what question it is that the measure answers, and then assess whether the question itself is a worthwhile one. In the case of Linn Energy’s distributable cash flow, the question the metric provided would seem to answer is “How much cash flow was generated by the company’s assets, excluding all expenditures that management considers to be associated with expansion activities?” Upon articulating the question, it might become apparent that it is not a very useful one, since management’s assessment of capital expenditures by category (growth vs. maintenance capital) is entirely subjective, and in many cases, the distinctions are without meaningful differences.

6. Incentives Matter: Pay Close Attention to How Executives Are Compensated

Conventional wisdom espoused by compensation experts (and accepted by investors) is that management compensation should be directly tied to performance. Mediocre performance should yield mediocre compensation (or termination), and fantastic performance should be rewarded with a handsome compensation package. Naturally, performance is measured relative to established targets. Pay close attention to these targets, as they will inevitably shape management’s strategy for the business.

When Valeant’s board set the CEO’s incentive compensation plan, the most significant financial performance metric specified was “cash earnings per share.” This metric was calculated to exclude all expenses associated with M&A activity, including restructuring, integration, and impairment costs, as well as the amortization expense associated with the acquired assets. Based on these targets, the most efficient way to maximize the underlying bonus would be to make large acquisitions using cash, *at any price*—since doing so would certainly improve cash earnings per share. Had the board instead designated a performance target based on a more inclusive measure of profitability (such as GAAP net income), the company would likely have pursued a very different strategy.

7. Even in Financial Disclosures: Location, Location, Location

Earnings Releases, annual and interim financial reports, and other regulatory filings are comprised of a combination of required disclosures and voluntary content, including additional information and commentary. Naturally, companies can highlight the most positive information in their Earnings Releases and quarterly investor presentations, which are broadly disseminated and read, and bury necessary but unflattering disclosures in the back pages of regulatory filings where few readers will find them. For this reason, we always read through these documents in their entirety, and our skeptical antennae are most engaged in sections of the filings that are too technical or boring for most readers. When we come across concerning information that seems relevant to the health of the business in these back sections (often in small type), we can be reasonably confident that we have discovered disclosures that management was trying to hide from investors. These are often the most valuable inputs.

In Chapter 7 we discussed the unusual boost to Under Armour's earnings in the fourth quarter of 2016, when the company reversed a $48 million charge (previously accrued as bonus compensation) back into the Income Statement. This action artificially lowered reported SG&A expense, making profitability look stronger in the quarter. Interestingly, the only mention of this reversal was made deep in the company's 10-K filing in a footnote to a completely unrelated table that detailed the business's seasonality patterns. Clearly this was a disclosure that management was trying to bury.

8. Like in Golf, Every Shot Counts

Golf stands apart from any other widely played spectator sports in this country. Unlike tennis, soccer, or basketball, in golf every shot is extremely meaningful. Professionals play 72 holes in a four-day tournament, and the player needing the fewest strokes wins. If you have a few terrible holes, you may still win, but every shot you take will count in your final tally. And that is how the game of accounting and financial reporting works under GAAP, as well. Companies that regularly encourage investors to ignore certain expenses or outflows are asking for a "mulligan" (a free shot). Those should only be accepted in very rare cases.

In Chapter 5, we discussed how for over a quarter century, Whirlpool consistently excluded its annual restructuring charges when presenting non-GAAP earnings, presumably on the grounds that such expenses were not part of the company's normal operations. Similarly, product recalls, litigation, M&A integration, and other expenses are all part of the cost of doing business. To pretend they are not is tantamount to cheating on the golf course—but with far worse consequences!

9. Patterns of Behavior Provide a Reliable Signal

We have long been fans of Nobel laureate Richard Thaler, a pioneer of behavioral finance. He has developed very useful theories about why investors consistently make seemingly irrational decisions, and he suggests how to avoid problematic biases.

About 15 years ago, Howard spoke at an investment conference in Chicago, immediately after Thaler had presented his research. Howard capitalized on Thaler's presentation adding that while Thaler's research had succeeded in profiling the predictable *behavior of investors*, our work focuses on profiling the predictable *behavior of corporate executives*. Indeed, investors attuned to executives' patterns of behavior can benefit knowing that these patterns tend to persist. For example, a CFO who uses aggressive accounting methods at one company is apt to do the same at a subsequent company. Moreover, if one Balance Sheet metric signals that the firm has "stuffed its sales channel" full of inventory, investors should look for similar trends in the company's history to see if a revenue shortfall followed similar aggressive behavior in the past. While forensic analysis is more art than science, you will find that many relationships and patterns have reliable persistence.

10. Be Humble and Curious, and Never Stop Learning

As we completed this special twenty-fifth anniversary edition of *Financial Shenanigans*, it became clear how much we had learned since the original edition. We are curious people by nature, and always look for opportunities to learn new things. Also, we are fortunate to be surrounded by teammates and clients and who are similarly motivated to crack complicated problems and acquire new skills and expertise. As we have become credentialed

“gurus” in the field of forensic accounting, we keep humble, keenly aware that the learning curve ahead remains steep, with much to learn from everyone around us. We also appreciate the importance of recognizing when we have made a mistake and learning from it. Most important, we come to the office every day expecting to work hard, figure out how to solve difficult problems, learn something useful, and teach others something valuable.

Concluding Thoughts

This fourth edition of *Financial Shenanigans* updates investors with lessons gleaned from our examination of many deceptive financial reporting practices employed during the last quarter century. Since we published the original edition of *Financial Shenanigans*, corporate management has continued to concoct new ways to manipulate its financial reports to inflate its share price and other compensation-related metrics. And, looking to the future, as management works to create newfangled tricks, diligent investors must continue to learn to detect these new financial shenanigans.

> *What has been will be again, what has been done, will be done again; there is nothing new under the sun.* (Ecclesiastes 1:9)

Corporate financial scandals have been around for as long as corporations and investors themselves. Dishonest management has preyed on unsuspecting investors, and it is time for such investors to redouble their efforts to be alert for such financial shenanigans so that they can protect themselves.

Since shenanigans at their most basic level represent management’s attempt to put a positive spin on a company’s financial performance and economic health, our universal message is that investors should assume that the urge to exaggerate the positive and hide the negative will never disappear. And where temptation exists, shenanigans often follow.

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Acknowledgments

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We are also deeply grateful for the love and support of our families:

To Diane, my amazing wife of 37 years, your love and support has been the bedrock in every achievement. To Jonathan, Suzanne, and Amy, your father could not be any prouder. And to the next generation of Schilit shenanigan-busters (Levi, Micah, and Grace), Grandpa is expecting that you also will make a wonderful contribution to the world for the next century.

—Howard

To my wife Andrea, who strengthens and inspires me every day with her brilliance, benevolence, and endless love. To our four beautiful children: Shira, Orli, Lev, and Rina; who inspirit and enlighten me with their curiosity, kindness, and enthusiasm. And to my parents, Vicki and Arthur, my daily models of devotion and integrity.

—Jeremy

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—Yoni

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