Financial Shenanigans

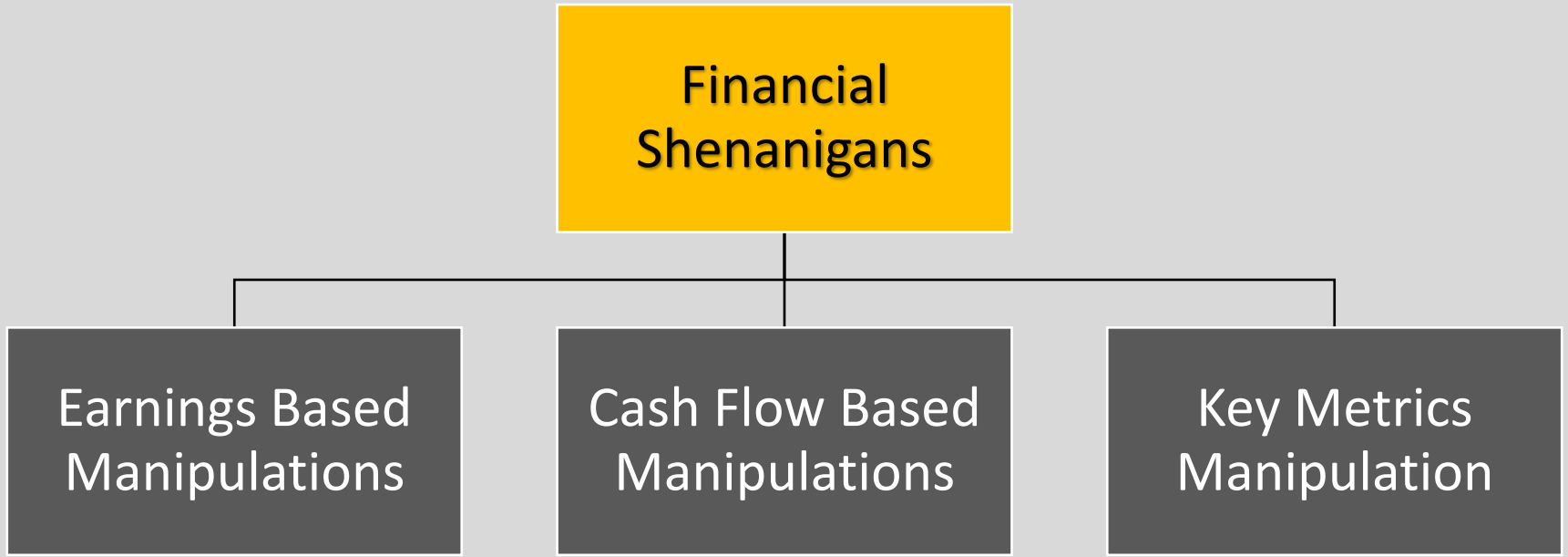
- By MJK Investments

What Are Financial Shenanigans?

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

• Companies often try inflate earnings to meet the earnings expectations, which in turn lead to steady stock price or boom in stock price. All these shenanigans are adopted by the management primarily to keep their share price stable.

Financial Shenanigans are classified across 3 Broad groups:



Breeding Ground for Shenanigans

- Absence of checks and balances among senior management
- An extended streak of meeting or beating Wall Street expectations
- A single family dominating management, ownership, or the board of directors
- Presence of related-party transactions
- An inappropriate compensation structure that encourages aggressive financial reporting
- Inappropriate members placed on the board of directors financial reporting
- Inappropriate business relationships between the company and board members
- An unqualified auditing FIR
- An auditor lacking objectivity and the appearance of independence
- Attempts by management to avoid regulatory or legal scrutiny

How Investors should go about analyzing a company?

→ **In evaluating any company an investor should:**

1. Understand the nature of the business and assess whether the numbers make sense:	**Try to look at the nature of the industry and compare the company's metrics with that of industry or peers to get a more clear picture.**
2. Assess the competence and ethics of management:	**Evaluate the BOD and Professional management. Check for the quality of board.**
3. Evaluate the adequacy of checks and balances:	**After having all the required info, then evaluate the necessary info and cut down all the unnecessary information which is not important for analysis.**

Earnings Manipulation Shenanigan No. 1: Recording Revenue Too Soon

Shenanigan No. 1: Recording Revenue Too Soon

1. Changing Revenue Recognition Policy to Record Revenue Sooner:

Case in Point: Transactions System Architects changes its revenue recognition policy to record the entire value of five year upfront as compared to previous approach of spreading the revenue over the five-year contract period. Because of this change, it reported a misleading jump of 21% in total revenue, however actually the revenue declined by 10%.

How the red flag could be recognized:

***CFO materially lagging net income:** A simple comparison of CFO with PAT would have made things clear, a growing difference clearly means aggressive recognition or money getting stuck in receivables.

****The difference b/w CFO and Net income has increased drastically from 1998 to 1999.**

($ millions)	Q2-1999	Q2-1998
CFO	1.4	9.4
Net Income	10.9	8.3
CFO Less Net Income	-9.5	1.1

- **Jump in Unbilled Receivables:** A second warning sign for investors related to sudden jump in unbilled receivables. Unbilled receivables are not receivables at all, these are created during production period when the customers are not yet responsible for payment. Unbilled receivables increased 65% during 1998-99 whereas sales just increased 22% during the same period. This clearly suggests more aggressive revenue recognition.

$ millions	Q4-99	Q3-99	Q2-99	Q1-99	Q4-98	Q3-98	Q2-98
Revenue	92.6	89.1	87	86.1	79.3	69.1	71.8
Current BR	50.6	57.1	61.2	66.4	58.1	42.5	44.7
Unbilled BR	41.9	39.2	40	34	33	35.2	24.1
Long Term BR	26.9	13	9.3	0.8	2.1	1	1
Total BR	119.4	109.3	110.5	101.2	93.2	78.7	69.8

**The constant rise in unbilled receivables and Long term receivables as compared to Revenue also shows aggressive accounting policies.

****Long Term receivables growing faster than the Revenue:** Long Term Receivables represent receivables more than a year old. Long Term receivables jumped to 9.3 m $ from just 1 m$ a year earlier.

Conclusion: By accelerating future period sales into an earlier period, company successfully plugged its short term revenue shortfall, while creating enormus problems for the future. Now by recognizing total revenue upfront, there would be no future revenue and secondly achieving revenue growth in future on the top of inflated sales figure would be an enormus challenge.

Shenanigan No. 1: Recording Revenue Too Soon

2. Recording Revenue before Buyers Final Acceptance of the Product:

Three type of tricks that produce revenue before final acceptance of the buyer:

- **Before the shipment of the product to the buyer:** One controversial method of revenue recognition involves bill and hold agreements. Under this approach, the seller bills the customer and recognizes the revenue, but continues to hold the product

**Watch for Bill and Hold Transactions Initiated by the Seller- If a seller initiates a bill-and-hold transaction, investors should assume that the seller is attempting to recognize revenue too early.

Case in Point: Sunbeam Co. in order to boosts its revenue, hoped to convince retailers to buy grills nearly 6 months in advance before they were needed, In exchange for major discounts, retailers agreed to purchase merchandise that they would not physically receive until months later and would not pay for until six months after billing. In the meantime, the goods would be shipped out of the grill factory in Missouri to third-party warehouses leased by Sunbeam, where they would be held until the customers requested them.

Nonetheless, Sunbeam booked the sales and profits from all of the $35 million in bill-and-hold transactions. When outside auditors later reviewed the documents, they reversed a staggering $29 of the $35 million and shifted the sales to future quarters.

- **Seller Records Revenue upon Shipment to Someone Other Than the Customer:** The auditors often look at shipping records as evidence that the seller delivered the product to the customer, allowing revenue to be recorded.

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

Shenanigan No. 1: Recording Revenue Too Soon

3. Recording Revenue When the Buyer's Payment Remains Uncertain or Unnecessary

- **Buyer Lacks the ability or the Necessary Approval to Pay:**

Case in Point: Stirling Homex Corporation, a manufacturer of completely installed modular dwelling units. Stirling sold homes to low-income buyers who had limited resources, Stirling improperly recorded revenue when HUD signed a preliminary commitment of funding, rather than waiting for the final approval. As a result, Stirling recorded revenue for certain customers who ultimately failed to receive financing. Thus, the financial statements that portrayed Stirling as a healthy, prosperous company with increasing sales and earnings in reality covered up the company's serious business and financial problems.

- **Seller Induces Sale by Allowing an Exceptionally Long Time to Pay:** Rather than using a third-party institution for financing, some cash-strapped customers use financing provided by the seller itself. Investors should be cautious about seller-provided financing arrangements (including very generous extended payment terms), as they may indicate the acceleration of revenue into the current period, tepid customer interest in the product, or the buyers' lack of ability to pay.
- **Be Wary of Extended Payment Terms on New Products:** To stimulate sales of new products, a seller may allow customers to pay over an extended period of time.
- **Sound the Alarm When New Extended Payment Terms Are Disclosed and DSO Jumps:** Investors should be particularly concerned about accelerated (or even improper) revenue recognition when a company begins extending very generous payment terms and Days of Sales Outstanding (DSO) spikes.

Case in Point: Trex Company, for example, provided extended payment terms to customers under what it called an "early buy program" in late 2004 and early 2005. As demand declined, it seemed that Trex enticed customers to accept products earlier than normal (without having to pay for them). This arrangement had minimal impact on the buyers' total purchases, but allowed Trex to record revenue in an earlier period.

Trex's Extended Payment Terms Cause Receivables to Jump

$ millions	Q1-05	Q1-04	Q1-03	Q4-04	Q4-03	Q3-04	Q3-04	Q2-04	Q2-03
Account Receivable	68.8	31.9	13.9	22	5.8	12.8	13.1	31.2	21.9
Revenue	89.9	76.3	68.7	29.6	21.9	64.4	41.2	83.4	59.2
DSO	70	38	18	68	24	18	29	34	34

How Aggressive Revenue Recognition could be recognized?

If a company changes its revenue recognition policy and adopts a aggressive recognition, then this could be recognized by looking at following ratios:

- Check for sudden Increase in Receivables
  Ratio: Receivables as a % of Sales
- Check for Increase in both Short Term as well as Long Term Receivable Days
- Compare growth of Revenue with the Growth in Receivables
- Check whether operating Profit is being converted into Cash
  Ratio: CFO after WCC/EBITDA

Warning Signs: Recording Revenue Too Soon

If a company is aggressive in recognizing revenue, then look for these signals through which an investor can check for it:

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

Earnings Manipulation Shenanigan No. 2: Recording Bogus Revenue

Shenanigan No. 2: Recording Bogus Revenue

1. **Recording Revenue from Transactions That Lack Economic Substance:** First technique involves simply dreaming up a scheme that has the "look and feel" of a legitimate sale, yet in reality lacks economic substance. In these transactions, the so-called customer is under no obligation to keep or pay for the product.

Case in Point: AIG and several other insurers began to market a new product called finite insurance. Now this magic product would guarantee clients the ability to always produce earnings that were acceptable to Wall Street or that would meet or exceed street expectations.

However, there was a big problem: some of these "insurance" contracts were not really legitimate insurance arrangements at all; rather, they were actually "**financing transactions.**"

Lets look at, Brightpoint Inc. to see how some finite insurance transactions were economically more akin to financing arrangements. Brightpoint Inc. earnings for the December quarter were tracking about $15 million below the guidance given to Wall Street at the beginning of the quarter. As the quarter closed, management feared that investors would be unprepared for this news, and that, as a result, the firm's stock price would be hammered.

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

Look for such arrangements under footnotes, and check the company's history of transaction AIG, so if out of a sudden name of AIG appears given that transaction is material, then it should be looked with skepticism

Shenanigan No. 2: Recording Bogus Revenue

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

What is a related party transaction?

A sale to a vendor, a relative, a corporate director, a majority owner, or a business partner raises doubt as to whether the terms of the transaction were negotiated at arm's length.

Case in Point: Syntax- Brillian Corp., the Arizona-based maker of high-definition televisions. The company more than tripled its revenue in fiscal 2007, with sales approaching $700 million, up from less than $200 million the prior year. The company's staggering revenue growth came from a tenfold increase in sales to a related party that accounted for nearly half of its total revenue—an Asian distributor named SCHOT.

Many investors failed to question the company's significant uptick in sales to SCHOT, as they believed that demand in China was high. However, a simple look at Related party sales as a % of total Sales could raise concerns about the recognized revenue.

If the investor have simply looked at this excerpt from the SEC filing, it would raise questions about the revenue recognized:

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

Be Alert to Two-Way Transactions with a Nontraditional Buyer

Case in Point: Symbol Technologies, purchased software for $8.5 million and sold one of its products to that vendor-customer company for $4.25 million (of which $2 million was returned). Curiously, Symbol retained possession of the inventory it had "sold" and provided the funds for the software company to "purchase" its product. In a side agreement, the software company had an unlimited right of return for an indefinite period.

What could be done to question this transaction: If an analyst would look under the related party head, then such arrangement should be questioned and also it should be checked whether this is a one time transaction or repetitive.

Shenanigan No. 2: Recording Bogus Revenue

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

- **Question Revenue Recorded When Cash Is Received in Lending Transactions:** Never confuse money received from your friendly banker with money received from a customer. Cash received because of loan cannot be recognized as Revenue. However companies adopt these methods to recognize revenue on their books.

Case in Point: Delphi Corporation, failed to understand the distinction between a liability and revenue. In late December 2000, Delphi took out a $200 million short-term loan, posting inventory as collateral. Rather than recording the cash received as what it was (a liability that needed to be paid back), Delphi improperly recorded it as the sale of goods.

- **Challenge Advances Received from a Partnership That Are Classified as Revenue:** Companies recognize revenue, when they receive cash from a Joint Venture Partner.

Case in Point: Consider the research and development partnership on waste technology formed between Molten Metal and Lockheed Martin. Lockheed provided the funding, and Molten performed the research. Molten took $14 million from the partnership and recorded that amount as revenue.

However, The $14 million taken from the partnership should have been considered a distribution or a loan from the partnership to fund the research, not revenue.

- **Be Wary of Revenue Recorded on Receipts from Vendors:** Generally, there is a cash outflow when cash is paid to vendors for purchases and sometime extra cash is paid for future purchases such that vendor would provide cash discount or rebate. However, the rebate received in future cannot be recognized as revenue it should be adjusted to the cost of inventory purchased. However some companies record this rebate as revenue.

Case in Point: Sunbeam played a neat trick to boost revenue in which it advanced cash to vendors and then recorded revenue when that cash was repaid. Additionally, Sunbeam would commit to future purchases from a particular vendor in exchange for an immediate “rebate” from that vendor, which Sunbeam, of course, recorded as revenue.

Shenanigan No. 2: Recording Bogus Revenue

4. **Recording Revenue from Appropriate Transactions, but at Inflated Amount:** Now lets look at the companies, which have met the broad guidelines for recognizing revenue, but however they recorded revenue in excess or the amount was misleading to investors.

- **Using an Inappropriate Methodology to Recognize Revenue:**

Case in Point: Education Alternatives, provided consulting services to school boards. So whenever a company receives a contract for management of a school, a general practice would be to record the fees it received from the contract as Revenue and not the entire contract amount.

For Example: Education Alternatives won a contract to manage the entire budget for nine Baltimore public schools. The $133 million contract over the next five years. So, $133 million total for the five years. That deal worked as follows Baltimore would pay no more than the amount allocated in the budget, $26.6 million annually. If, for example, Education Alternatives spent $25 million on the schools, the remaining $1.6 million would be considered its fee,

Ideally, Education Alternatives should recognize the fee amount $1.6 million as revenue, but the company instead decided to recognize as its own revenue the entire $26.6 million received each year (or $133 million over five years). As a result, the company's revenue jumped from approximately $3 million to $30 million in the first year of the contract.

So, by looking at a dramatic increase in revenue over a year, the investors must have arrived at one of these conclusions (1) there was a typo in the company's revenue line, with a zero mistakenly added, (2) the company was an unbelievably attractive investment opportunity, or (3) the company was a complete fraud.

Similarly, in 1995 the revenue raced to $214 million as it treated the entire budget for Hartford's schools as its own sales. As a result, revenue that in 1992 had barely reached $3 million climbed to over $200 million in three short years.

Shenanigan No. 2: Recording Bogus Revenue

How this Inappropriate Revenue Recognition could be evident to investors?

If there's a meteoric rise in any company's revenue over such a short span like say in 1 year or over 3 years then compare it with other companies in the same industry. Also, be skeptical whether a small company like Education Alternatives with few dozen employees can reach to this scale.

Grossing Up Revenue to Appear to Be a Larger Company: Some companies act as matchmakers between buyers and sellers, they just facilitate transaction and receive handling fee or portion of sale for providing the platform or connecting the buyers and sellers.

For Example: If you sell your car on eBay for $20,000, eBay will keep a portion of the sale (say $500) as a service fee. Certainly, eBay should not be entitled to record the gross amount of the sale ($20,000), as it did not really sell the car. If eBay were to inappropriately recognize revenue under the gross method, its revenue would be massively overstated.

Case in Point: Enron's dazzling revenue growth in the late 1990s was aided by its aggressive accounting practice of grossing up sales in its trading business. Generally, Enron should recognize revenue related to brokerage received from the trade and not the gross amount of trade as revenue. However, Enron recorded the trade amount as revenue which was instrumental for it to reach the "$100 billion club" in revenue terms.

Warning Signs: Recording Bogus Revenue

If a company is recognizing revenue too soon, then look for these signals through which an investor can check for it:

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

Earnings Manipulation Shenanigan No. 3: Boosting Income Using One-Time or Unsustainable Activities

Shenanigan No. 3: Boosting Income Using One-Time or Unsustainable Activities

1. Boosting Income Using One-Time Events

Case in Point: IBM, indeed ran into a rough patch during 1999, as the company's costs increased faster than revenue. As the table below shows , cost of goods and services (CGS) grew 9.5 % in 1999, while revenue was up 7.2 %, resulting in a lower gross margin. However, somehow IBM's operating and pretax profits jumped a very impressive 30 %.

The large discrepancy between revenue and operating income growth should have tipped off diligent investors to do some further digging. When looking at the Income Statement One thing that should immediately stand out is the 11.6 % decline in (SG&A) expenses, in contrast to the 9.5 % increase in the CGS category. Second, the 30 % growth in both operating and pretax income seems very surprising on just 7.2 % sales growth.

A footnote, disclosed that IBM booked a $4.057 billion gain from selling its Global Network business to AT&T and curiously included that gain as a reduction in the SG&A expense. When we adjust the Income statement for this effect SG&A expense would cause the expense to jump **12.7 %** (rather than the reported *decline* of 11.6 percent) and operating and pretax profit actually declined by **14.1 and 14.8 percent**, respectively (rather than the reported increases of 30.2 and 30.0 percent).

Shenanigan No. 3: Boosting Income Using One-Time or Unsustainable Activities

Income Statement as Reported by IBM

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

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

Income Statement Adjusted for One-time Event

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

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

**Restated numbers, led to decline

Shenanigan No. 3: Boosting Income Using One-Time or Unsustainable Activities

2. Watch for Improper Capitalization of Marketing and Solicitation Costs: Marketing and solicitation costs are other examples of normal operating expenses that produce short-term benefits. Most companies spend money to advertise their products or services. Accounting guidelines normally require that companies expense these payments immediately as normal recurring short-term operating costs. However, certain companies aggressively capitalize these costs and spread them out over several periods.

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

If investors would have noticed, the dramatic increase in the DSAC balance over the next few years. By June, 1996 the DSAC amount on the Balance sheet has ballooned to **$314 million**, or 33 percent of total assets and 61 percent of shareholders' equity. Had these costs been expensed as incurred, AOL's 1995 pretax loss would have been approximately **$98 million instead of $21 million** and AOL's 1996 pretax income of $62 million would have been transformed to a **loss of $175 million.**

Investors should have been alarmed when they would have reviewed these things:

- The enormous growth in the unamortized DSAC represented a material underreporting of expenses and over reporting of profit during these three years.
- AOL merely shifted expenses from current to future periods, and those costs would materially dampen expected earnings in those future periods.
- The company made the initial change from expensing to the much more aggressive capitalizing.

Shenanigan No. 3: Boosting Income Using One-Time or Unsustainable Activities

3. **Watch for Changes in Policy from Expensing Costs to Capitalizing Them:** Excel Communications changed from expensing to capitalizing regular operating costs at a pivotal time in its history—right before its IPO. It decided to change its accounting related to sales commissions. Until 1995, Excel had expensed these marketing costs immediately. Beginning in 1995, it capitalized them and then amortized them over a 12-month period. In 1995, earnings almost tripled, to $44.4 million (or 46 cents per share) from $15.9 million (or 18 cents per share) a year earlier. The aggressive accounting inflated profit by $22.7 million (or 51 percent of the 1995 earnings).

If any diligent investor must have checked the footnotes, the company clearly mentioned that its changing its recording technique for marketing costs and would now be capitalizing it.

4. **Improper Capitalization of Costs Also Inflates Operating Cash Flow:** While normal operating costs are reflected as an operating cash outflow, capitalized costs would be presented as capital expenditures in the Investing section of the Statement of Cash Flows. By capitalizing normal operating costs, companies inflate not only earnings, but also operating cash flow.

- **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.

Case in Point: Intel Corp. and Marvell Technology Group made a deal where Intel agreed to sell certain assets of its communications and application business to Marvell. At the same time, Marvell agreed to purchase a minimum number of wafers from Intel over the next two years. However, there was a problem Marvell agreed to purchase at inflated prices and not the prevailing market price.

Shenanigan No. 3: Boosting Income Using One-Time or Unsustainable Activities

So, technically why would any business overpay for a product remember both the companies made a deal where Intel sold certain assets to Marvell, so obviously Marvell must have under paid for the purchase and therefore it is agreeing to overpay for products later.

So what's the benefit for Intel:

1. Intel, although received less cash upfront from sale, but will going forward receive revenue from Marvell in form of sale at inflated prices to Marvell;

2. This certainly works out well for Intel, as a recurring revenue stream impresses investors far more than cash received from the sale of a business.

So, how these transaction was recorded by Intel (hypothetical example):

Let's assume the value of the asset is Rs. 1,00,000 and the deal is structured where Marvell will pay 80,000 upfront and 20,000 later as inflated price of the products. Also, assume book value of the asset was Rs. 70,000 so the gain from the sale of business is Rs. 30,000. So Intel should record sales as follow:

But Intel instead recorded the transaction as follows:

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

When Intel sold asset to Marvell

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

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

When it received inflated revenue for product sale

Cash	$350,000	
Revenue		$350,000

Shenanigan No. 3: Boosting Income Using One-Time or Unsustainable Activities

2. Boosting Income through Misleading Classifications

The Statement of Income can be divided into two broad sections:

Above-the-line: income from the core business (revenue minus operating expenses)

Below-the-line: noncore or nonrecurring gains or losses

This section identifies 3 types of financial statement classifications that could inflate operating (above-the-line) income:

(1) shifting the "bad stuff" (i.e., normal operating expenses) out to the non-operating section,

(2) shifting the "good stuff" (i.e., non operating or nonrecurring income) into the operating section, and

(3) using questionable management decisions regarding Balance Sheet classification to help offload the bad stuff or upload the good stuff.

When we analyze a company's business performance, we need to analyze earnings from core operation by excluding the on time impacts of interest income, asset sales, investment sales and other sources which are not related to the daily operations of the business. Some companies will misclassify the income from non core activities to core operations which will lead to inflated operating revenue or income.

Investors typically pay much more attention to the operating income in assessing a company's health. So naturally, companies prefer to show case strong recurring operating income.

Let's Look at the ways in which companies misclassify

a. **Shifting Normal Expenses Below the Line:** The most common way to shift normal operating expenses below the line involves one-time write-offs of costs. For example, a company taking a one-time charge to write off inventory or plant would effectively shift the related expenses (i.e., cost of goods sold or depreciation) out of the operating section into the non-operating section and, as a result, push up operating income.

b. **Watch for Companies That Constantly Record "Restructuring Charges.":** Recording restructuring charges once is not a problem, however if a company recognizes restructuring charges every year on its Income Statement then it's a concern, the company may be bundling normal operating expenses into these charges and trying to pass them off as one-time in nature. If an investor finds frequent recording of restructuring charges then it must be investigated to know the real nature of the transaction.

c. **Watch for Companies That Shift Losses to Discontinued Operations:** Consider a struggling company with 3 divisions producing the following operating results: Division A, $100,000 income; Division B, $250,000 income; and Division C, $400,000 loss. The company would report a $50,000 net loss—unless it had decided to put Division C up for sale at the beginning of the period and account for it as a **"discontinued operation."** In so doing, that entire $400,000 loss would be moved below the line and most likely be ignored by investors. Although the company still operates all 3 divisions at a combined loss of $50,000, it would report operating income of **$350,000** and an **$400,000** below the-line loss.

d. **Shifting Non-operating and Nonrecurring Income Above the Line:** Shifting Non-operating income above the line and inflating the operating profit is the most common way to misrepresent the numbers. As, discussed previously with IBM, inflating operating income by including a one-time gain from selling a business could mislead investors about a company's true underlying economic health.

e. **Watch for Companies That Include Investment Income as Revenue:** Investors should be cautious when companies include investment income in revenue. For E.g Boston Chicken inflated its revenue by including its interest income into revenue calculation. While treating interest income as revenue clearly would be appropriate for banks and other financial institutions, it certainly sounds a bit unusual for a restaurant. Investors should remove the impact of interest income and then recalculate revenue to see the real picture.

Companies' Misclassification

g. **Be Suspicious of Inflated Operating Income Related to Subsidiaries:** Consider this hypothetical situation assuming a subsidiary with (1) total revenue of $1,000,000 and (2) total expenses of $400,000. Under accounting rules, the parent that owns 60 percent of the subsidiary still reports 100 percent of the revenue and operating expenses, or a $600,000 operating profit. Since in reality it owns not 100 but 60 percent, the 40 percent difference, or $240,000 (40 percent of $600,000), is subtracted below the line. Thus, investors will see operating profit of $600,000, not the real economic profit of $360,000 (or 60 percent of $600,000), which unfortunately would be less visible.

h. **Pay Attention to Where Companies Classify Joint Venture Income:** Under the equity method of accounting for investments/Joint Ventures, its proportionate share of the profits should be included as non-operating investment income, not as revenue. However Health-care information company Medaphis improperly included in revenue its $12.5 million share of the profits from an investment joint venture. The misclassification resulted in sales being overstated by 10 percent and, more important, operating profit being inflated by 108 percent.

So, what can investors do to avoid falling in these traps:

1. Commonsizing each and every line item of P&L;
2. Comparing YoY growth of every line item with revenue growth (For e.g. as seen in the case of IBM, revenue grew by 7%, whereas Operating profit grew by more than 30%. So, if an investor has compared the YoY growth and has seen it with in conjunction of Commonsizing then immediately it would make the investor realize about the discrepancy);
3. Look for one time expenses in the P&L and their classification;
4. Compare the P&L of the company with its peers and look at the difference between the company's reporting. Is the expense reported is required in the Industry or its just that company is recording.

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

If a company is boosting revenue using one time or unsustainable activities , then look for these signals through which an investor can check for it:

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

Earnings Manipulation Shenanigan No. 4: Shifting Current Expenses to a Later Period

Shenanigan No. 4: Shifting Current Expenses to a Later Period

1. **Improperly Capitalizing Normal Operating Expenses:** Capitalizing an expense means, management improperly recording costs on the Balance Sheet as an asset (or "capitalizes" the costs), instead of expensing them immediately.

Case in Point: WorldCom Inc., entered into many long-term network access arrangements to lease line costs from other telecommunication carriers. These costs represented fees that WorldCom paid for the right to use other companies' telecommunication networks. At first WorldCom properly accounted for these costs as an expense on its Statement of Income. But with the tech slowdown in 2000, WorldCom's revenue growth began to slow, and investors started paying more attention to the company's large operating expenses. And line costs were, by far, WorldCom's largest operating expense.

To meet the expectations of Wall streets analyst, in mid-2000 it changed its accounting (Red Flag).

Rather than recording all of these costs as expenses, WorldCom capitalized large portions of them as assets on the Balance Sheet, which led to grossly understating expenses and overstating profit from mid-2000 to early 2002.

Warning Signs of Improper Capitalization of Line Costs: When World Com, continued paying out money on line costs, although it lowered the expenses on Income Statement but however, there was a cash outflow. A careful analysis of Free Cash Flow would have given the correct picture (free cash flow went from a positive $2.3 billion in 1999 (the year before capitalizing the line costs) to a negative $3.8 billion (an astounding $6.1 billion deterioration).

Also, large increase in capital spending should have raised questions. Company belied its own guidance (given at the beginning of the year) for relatively flat capital expenditure. Because of shifting the expense from income statement to balance sheet the capital expenditures increased 32%, diligent investors should have questioned this rise in capital expenditures when the whole IT industry was experiencing a slowdown.

Shenanigan No. 4: Shifting Current Expenses to a Later Period

To summarize what are the warning Signs of Improperly Capitalizing Normal Operating Expenses:

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

2. Amortizing Costs Too Slowly

- **Be Wary of Companies That Depreciate Assets Too Slowly:** By comparing depreciation policies with industry norms, investors can determine whether a company is writing off assets over an appropriate time span. Investors should be concerned when a company depreciates its fixed assets too slowly.
- **Be Particularly Concerned When a Company Stretches Out Its Depreciable Life:** Company that chooses an overly long depreciation or amortization period generally would be considered guilty of using aggressive accounting. A more serious offense, however, is a company's changing to a longer period.

Case in Point: Time Warner Telecom changed its depreciable life for fixed assets in 2007, decision to lengthen the depreciable life on certain assets from 15 to 20 years inflated profit by about $4.9 million in that quarter. The $4.9 million represented nearly all of the company's $5.4 million in operating income that quarter, and an annualized $19.6 million certainly helped the company to improve on the $16.3 million in operating income reported in the previous year.

Shenanigan No. 4: Shifting Current Expenses to a Later Period

- **Watch for Slow Amortization of Inventory Costs:** In the film business, for example, the costs of making movies or TV programs are capitalized before the films' release. These costs are then matched (charged as expense) against revenue based on the receipt of revenue. Since revenue may be realized over several years, however, a film company must project the number of years of anticipated revenue flow. If it chooses too long a period, the inventory and profits will be overstated.

Consider, for example, a film that cost $20 million. If the company assumed that revenue would be received evenly over two years, it would expense $10 million each year. If, instead, it assumed that revenue would come in over four years, it would expense $5 million each year. If the movie wound up generating revenue over only two years instead of the four that were estimated, the company would have inflated profits by $5 million during those early years.

- **Be Alert for Boosts to Income by Stretching Out the Amortization Period:** In 1994**,** AOL Company, adopted aggressive capitalization of advertising costs and the decision to spread those costs over the next 12-month period. This aggressive capitalization completely misled investors, who believed that the company had been profitable, although in reality it was hemorrhaging cash and sustaining real economic losses.

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

Shenanigan No. 4: Shifting Current Expenses to a Later Period

3. Failing to Write Down Assets with Impaired Value

- **Failure to Write Off Impaired Plant Assets:** Company cannot simply keep on depreciating fixed assets on a rigid schedule, must continuously review these as sets for possible impairment and record an expense whenever the assumed future benefits fall below book value.

For example: Consider a piece of equipment that management first assumed would last for 10 years, but that breaks down permanently during year 5. Once it's out of service, the original depreciation schedule should be abandoned, and the remaining asset balance must be moved to the expense section immediately. If the company still recognizes depreciation on its P&L then it overstating its profit for that particular year, because if it takes one time hit on P&L by recognizing the remaining costs of the asset, then it will lead to huge reduction in profits.

- **Failure to Write Off Obsolete Inventory:** Companies naturally build up inventory in anticipation of selling product to customers. Sometimes, however, the demand for a product fails to meet a company's lofty expectations. As a result, the company may have to lower its prices in order to move the less desirable inventory. Or it may have to scrap (write off) the inventory completely. Management must routinely estimate its "excess and obsolete" inventory and reduce its inventory balance accordingly by recording an expense (often called inventory obsolescence expense).

Case in Point: Vitesse Semiconductor, recorded inventory obsolescence charges of $30.5 million in 2002 and $46.5 million in 2001. However, it decided to record no inventory obsolescence expense in 2003. Not recording obsolescence expense in 2003, helped its gross profit double to $83.2 million from $41.6 million the prior year on a mere 3 percent increase in sales.

Shenanigan No. 4: Shifting Current Expenses to a Later Period

- **Watch for an Unexpected Inventory Buildup:** Investors should monitor a company's inventory level by calculating its days' sales of inventory (DSI). Just as days' sales outstanding (DSO). This calculation helps investors determine whether an increase in the absolute level of inventory is in line with the overall growth of the business, or whether it might be a reason for margin pressure.

Whenever, a company is aggressively building up its inventory because the management is forecasting rapid revenue growth. To check whether the inventory buildup is justified or not simply compare the growth in the absolute level of inventory to the company's expected revenue growth. If inventory growth far exceeds the expected sales growth, the inventory bulge is probably unwarranted and a concern for investors.

Case in Point: Coldwater Creek Inc., whose inventory swelled in the July 2006 quarter. Management told investors, the rise in inventory was because of need to fill the shelves at the new 60 stores.

A quick calculation of DSI (98 days versus 78 days the year before), however, revealed that the inventory growth had exceeded the recent growth of the business. Moreover, the YoY growth in the company's **inventory balance (67.2 percent)** seemed completely unjustified when compared with management's expectations for revenue growth in the second half of **2006 (24.3 percent).**

When company came up with the results at the end of 2007, diligent investors were not surprised at the miserable results announced by the company because they knew this was coming!!

Shenanigan No. 4: Shifting Current Expenses to a Later Period

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

- **Failure to Adequately Reserve for Uncollectible Customer Receivables:** Companies must routinely adjust their accounts receivable balance to reflect expected customer defaults. This means, recording an expense on P&L as ("bad debts expense") and a reduction of accounts receivable on the Balance Sheet (the "allowance for doubtful accounts," which offsets gross receivables). However, many companies don't recognize bad debts even when they know they are not going to receive payment from that customer, failing to record such bad debt expense leads to artificially inflating profit

- **Watch for a Decline in Bad Debts Expense:** Vitesse Semiconductor, decided to record just $1.9 million in bad debts expense in the year 2003 after recording $14.3 million in the previous year. Vitesse accrued just $2.2 million in estimated expenses during 2003, after having recorded $49.9 million in such expenses during 2002. Had Vitesse accrued these expenses at the same percentage of revenue as in the previous year, its operating income would have been approximately $50 million lower.

So, whenever there is such drastic reduction in any expense item the investors should be cautious and try to find the reason for such a reduction.

- **Watch for a Drop in Allowance for Doubtful Accounts:** A, sharp decline in the allowance, coupled with a rise in receivables, often signals that a company has failed to record enough bad debts expense, and therefore has overstated earnings.

Case in Point: Scholastic Corporation, the company's accounts receivable balance jumped 5 percent in fiscal 2002, yet the allowance for doubtful accounts (ADA) declined by 11 percent. On a percentage basis, ADA dropped to 20.4% of gross receivables in 2002 from 24.1% in 2001. Had Scholastic kept the allowance account at 24.1 percent, 2002 operating income would have been $11.3 million lower.

Shenanigan No. 4: Shifting Current Expenses to a Later Period

- **Failure by Lenders to Adequately Reserve for Credit Losses:** Financial institutions and other lenders must continually estimate the portion of the loans they make that they expect to never collect (called credit losses or loan losses). The lender records an expense on the Statement of Income (called a "provision for credit losses" or "loan loss expense") and a reduction in total loans receivable on the Balance Sheet (called "allowance for loan losses" or "loan loss reserve"), shown as an offset to gross loans. Ideally, the total amount in the loan loss reserve should be enough to cover all loans that the bank believes.

When management fails to reserve a sufficient amount for losses, however, profits will be overstated. This overstatement will eventually catch up to the company when the loans go bad, as the company will be forced to write off bad loans with insufficient reserves accrued.

Case in Point: According to a mid-2007 study by Risk Metrics, from 1990 through 2006, major U.S. commercial banks had consistently reduced their loan loss reserve levels, which inflated their profits but left the companies woefully under reserved. Loan loss reserves fell to just 1.21 percent of total loans—a historic low, and well below the 2.50 percent range in the early 1990s. The low loan loss reserves helped the companies to o continuously inflate their profits.

These paltry industrywide reserve levels in 2006 not only boosted earnings and left companies exposed to the coming credit crisis, but indeed actually helped to create the crisis itself.

Warning Signs: Shifting Current Expenses to a Later Period

If a company is shifting current expenses to later period, then look for these signals :

- **Improperly capitalizing normal operating expenses.**
- **Changes in capitalization policy or accelerated capitalization of costs.**
- **New or unusual asset accounts and Jump in soft assets relative to sales.**
- **Unexpected increase in capital expenditures.**
- **Amortizing or depreciating costs too slowly.**
- **Stretching out depreciable asset life.**
- **Improper amortization of costs associated with loans.**
- **Failing to record expenses for impaired assets.**
- **Jump in inventory relative to cost of goods sold.**
- **Failure by lenders to adequately reserve for credit losses.**
- **Decrease in loan loss reserve relative to bad loans.**
- **Decline in bad debt expense or obsolescence expense.**
- **Decrease in reserves related to bad debts or inventory obsolescence.**

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

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

This chapter presents a more challenging financial shenanigan for investors to detect: when management decides not to even record certain expenses anywhere in the accounts.

1. **Failing to Record an Expense from a Current Transaction:** The first section of this chapter discusses hiding expenses by simply failing to record all or some of an expense from various transactions.

- **Recording Only Part of a Transaction:** Rent-Way's (company) accounting department stopped recording bills from vendors and the related expenses several weeks before the close of 1999 fiscal year. By doing so, the company artificially reduced expenses in fiscal 1999 by $28 million, and then again in 2000 by $99 million.

The new CFO discovered that Rent-Way's inventory system indicated that there was less merchandise in the stores than was reflected in the accounting records, which led to company disclosing accounting improprieties related to underreporting $127 million expenses over the previous 2 years. After this disclosure the stock price subsequently plummeted 72 percent, to $6.50 from $23.44.

- **Investigate Unusual Transactions in Which Vendors Send Out Cash:** Artificially companies reduce expenses and inflate profits when they pay excess cash to suppliers and enter into agreement to receive the extra cash to be paid as **"rebate"** over the next year. Ideally this rebate amount should be adjusted to the price of future supplier purchases. Instead of adjusting this rebate against price of future supplies, companies records this rebate as an immediate reduction of some expenses (e.g. office expenses). So this misclassification leads to inflated profits for that particular year.

So how can investors be cautious of this transaction: Always question any cash receipt from a vendor. Cash normally flows out to vendors, not in, so unusual cash inflows from vendors may signal an accounting shenanigan.

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

- **Failing to Properly Account for Stock Option Backdating Expense:** The options backdating scheme was really quite simple. Before finalizing an option grant, executives pulled up the stock chart and looked back in time to find a date on which the stock price was at a much lower level. Of course, options backdating had accounting implications as well. By not reporting the compensation expense resulting from these "in-the-money" grants, companies were overstating their earnings to shareholders.

Case in Point: The saga began when Broadcom's board initiated a review of option-granting practices on May 18, 2006, two days after a seminal CFRA (Center for Financial Research and Analysis) survey on options backdating. Broadcom finally admitted what it had done and estimated that this abuse of the system had allowed the company to avoid a whopping **$750 million in compensation expense.** Broadcom shocked investors by announcing an **unbelievable $2.2 billion expense**, which tripled the original estimate.

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

- **Watch for Declines in Reserves for Warranties or Warranty Expense:** For example, if you were to purchase a laptop from Dell, it might come with a two-year warranty promising that Dell will replace or repair all defective parts during that period.

Accounting rules require Dell to record an expense for expected future warranty costs at the time the product is sold. Naturally, management can exercise great discretion in the amount it records as warranty expense each period. If it chooses too little, the profit will shoot up; if it chooses too much, profits will be constrained (or simply held back for a rainy day).

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

Dell's Audit committee raised questions about the warranty expense recognition. Audit committee discussion "***There were also instances where warranty reserves in excess of the estimated warranty liability, as calculated by the warranty liability estimation process, were retained and not released to the Statement of Income as appropriate. Additionally, certain adjustments in the warranty liability estimation process were identified where expected future costs or estimated failure rates were not accurate.***"

So, how do investors avoid this?:

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

- **Watch for Declines in the Employee Bonus Accrual:** Employees earn bonuses over the course of the year, and naturally, accounting rules require that the expense be spread throughout the year even if the employees receive a single lump-sum payment. If management fails to record this accrual in any particular quarter, earnings for that period will be overstated. Moreover, the inappropriate reversal of past bonus accruals will inflate earnings as well.
- **Be Alert for Companies That Fail to Accrue Expenses for Loss Contingencies:** Occasionally, management may be required to establish a contingency reserve and record an expense (or loss) for outstanding, yet unsettled disputes. Accounting rules require that losses be accrued for such contingencies (e.g., expected payments related to litigation or tax disputes) when the following two conditions exist: (1) there is a probable loss, and (2) the amount of the loss can be reasonably estimated.

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

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

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

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

Increase:	Loss from Litigation	$6,000	
Increase:	Estimated Liability		$6,000

3. **Failing to Record or Reducing Expenses by Using Aggressive Accounting Assumptions:** This technique demonstrates how management's flexibility in selecting accounting policies and estimates can be a tool for hiding expenses. Management can manipulate earnings (and reduce liabilities) by changing accounting or actuarial assumptions.

- **Boosting Income by Changing Lease Assumptions:** Lease accounting provides management with another in which it can knead estimates to help inflate earnings.

Case in Point: Xerox, in the late 1990s accelerated the recognition of lease revenue. One of the estimates that Xerox manipulated was the residual value on certain leases. The residual value is a company's estimate of what the leased equipment will be worth when it is returned by the customer at the end of the contract. Since equipment will be depreciated till residual value, companies can boost profits by having a high residual value as this would lower the depreciation amount thus high earnings.

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

4. **Reduce Expenses by Releasing Reserves from Previous Charges:** One benefit of taking a special charge is to inflate future-period operating income because future costs have already been written off through that charge. In this section, we consider another type of reserve: generic liability reserves that management might have established by taking a charge at some point. These "cushion" reserves can be especially scary for investors.

- **Watch for the Release of Restructuring Reserves into Income:** Lets look at how Sunbeam corporation. When the company went through a large restructuring it recorded many restructuring charges, thereby creating reserves to be used for future expenses related to restructuring plan. These improper reserves were later reversed into income, inflating profit margins and creating the illusion of a successful restructuring.

Example: Assume that the company announces a 1,000-person layoff with a severance package totaling $10 million. The transaction will lead to twin effects on Balance Sheet: (1). Increase in Restructuring expense by $10 million and (2). Increase in Liability for severance by $10 million.

Now, Six months later, the layoffs have been completed, yet only 700 employees lost their jobs. The company eliminates the remaining liability and boosts income by reducing an expense: (1). Decrease in Restructuring expense by $3 million and (2). Decrease in Liability for severance by $3 million.

So, what can investors do to avoid falling in these traps:

Many of these liability reserves (especially the generic ones) are often grouped in a "soft" liability account sometimes called "other current liabilities" or "accrued expenses."

Investors should monitor soft liability accounts closely and flag any sharp declines relative to revenue. Often, companies discuss these soft liabilities in a footnote. Make sure to find them and track the individual reserves as well.

Warning Signs: Employing Other Techniques to Hide Expenses or Losses

If a company is shifting current expenses to later period, then look for these signals :

- **Unusually large vendor credits or rebates.**
- **Unusual transactions in which vendors send out cash.**
- **Failing to record an expense for a necessary accrual or reversing a past expense.**
- **Unusual declines in reserve for warranty or warranty expense.**
- **Declining accruals, reserves, or “soft liability” accounts.**
- **Unexpected and unwarranted margin expansion.**
- **Unusually “lucky” timing on the issuance of stock options.**
- **Failing to accrue loss reserves.**
- **Failing to highlight off-balance-sheet obligations.**
- **Changing pension, lease, or self-insurance assumptions to reduce expenses.**
- **Outsized pension income.**

Earnings Manipulation Shenanigan No. 6: Shifting Current Income to a Later Period

Shenanigan No. 6: Shifting Current Income to a Later Period

1. Creating Reserves and Releasing Them into Income in a Later Period:

- **Creating Deferred (or Unearned) Revenue:** Assume that a company made a cash sale for $900. The correct journal entry would be (1). Increase in Cash by $900 and (2) Increase in Sales Revenue by $900. Now Instead, if management decided to only record $600 of the sale this year and squirrel away the rest for next year, it would record: (1). Increase in Cash by $900 and Increase in Sales Revenue by $600 and Deferred revenue by $300.

Then next year, management would simply release that "pent-up" deferred revenue into revenue. The underlying effect would be (1). Decrease in Deferred revenue by $300 and Increase in Sales Revenue by $300.

- **Saving Up for a "Rainy Day"- Software giant Microsoft:**

- **Stretching Out Unexpected Gains over Several Years:** Companies shifts large amount of gains to later periods to show sustained growth in revenue. Consider W. R. Grace (company). In the early 1990s, Grace's health-care subsidiary experienced a significant and unanticipated increase in revenue as a result of changes in Medicare reimbursements. Management deferred some of the unanticipated income by increasing reserves so that it could be later released into net income. These reserves ballooned to more than $50 million by the end of 1992. By creating these reserves and then releasing some of them, the subsidiary reported steady earnings growth of **from 23% to 37 % between. The actual growth rates ranged from minus 8% to plus 61%.**

- **Shifting Huge Trading Gains to the Future:** In 2000-01, Enron's earned huge windfall profits in its trading division. The profits were so large that management decided to save some for future quarters. This scheme was fairly straightforward: simply defer some of the trading gain by storing it in a reserve on the Balance Sheet. These reserves came in handy and helped Enron avoid reporting large losses during difficult periods. By early 2001, Enron's undisclosed reserve accounts had ballooned to over $1 billion.

Shenanigan No. 6: Shifting Current Income to a Later Period

The company then improperly released hundreds of millions of dollars of these reserves to ensure that Wall Street's expectations were met.

- **Using Reserves to Smooth Income Is a Serious Transgression:** Smoothing of income is not an uncommon strategy for management to engage in, as Wall Street rewards solid and predictable profit growth. When revenue is recorded too early, future income is recorded in the current period; conversely, with income smoothing, current income is shifted to a future period.

2. **Improperly Accounting for Derivatives in Order to Smooth Income:** Consider mortgage giant Federal Home Loan Mortgage Corporation (Freddie Mac or Freddie) and its desire to portray very smooth earnings despite a period of volatile interest-rate movements.

- **Volatile Interest-Rate Market Makes "Steady Freddie" Much Less Predictable:** Freddie's earnings manipulation was related largely to its incorrect accounting for derivative instruments, loan origination costs, and reserves for losses. From 2000 to 2002, Freddie Mac underreported net income by nearly $4.5 billion. As shown in Table 8-2, Freddie's smoothing techniques allowed it to report earnings growth of 63 and 39 percent in 2001 and 2002, when in reality, earnings growth was a much more volatile negative 14 % in 2001 and positive 220 % in 2002. The company's rock-solid stock price was largely built on its ability to produce steady and predictable earnings. In order to please Wall Street, company held back a large part of windfall gain and release it in portions, needed to smooth earnings.

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

Shenanigan No. 6: Shifting Current Income to a Later Period

- **Fannie Trumps Freddie in Income Manipulation:** Fannie Mae, the larger competitor of Freddie Mac, had a similar desire and incentive to present a steady stream of earnings growth in the volatile and unpredictable mortgage market. The largest part of Fannie's accounting fraud involved improper accounting for these derivatives.

For example, all quarterly gains or losses from the change in value (i.e., the mark-to market adjustment) on a hedge that is deemed to be "ineffective" should be recognized as current-period income. Yet for certain types of "effective" hedges, the change in value does not affect earnings at all. In a nut shell, Fannie did not record declines in the value of its derivatives appropriately; it classified some hedges as effective (no impact on earnings) when they should have been treated as ineffective (impact on earnings).

- **Watch for Large Gains from Ineffective Hedging:** Investors should be cautious when a company reports large gains from hedging activities, as these ineffective (sometimes called economic) "hedges" may really be unreliable speculative trading activities. Consider Washington Mutual Inc., with its history of presenting large gains on activities that it characterized as hedging. In 2004, the company reported $1.6 billion in gains that were classified as "economic hedges" against a $500 million loss from its unhedged MSR (mortgage servicing rights) asset. In other words, Washington Mutual's hedging activities resulted in gains that were three times the size of the underlying loss.

*****Investors should also be wary of "hedges" that move in the same direction as the underlying asset or liability, as this may signal that management is using derivatives to speculate, not to hedge.**

Shenanigan No. 6: Shifting Current Income to a Later Period

3. **Creating Reserves in Conjunction with an Acquisition and Them into Income in a Later Period:** Companies that are making acquisitions might be tempted to have the target company hold back some revenue that was earned before the deal closes so that the acquirer can record it in the later period Inflating revenue right after closing on an acquisition is a pretty simple trick: once the merger is announced, instruct the target company to hold back revenue until after the merger closes. As a result, the revenue reported by the newly merged company improperly includes revenue that was earned by the target before the merger.

Case in Point: Consider the 1997 merger of 3Com with U.S. Robotics. Apparently, U.S. Robotics held back an enormous amount of revenue so that it would be available to 3Com after the merger closed. U.S. Robotics reported a minuscule $15.2 million of revenue for the two-month stub period (approximately $7.6 million per month), a tiny fraction of the $690.2 million in revenue that the company had reported during the preceding quarter (approximately $230 million per month). Rather than recognizing the revenue during the normal course of business, U.S. Robotics apparently held back well over $600 million.

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

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

- **Be Alert for Lower Revenue at a Target Company Just Before It Is Acquired:** Consider, for example, Computer Associates' 1999 purchase of Platinum Technologies. During the March 1999 quarter, the last one before the deal closed, Platinum's revenue plunged to its lowest level in seven quarters, falling by more than $144 million sequentially and by more than $23 million from the year-ago period. Whatever the real reasons, however, Platinum's failure to close these sales provided its new owner with an artificial revenue boost.

Shenanigan No. 6: Shifting Current Income to a Later Period

If the investor had analyzed further, they should still be concerned that Computer Associates was buying a business with rapidly shrinking revenue.

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

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

4. Recording Current-Period Sales in a Later Period: Management simply decides to record the sale after the period closes, thereby holding back revenue until the later period. Sales continue at a brisk pace, and management has an idea that will ensure high bonus payments for the next period as well—stop recording any more sales and shift them to the next quarter. It is simple to do, it is unlikely that the auditors will even know about this trick, and your customers certainly won't object, since they will get billed later than they expected.

Warning Signs: Shifting Current Income to a Later Period

If a company is shifting current expenses to later period, then look for these signals :

- **Creating reserves and releasing them into income in a later period.**
- **Stretching out windfall gains over several years.**
- **Improperly accounting for derivatives in order to smooth income.**
- **Holding back revenue just before an acquisition closes.**
- **Creating acquisition-related reserves and releasing them into income in a later period.**
- **Recording current-period sales in a later period.**
- **Sudden and unexplained declines in deferred revenue.**
- **Changes in revenue recognition policy.**
- **Unexpectedly consistent earnings during a volatile time.**
- **Signs of revenue being held back by the target just before an acquisition closes.**

Earnings Manipulation Shenanigan No. 7: Shifting Future Expenses to an Earlier Period

Shenanigan No. 7: Shifting Future Expenses to an Earlier Period

1. Improperly Writing Off Assets in the Current Period to Avoid Expenses in a Future Period:

- **Improperly Writing Off Deferred Marketing Costs:** AOL(company), were struggling to show a profit and had begun capitalizing marketing and solicitation costs in order to push the company into the black. AOL had accumulated more than $314 million in the asset account labeled deferred subscriber acquisition costs (DSAC).

But the company still had a big problem: those costs represented tomorrow's expense, and they would need to be amortized over the next eight quarters—a $40 million hit to earnings each quarter. Considering AOL's modest earnings level ($65.2 million in operating income in fiscal 1996), a recurring $40 million quarterly charge would be, to put it mildly, quite unwelcome.

So, 3 months later, when its DSAC asset had ballooned to $385 million. Rather than amortizing the marketing costs over the next eight quarters, AOL switched gears and announced "a one-time charge" to write off the entire amount in one fell swoop.

- **Cisco Systems Writes Off Billions in Inventory:** Cisco System Inc.'s $2.25 billion inventory write-off in April 2001, however, stood out from the pack as unusual. Compared with the most recent quarter's cost of goods sold, we really understood the magnitude of that number: the amount written off represented more than 100 % of that entire quarter's inventory sales.

For Example: Cisco spends $100 to manufacture inventory, and then sells it for $150, producing a $50 gross profit. If, during that earlier period, the $100 unit had been written off to zero and subsequently sold for $150, Cisco would recognize a $150 profit (100 percent margin). Or even if it had just written down the inventory to $75, Cisco would recognize a $75 profit (50 percent margin).

Shenanigan No. 7: Shifting Future Expenses to an Earlier Period

- **Too Many Toys:** Toys 'R' Us accumulated excess inventory that it failed to sell. The company announced that it would take a $396.6 million (pretax) restructuring charge to cover the cost of a "strategic inventory repositioning" (interpretation: it simply moved slow selling inventory off of its shelves).
- **Conclusion:** Whether it is AOL, Cisco or Toys 'R' all of them large one-time charges, each seemingly had the same ultimate result: accelerating future-period expense into the current period and, moreover, categorizing the write-off as being unrelated to normal activities and showing it below the line. Such actions inflate future-period profits with no detriment to current-period operating results.

2. Improperly Recording Charges to Establish Reserves Used to Reduce Future Expenses:

- **Watch for Dramatic Improvement in the Numbers Right After the Restructuring Period:** Sunbeam's operating income surged to $132.6 million in the 9 months following the restructuring charge, from $4.0 million in the prior-year period. During the December 1996 quarter, Sunbeam recorded a special charge of $337.6 million for restructuring and another $12 million charge for a media advertising campaign. During the same period revenue increased by 16% whereas operating income grew 30 times (so surely this presents some suspicious activity).
- **Watch for Companies That Create Reserves at the Time of an Acquisition:** In December 2000, Symbol Technologies recorded $185.9 million in charges in connection with its purchase of competitor Telxon Corporation. At the time, Symbol justified these charges as being necessary for restructuring of operations, impairment of assets (including inventory), and merger integration costs. It turned out that the reserves were fictitious used to inflate earnings in future.

Shenanigan No. 7: Shifting Future Expenses to an Earlier Period

- **Using a Restructuring Reserve to Smooth Earnings:** For example company plans to lay off 100 people and takes charge for these 100 as a restructuring charge. So, management announces a 200-person layoff when 100 would be sufficient, management doubles the restructuring expense and liability. Let's assume that management provides a $25,000 severance package for each person who is laid off. That works out to $2.5 million if management acts ethically; alternatively, by doubling the 100 employees to 200, it takes a $5 million charge. Now the company has recorded an extra $2.5 million, so now it releases this extra liability amount as a way of reduction in operating expenses, which in turn leads to inflating the earnings.

Now what things should be looked at, to check whether management is shifting future expenses to earlier period:

- Check for drastic increase in reserve amount, which is not part of daily operations.
- Compare the growth of company with its peers during all the cycles (if the nature of industry is cyclical and despite that company is reporting consistent earnings then we should be skeptical).
- Look for changes in Income statement post any acquisition, and also check whether the company is doing a reasonable acquisition.

Warning Signs: Shifting Future Expenses to an Earlier Period

If a company is shifting future expenses to earlier period, then look for these signals :

- **Improperly writing off assets in the current period to avoid expenses in a future period.**
- **Improperly recording charges to establish reserves used to reduce future expenses.**
- **Large write-offs accompanying the arrival of a new CEO.**
- **Restructuring charges just before an acquisition closes.**
- **Gross margin expansion shortly after an inventory write-off.**
- **Repeated restructuring charges that serve to convert ordinary expenses to a one-time expense.**
- **Unusually smooth earnings during volatile times.**

Part 2: Cash Flow Shenanigans

Part 2: Cash Flow Shenanigans

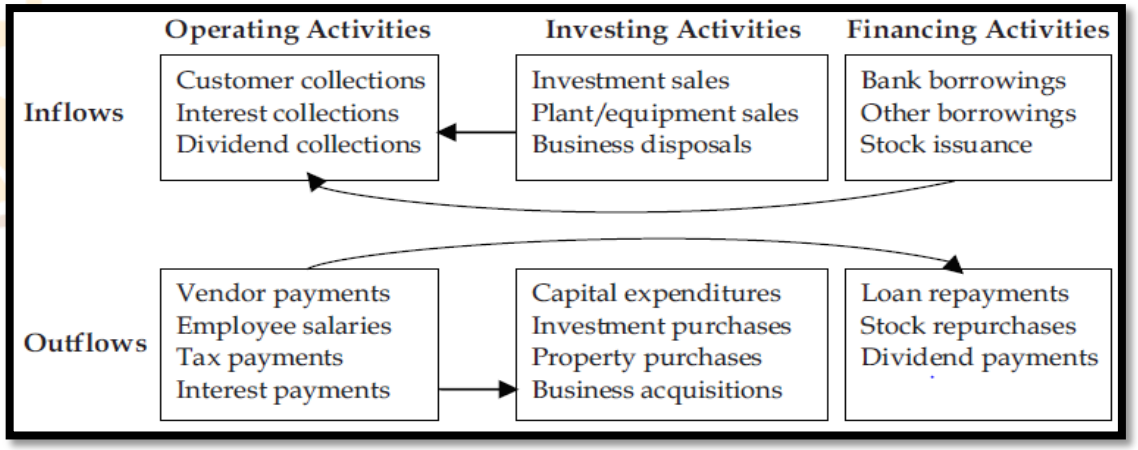
We will look at 4 Cash Flow Shenanigans:

1. Shifting Financing Cash Inflows to the Operating Section;
2. Shifting Normal Operating Cash Outflows to the Investing Section;
3. Inflating Operating Cash Flow Using Acquisitions or Disposals;
4. Boosting Operating Cash Flow Using Unsustainable Activities.

Lets look at some common Cash Flow manipulation techniques:

	Operating Activities	Investing Activities	Financing Activities
Inflows	Customer collections Interest collections Dividend collections	Investment sales Plant/equipment sales Business disposals	Bank borrowings Other borrowings Stock issuance
Outflows	Vendor payments Employee salaries Tax payments Interest payments	Capital expenditures Investment purchases Property purchases Business acquisitions	Loan repayments Stock repurchases Dividend payments

Common ways of manipulating Cash flow (Main purpose is to inflate CFO):



Whenever an investor carefully analyses the Cash Flow from Operations, he will for sure catch mostly all the accounting gimmicks by management.

For example: If a company tries to inflate its operating profit, the most simplest way to check whether the operating profits are real or it is just the result of company's aggressive earnings recognitions. Just check CFO/EBITDA ratio over a period of time. If the ratio is very low say for example it is 40%, it signifies only 40% operating profit is converted into cash and the remaining is stuck in working capital.

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

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

Companies manipulate Cash Flows by sending all of the desirable cash inflows to the most important section (Operating) and all of the unwanted cash outflows to the other sections (Investing and Financing).

Techniques to Shift Financing Cash Inflows to the Operating Section:

1. Recording Bogus CFFO from a Normal Bank Borrowing;
2. Boosting CFFO by Selling Receivables Before the Collection Date;
3. Inflating CFFO by Faking the Sale of Receivables.

Lets look at each technique in detail:

1. Recording Bogus CFFO from a Normal Bank Borrowing:

- **Sham Sales of Inventory to a Bank:** At the end of 2000, Delphi Corporation was in troubles. Delphi's operations continued to deteriorate in the fourth quarter of 2000, and the company was facing the prospect of having to tell investors that cash flow from operations had turned severely negative for the quarter.

Delphi went to its bank and offered to sell it $200 million in precious metals inventory. Lets look at the economics of the transaction. Delphi took out a short-term loan from Bank, now the banks requires some collateral so the inventory is kept as collateral. Delphi should have recorded the $200 million received from Bank One as a borrowing (an increase in cash flow from financing activities). As a plain vanilla loan, this transaction should have increased cash and a liability (loan payable) on Delphi's Balance Sheet.

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

Now, the company recorded the transaction in a different way altogether Delphi brazenly recorded it as the sale of $200 million in inventory. In so doing, Delphi inflated revenue and earnings. Moreover, it also overstated CFFO by the $200 million that Delphi claimed to have received in exchange for the "sale" of inventory. Without this $200 million, Delphi would have recorded only $68 million in CFFO for the whole year (rather than the $268 million reported).

- **Remember That Bogus Revenue May Also Mean Bogus CFFO:** We consider that decision unwise. Investors should understand that bogus revenue might also signal bogus CFFO. This was clearly the case in the Delphi example discussed here, as well as in many other so-called boomerang transactions. Thus, as a rule, signs of bogus revenue may also portend inflated CFFO as well.

- **Be Wary Around Pro Forma CFFO Metrics:** Delphi steered investors away from its reported CFFO, and instead highlighted a cash flow measure that it defined itself and confusingly labeled "Operating Cash Flow." Normally investors use the terms CFFO and operating cash flow interchangeably; however, Delphi defined them very differently. In FY 2000, Delphi reported $268 million in CFFO ; however, its self-defined "Operating Cash Flow" (reported in the earnings release) was $1.636 billion. No, we're not kidding—a differential of an amazing $1.4 billion. Careful investors would have noticed this shenanigan.

- **Complicated Off-Balance-Sheet Structures Raise the Risk of Inflate CFFO:** Enron, particularly its use of off-balance-sheet vehicles such as special purpose entities. Some of the schemes that Enron concocted helped it present a misleadingly stronger CFFO. For example, Enron would create such a vehicle and then help it borrow money by co-signing its loans. The Enron-controlled vehicle then used the cash received to "purchase" commodities from Enron. Enron recorded the cash received as an Operating section inflow (CFFO) from the "sale" of the commodities.

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

2. **Boosting CFFO by Selling Receivables Before the Collection Date:** Companies often sell accounts receivable as a useful cash-management strategy. How does selling of receivables work: The company finds a willing investor (often a bank) and transfers the ownership of some receivables to it. In return, the company pockets a cash payment for the total amount of receivables, less a fee. The appropriate place to record cash received from the sale of receivables would be as an Operating, not a Financing inflow.

- **Selling Accounts Receivable: An Unsustainable Driver of Cash Flow Growth:** Lets look at, Cardinal Health (company). The company needed to generate extra cash, so management decided to sell accounts receivable to help the company raise substantial amount of cash quickly. By the end of Q2, 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. By doing so it shifted future period cash inflows into the current quarter.

- **Watch for Sudden Swings on the Statement of Cash Flows: To avoid the case that occurred in Cardinal Health, look for sudden swings in CFO.**

The CFO increased by a $1.1 billion (from $548 million to $1.5 billion), mainly because of 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**. By looking at the sudden jump in accounts receivable investors should be cautious about this. And mainly investors should not focus on **"how much CFO grew"** instead try to find out **"how it grew".**

- **Stealth Sales of Receivables:** Take, for instance Sanmina-SCI Corporation reported its Q4 results, the results displayed strong CFO and Accounts receivable too decreased. 2 months later the 10-K filed by the company highlighted that the primary driver of CFFO in Q4 was the sale of receivables. Sanmina reported that $224 million in receivables. The company has been selling receivables for quite long. As shown in the table, without this increase in receivables sold CFO would have been $36 million instead of reported $175 million.

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

Now, by reading the filing done by company would have made investors aware of the reason of sudden jump in CFO. However, astute investors who have read previous quarters filing, would have noticed that company discussed sale of receivables for at least 4 times and therefore the diligent investors would have known the reason behind sudden decrease in receivables and increase in CFO.

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

3. Inflating CFFO by Faking the Sale of Receivables: In this section, we will look at another procedure "faking the sale of receivables".

- **Shame Sales of Receivables:** Lets look at Peregrine (company). Peregrine adopted deceptive practices such as recording bogus revenue and entering into reciprocal transactions. All of this fake revenue resulted in bloated receivables on the Balance Sheet that would never be collected. Concerned with increased receivables it began ***"fake sales of accounts receivable".*** **In this arrangement company transferred its receivables to bank in exchange for cash, however collection risk 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.**

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. Investors should watch carefully for disclosure changes in Risk factors.

For example: Peregrine highlighted twice in its disclosure about the risks have increased 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. Then, in December 2001, Peregrine added one small sentence to the end of the new disclosure from the June period, it was clearly mentioned that company might sell receivable balances with third parties.

Warning Signs: Shifting Financing Cash Inflows to the Operating Section

If a company is shifting financing cash flows to operating section, then look for these signals :

- **Recording bogus CFFO from a normal bank borrowing.**
- **Boosting CFFO by selling receivables before the collection date.**
- **Disclosures about selling receivables with recourse.**
- **Inflating CFFO by faking the sale of receivables.**
- **Changes in the wording of key disclosure items in the financial reports.**
- **Providing less disclosure than in the prior period.**
- **Big margin expansion shortly after an inventory write-off.**

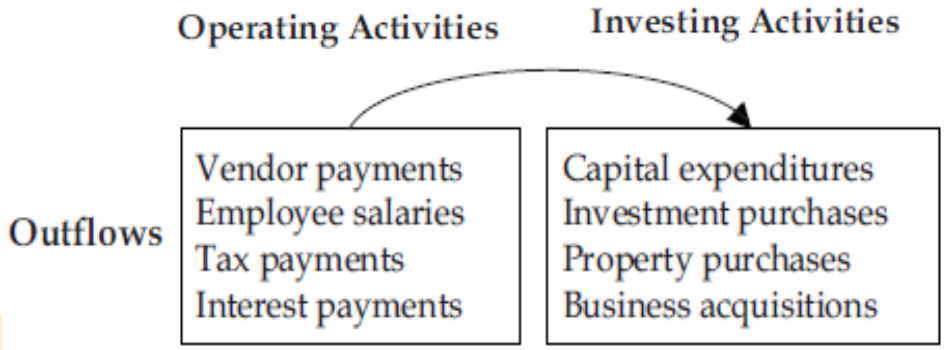
Cash Flow Manipulation Shenanigan No. 2: Shifting Normal Operating Cash Outflows to the Investing Section

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

The Companies have found numerous clever ways to dump normal operating cash outflows into the Investing section, hoping that they will vanish forever.

Techniques to Shift Normal Operating Cash Outflow to the Investing Section:

1. Inflating CFFO with Boomerang Transactions;
2. Improperly Capitalizing Normal Operating Costs;
3. Recording the Purchase of Inventory as an Investing Outflow.



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1. **Inflating CFFO with Boomerang Transactions**: Global Crossing was one of the highest-flying technology companies during the 1990s dot-com bubble. In 2000, despite a negative $1.7 billion in earnings, the company reported to investors a positive $911 million in operating cash flow. Normally, investors would be overjoyed about a company that generates more CFO than net income, however the CFO was not showing a correct picture.

As tech industry was witnessing 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. **How it worked:** Global Crossing would sell capacity to a customer and simultaneously buy a similar amount of capacity on a different network.

How does it impact Cash Flow? ***"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"***

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

How investors could have avoided it?

- **Looking at the simple disclosure:** Global Crossing in its March 2001 10-K disclosure mentioned 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."
- If you identify a boomerang transaction, investors should dig around and try to understand the arrangement.

2. **Improperly Capitalizing Normal Operating Costs:** 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:** Lets consider World Com, it inflated its earnings by recording its line costs (a clear operating expense) as an asset rather than as an expense. This move also allowed WorldCom to present strong operating cash flow. Purchases of capital assets (called "capital expenditures") are classified on the Statement of Cash Flows as Investing activities.

By classifying line costs as a capital asset, WorldCom shifted a 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.

Together with other improperly capitalized costs and CFFO boosts, WorldCom's operating cash flow was overstated by a whopping $8.588 billion over these two years.

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

How to check whether company is adopting Improper Capitalization:

- Rapidly growing fixed asset accounts or "other assets" may be a sign of aggressive capitalization. Create a quarterly common-size Balance Sheet to help you quickly identify assets that are growing faster than the rest of the Balance Sheet.
- Calculate Free Cash to get a more clear picture

Table 11-3. WorldCom's Free Cash Flow

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

3. **Recording the Purchase of Inventory as an Investing Outflow:** The economics of purchasing goods to be sold to customers suggests that these purchases should be classified as an Operating activity. Curiously, some companies treat these purchases as an Investing outflow.

- **Purchase of DVDs: Operating or Investing?:** Consider the case of Netflix Inc., the online movie rental company. While Netflix's Statement of Income appropriately reflects the economics of its DVD costs, its Statement of Cash Flows does not. Instead, it considers the purchase of DVDs to be the purchase of a capital asset, and therefore the cash outflows are presented in the Investing section.

However, Netflix's competitor Blockbuster Inc reported DVD purchases as an Operating Cash Outflow after a consulting with the regulator.

How investors should analyze such discrepancies between two similar companies:

- Since Netflix puts DVD purchases in the Investing section and Blockbuster puts them in the Operating section, investors have little ability to compare the CFFO of the two companies without making an adjustment.
- If the investors have just looked at full detailed cash flow from investing section of Netlfix, the picture would be clear to them as company was describing purchase of DVD as investing outflow,

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

- **Purchasing Patents and Newly Developed Technologies:** Some companies report cash paid to acquire already researched and developed products as an Investing outflow. Lets look at biopharmaceutical company Cephalon. Cephalon went on a $1 billion shopping spree in 2004 and 2005, snapping up patents, rights, and licenses related to several newly developed drugs. Cephalon presented these cash payments as "acquisitions" and dumped them into the Investing section of the Statement of Cash Flows. Had they been classified as Operating, CFFO instead would have been severely negative in both years.

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

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

- **I'll Gladly Pay You Tuesday for a Hamburger Today:** Biovail Corporation, Canada's largest pharmaceutical company, 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. 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.**

Warning Signs: Shifting Normal Operating Cash Outflows to the Investing Section

If a company is shifting operating cash outflows to Investing section, then look for these signals :

- **Inflating operating cash flow with boomerang transactions.**
- **Improperly capitalizing normal operating costs.**
- **New or unusual asset accounts.**
- **Jump in soft assets relative to sales.**
- **Unexpected increase in capital expenditures.**
- **Recording purchase of inventory as an investing outflow.**
- **Investing outflows that sound like a normal cost of business.**
- **Purchasing patents, contracts, and development-stage technologies.**

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

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

In this chapter, we will discuss three techniques by which Tyco, WorldCom, and other such companies use acquisitions and disposals to enhance and flatter cash flow from operations (CFFO).

Techniques to Inflate Operating Cash Flow Using Acquisitions or Disposals:

1. Inheriting Operating Inflows in a Normal Business Acquisition;
2. Acquiring Contracts or Customers Rather Than Developing Them Internally;
3. Boosting CFFO by Creatively Structuring the Sale of a Business.

1. Inheriting Operating Inflows in a Normal Business Acquisition: Whenever a company is acquired the, it is done without affecting CFO If you buy the company with cash, the payment is recorded as an Investing outflow. When you acquire a company, however, and inherit its accounts receivable, the cash outflows involved in generating those receivables were recorded on the acquired company's books prior to the acquisition. This means that when you collect those receivables, you will be receiving an Operating cash inflow without ever having recorded a corresponding Operating cash outflow.

So, we can say that acquisition could lead to boost to CFO, in the books of acquirer. However, it becomes very important to check the quality of earnings on the back of boost to CFO.

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

- **Case in Point:** Tyco made a lot of acquisitions. From 1999 to 2002, Tyco bought more than 700 companies (that's not a typo) for a total of approximately $29 billion. Some of these acquisitions were large companies; however, most of the businesses acquired were small enough that Tyco considered them "immaterial" and chose to disclose nothing at all about them. Although there was healthy CFO generation, but when the CFO was adjusted for capital expenditures and cash paid for acquisitions it depicted the clear picture:

Table 12-2. Tyco's Free Cash Flow After Acquisitions (from Continuing Operations)

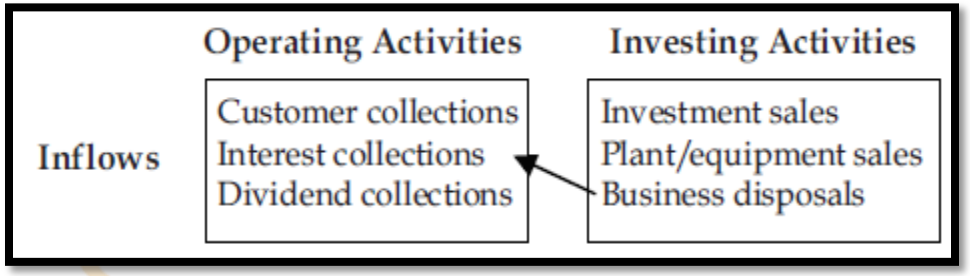
($ millions)	2002	2001	2000	1999
Reported cash flow from operations	5,696	6,926	5,275	3,550
Subtract: Capital expenditures	(1,709)	(1,798)	(1,704)	(1,632)
Subtract: Construction in Progress	(1,146)	(2,248)	(111)	—
Free cash flow	2,841	2,880	3,460	1,918
Subtract: Acquisitions	(3,709)	(11,851)	(4,791)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

2. **Acquiring Contracts or Customers Rather Than Developing Them Internally:** Witness Tyco (again) and its electronic security monitoring business. **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.

- However, Tyco executives did not view these $800 payments to dealers to be normal customer solicitation costs rather it ousted for normal business acquisitions: as Investing outflow. Later, 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.

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

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. Tyco used a "Dealer Connection Fee Sham Transaction" to **fraudulently generate $719 million in CFFO.**



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

- **Recording CFO for Proceeds from the Sale of a Business:** In 2005, Softbank sold its modem rental business to Gemini, and simultaneously, the companies entered into a "service agreement" in which Gemini would pay Softbank royalties based on the modem rental business's future revenue. At the time of the sale, Softbank received ¥85 million in cash from Gemini, but it did not consider the entire amount to be related to the sale price of the business.

Rather than recording an ¥85 million Investing inflow from the sale of the business, Softbank recorded (1) a ¥45 million Investing inflow from the sale of the business and (2) a ¥40 million Operating inflow from the "advance" on future revenue. This ¥40 million boost to CFFO represented 69 % of Softbank's ¥57.8 million in CFFO for the full year.

How it could easily be avoided: Investors could easily have spotted Softbank's CFFO boost just by looking at the Statement of Cash Flows. New line item surfaced in 2006—a ¥40 million "increase in deferred revenue.

Warning Signs: Inflating Operating Cash Flow Using Acquisitions or Disposals

If a company is inflating operating cash flow using Acquisitions or Disposal, then look for these signals :

- **Inheriting Operating cash inflows in a normal business acquisition.**
- **Companies that make numerous acquisitions.**
- **Declining free cash flow while CFFO appears to be strong.**
- **Acquiring contracts or customers rather than developing them internally.**
- **Boosting CFFO by creatively structuring the sale of a business.**
- **New categories appearing on the Statement of Cash Flows.**
- **Selling a business, but keeping the related receivables.**

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

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

Here, we will discuss 4 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 Benefit.

1. **Boosting CFFO by Paying Vendors More Slowly:** The CFO of Home Depot more than doubled from $2.8 billion to nearly $6 billion from 2000-01. This cash flow growth, however, would prove to be unsustainable and unrelated to increasing sales at the business. The growth in CFO was mainly because of delayed payments to vendors (stretched out accounts payable to 34 days from 22 the year earlier). So, for 2001 the mission was accomplished The next year, Home Depot was faced with the challenge of improving upon an incredible 2001. In order to grow CFFO again, however, the company firs would have to replicate the 2001 boost that it would no longer receive in 2002. The company was able to stretch payables again in 2002, but not to the extent of the prior year (as payables reached 41 days from 34 days). CFFO for 2002 fell to $4.8 billion from $6.0 billion in 2001.

The takeaway however here is, is that the $3 billion increase in CFFO during 2001 should have been viewed as nonrecurring.

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

How Investors should be wary of these ways to boost CFO:

- Watch for an Increase in Payables.
- Look for Large Positive Swings on the Statement of Cash Flows.
- Watch for Swings in Other Payables Accounts.

2. Boosting CFFO by Collecting from Customers More Quickly: The growth in CFO that results from accelerated collections should be deemed unsustainable.

Take, for example, technology services provider EDS. In 2002, EDS renegotiated a contract with an existing customer and received up front a $200 million prepayment for services that the company was scheduled to provide over the next two years. However, EDS should have notified investors that this inflow in CFO should be considered just an accelerated payment and was unsustainable in nature. Indeed, the $200 million prepayment accounted for 26 percent of CFFO in the first half of 2002 and more than all of its growth over the prior year.

- **Watch for Elaborate Strategies to Influence the Timing of Cash Flow:** Consider, Silicon Graphics several quarters before its May 2006 bankruptcy. The company was burdened with debt and did everything in its power to portray to investors a stronger liquidity position. In order to accelerate collections it was compelled to offer discounts to induce early payments. I investors would have looked at the 10-Q disclosure made by the company, Diligent investors would have noticed these issues and known that disaster was not far away.

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

- **Be Wary of Dramatic Improvements in CFFO:** Telecom equipment manufacturer UTStarcom reported markedly improved CFFO in early 2008. After a dismal 2007, in which it logged four consecutive quarters of negative CFFO (for a total cash burn of $218 million), UTStarcom suddenly reported positive cash flow of $97 million in March 2008.

Investors could have readily noticed that the cash flow turnaround resulted from a number of particularly aggressive working capital actions. A quick peek at the Balance Sheet revealed a $65 million drop in accounts receivable and a $66 million increase in accounts payable. The disclosure made by the company clearly mentioned the use of aggressive working capital management and thus we must derive at a conclusion all these measures will not lead to sustainable CFO growth.

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.

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. Stretching out vendor payments produced a large positive “swing” on the Statement of Cash Flows. In the same way, failing to restock inventory levels would also provide an unsustainable boost to CFFO. If we look at inventory outflow in CFO it was $1.1 billion outflow in 2000 outflow of only $166 million in 2001.

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.

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

However, in 2002 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.

4. **Boosting CFFO with One-Time Benefits:** Microsoft Corp. doled out billions of dollars to settle antitrust litigation in recent years. One of the largest recipients, Sun Microsystems, pocketed nearly $2 billion from Microsoft in 2004 ($1.6 billion of which was immediately recognized as income).

Sun presented this large one-time item in plain view on its Statement of Income, listing it separately as “settlement income.” Sun’s Statement of Cash Flows, however, was less clear. The company recorded the $2 billion in cash as an Operating inflow. As you would imagine, a $2 billion settlement was quite material to Sun’s results—CFFO for all of 2004 was $2.2 billion, up from $1.0 billion in 2003.

Diligent investors would have noticed this settlement reflected on the Statement of Income and should have immediately realized that it was an unsustainable source of CFFO.

Warning Signs: Boosting Operating Cash Flow Using Unsustainable Activities

If a company is boosting operating cash flow using Unsustainable Activities, then look for these signals :

- **Boosting CFFO by paying vendors more slowly.**
- **Accounts payable increasing faster than cost of goods sold.**
- **Increases in other payables accounts.**
- **Large positive swings on the Statement of Cash Flows.**
- **Evidence of accounts payable financing.**
- **New disclosure about prepayments.**
- **Offering customers incentives to pay invoices early.**
- **Boosting CFFO by purchasing less inventory.**
- **Disclosure about the timing of inventory purchases.**
- **Dramatic improvements in CFFO.**
- **CFFO benefit from one-time items.**

Part 3: Key Metrics Shenanigans

Key Metrics Shenanigans

Two Key Metrics Shenanigans:

1. Showcasing Misleading Metrics That Overstate Performance;

2. Distorting Balance Sheet Metrics to Avoid Showing Deterioration.

Investors are increasingly evaluating companies using both performance- and economic health–related metrics. Now, apart from analyzing the traditional Balance Sheet, Income Statement and Cash Flow, investors also look for additional info that would be beneficial to judge the efficiency of a business and can be used a key metric for comparing peers and evaluate them.

Categories of Performance Metrics:

- **Surrogates for Revenue:** Companies, try to clarify and give more disclosures on sales and insight into pricing power through giving specific data points for e.g. 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 include same-store sales, backlog, bookings, subscriber count, average revenue per customer, and organic revenue growth.**

- **Surrogates for Earnings:** Management sometimes tries to present a "cleaner" version of earnings in order to convey the true operating performance of the business. A chemical manufacturer, for example, may remove a large one-time gain from selling real estate when presenting earnings in order to convey its performance in a way that is comparable with that used in past and future periods.

- **Surrogates for Cash Flow:** As with earnings surrogates, management may also try to present a "cleaner" version of its cash flow. 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.

Key Metrics Shenanigans No. 1: Techniques to Showcase Misleading Metrics That Overstate Performance

Shenanigans No. 1: Techniques to Showcase Misleading Metrics That Overstate Performance

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. In this first section, we highlight ways in which companies can be less than honest using fairly common revenue surrogates and how careful investors can protect themselves.

- **Same-Store Sales:** To provide investors with that insight, management often reports a metric called "same-store sales" (SSS) or "comparable-store sales." However, because same-store sales falls outside any accounting body there 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.

To check the efficacy of Same store Sales growth:

- **Compare Same-Store Sales to the Change in Revenue per 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. If a material divergence in this trend suddenly appeared with SSS accelerating and revenue per store shrinking, investors should be concerned. This divergence indicates one of these two problems: (1) the company's new stores are beginning to struggle (driving down revenue per store, but not affecting SSS because they are not yet in the comp base), or (2) the company has changed its definition of same-store sales.

- **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. The second trick involves changing the types of stores included in the comp base.

Shenanigans No. 1: Techniques to Showcase Misleading Metrics That Overstate Performance

- **Watch for Bloated Same-Store Sales Resulting from Company Acquisitions:** The comp base can also be influenced by unrelated company activities, such as acquisitions. For example, from 2004 to 2006, the universe of stores in the comp base of Starbucks kept changing each quarter as the company continuously bought up its regional licensees and put them into the comp base. As a result, Starbucks calculated same-store sales using a slightly different universe each quarter—hardly a comparable metric. If Starbucks had been purchasing its strongest licensees, this acquisition activity would have had a positive impact on SSS performance, thereby misleading investors about the company's underlying sales growth.
- **Be Wary When a Company Stops Disclosing an Important Metric:** Just as Starbucks stopped disclosing same-store sales when business went sour, Gateway stopped disclosing the number of computers sold when times were tough in late 2000. This metric had been an important data point provided to investors.
- **Average Revenue per User:** In the broadcast industry, a common metric analyzed is ARPU (average revenue per user), calculated as total subscription revenue divided by average subscribers. Calculating the average revenue per subscriber sounds like it should be simple; however, varying definitions of ARPU abound.

Since these types of companies (e.g., research providers, telephone companies, newspapers, fitness clubs, and so on) rely on new subscribers for growth, it is helpful for investors to monitor subscriber levels in order to get a sense of the most recent trends in the business. Logically, the number of new subscriber additions each quarter is often a good leading indicator of upcoming revenue. Similarly, the level of cancellations (called "churn") is important to know when assessing the business.

Case in Point: Consider AOL Time Warner's (AOL's) scheme to inflate the number of subscribers to its online Internet service. One of the ways in which AOL sold subscriptions was to sell "bulk subscriptions" to corporations, which would then distribute these subscriptions to employees as a perk. AOL did not include these bulk subscription sales in its subscriber count because it knew that many of these subscriptions would never actually be activated.

Shenanigans No. 1: Techniques to Showcase Misleading Metrics That Overstate Performance

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

2. **Highlighting a Misleading Metric as a Surrogate for Earnings:** Global Crossing reported a net loss of $120 million in the March 2007 quarter. Desperate to show a profit First, management removed $97 million in expenses for interest, taxes, depreciation, and some other items to get to a metric it called “adjusted EBITDA. Then, it removed $15 million in noncash stock compensation expense, bringing the company to an “adjusted cash EBITDA” of negative $8 million. 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.

- **Pretending That Recurring Charges Are One-Time in Nature:** Peregrine Systems recorded bogus revenue and then tried to cover it up by fraudulently faking the sale of accounts receivable. This classification gave Peregrine the cover to exclude these charges from its pro forma earnings presentation so that investors would not be concerned.

Pretending That One-Time Gains Are Recurring in Nature: General Motors (GM) recorded a $259 million after-tax gain on the sale of an equity interest in a regional homebuilder in June 2006. Normally, GM removes any one-time gains or losses when presenting “adjusted income” in its earnings releases. However, GM decided gain would not be excluded.

Shenanigans No. 1: Techniques to Showcase Misleading Metrics That Overstate Performance

3. **Highlighting a Misleading Metric as a Surrogate for Cash Flow:** Sometimes companies create a pro forma cash flow metric in order to exclude a nonrecurring activity, such as a large litigation settlement. However, other times, companies may be looking to artificially enhance their cash-generation profile.

- **"Cash Earnings" and EBITDA Are Not Cash Flow Metrics:** Companies sometimes present metrics like "cash earnings" or "cash EBITDA". Do not con fuse 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.

- **Non-GAAP Cash Flow Metrics Put There to Confuse:** Well, management at Delphi also liked to mislead investors by presenting tricky cash flow metrics. We mentioned earlier that in 2000, Delphi's actual CFFO (as reported on the SCF) was $268 million, but its self-defined "Operating Cash Flow" (as presented in the earnings release) was $1.636 billion—an astonishing differential of almost $1.4 billion.

Delphi's free cash flow of negative $1.0 billion—bringing our differential to an outrageous $2.6 billion. (Oh, by the way, that $268 million in CFFO reported on the SCF was actually only $68 million if you exclude the sham sale of inventory

Warning Signs: Showcasing Misleading Metrics That Overstate Performance

If a company is showcasing misleading metrics that Overstate Performance, then look for these signals :

- **Changing the definition of a key metric.**
- **Highlighting a misleading metric as a surrogate for revenue.**
- **Unusual definition of organic growth.**
- **Divergence in trend between same-store sales and revenue per store.**
- **Inconsistencies between the earnings release and the 10-Q.**
- **Highlighting a misleading metric as a surrogate for earnings.**
- **Pretending that recurring charges are nonrecurring in nature.**
- **Pretending that one-time gains are recurring in nature.**
- **Highlighting a misleading metric as a surrogate for cash flow.**
- **Headlining a misleading metric on the earnings release.**

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

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

Categories of Economic Health Metrics:

1. **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.

2. **Evaluation of Inventory Management:** Naturally, investors monitor inventory level closely and use a metric called days' sales of inventory.

3. **Evaluation of Asset Impairments for Financial Companies:** Financial institutions provide metrics that give investors insight into the quality or strength of their financial assets. Companies may disclose, for example, delinquency rates on mortgage loans or the fair value of their investments. Investors must monitor these supplementary data to ensure that proper reserves and impairments are being recorded.

4. **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. Any company with debt outstanding could face equally serious consequences if it were to fall out of compliance with the conditions of its debt covenants. If a company fails to provide data on such threats (or worse, if it intentionally covers up those threats), investors will be in serious jeopardy.

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.

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

1. **Distorting Accounts Receivable Metrics to Hide Revenue Problems:** Company managements are well aware that investors review working capital trends carefully to spot signs of poor earnings quality or operational deterioration. They realize that a surge in receivables that is out of line with sales will lead investors to question the sustainability of recent revenue growth. Tricks used by management to keep accounts receivable lower:

- **Selling Accounts Receivable:** Selling Accounts receivable also serves another useful purpose: it lowers the days' sales outstanding (DSO) reported to investors (meaning that it makes it appear that customers have been paying more quickly). Dishonest management can easily conceal a jump in DSO simply by selling more accounts receivable.

- **Turning Accounts Receivable into Notes Receivable:** Symbol's receivables had been growing rapidly as a result of aggressive revenue recognition and channel stuffing, surging to 119 days in June 2001 (up from 94 in March 2001 and 80 in June 2000). Symbol simply asked some of its closest customers to sign paperwork that would convert these trade accounts receivable into promissory notes or loans. However, the new paperwork gave Symbol a convenient cover to move these accounts receivable to the notes receivable section of the Balance Sheet. This adjustment led to significant decrease in DSO.

- **Watch for Increases in Receivables Other Than Accounts Receivable:** UTStarcom pulled a similar fraud in 2004 by taking more payment in the form of "bank notes" and "commercial notes." Since these notes receivable were not categorized as accounts receivable on the Balance Sheet (in fact, the bank notes were considered cash), UTStarcom was able to present a more palatable DSO to investors, despite a severe deterioration in its business. Diligent inves tors could easily have spotted this improper account classification by reading UTStarcom's footnotes.

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

2. **Distorting Inventory Metrics to Hide Profitability Problems:** Investors typically view an unexpected rise in inventory as a sign of upcoming margin pressure.

- **Covering Up a Cover-Up:** Symbol Technologies sold products aggressively, offering customers very generous return conditions. Moreover, some purported sales turned out to be completely bogus because customers sent back products that they had never desired and, based on a side agreement with Symbol, could return them at any time and pay nothing. These returns led to increase in inventory levels, so Symbol created an “inventory reduction plan” designed to reduce inventory levels. The plan included recording fictitious ac counting 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. 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.

1. Misclassification of Expenses

Capitalizing Expense instead of Expensing it

Case in Point:

From mid-2000 to 2002 World Com classified its Line cost expenses from P&L to B/S. In doing so it dramatically understated its expenses and inflated its earnings.

1st Red Flag: Reported Cash flows continuously exceeded Net Income:

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

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

How this red flag could be Avoided?

- Calculating Free Cash Flow would have easily made us cautious of this misclassification and inflated CFO.
- Now, FCF= CFO- Capital Expenditure. Regardless of whether the expenses are recorded in Investing or Operating section of Cash Flow. During 1999, the period just before the company began capitalizing line costs, it generated USD 2.3 Billion in FCF. Now in the year 2000 we can see the contrast effect in FCF numbers.

By simply looking at FCF numbers, we could assess that the business was in deep trouble irrespective of fraud or no fraud.

Table 1-7. WorldCom's Free Cash Flow

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

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

MJK Investments

Simplicity Trumps Complexity

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