Accounting: Focus on the Red Flags

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The goal of this short article is to show the investor examples of how companies can manipulate their reported earnings. This article also provides information on what warnings signs to look for. The article has taken information from a variety of sources in order to provide the reader with a quick overview of accounting red flags. Focused investors practicing portfolio concentration should be particularly aware of these issues.

I have written the article for the individual investor who has an intermediate level of accounting knowledge. That being said I believe the beginning investor with only a moderate understanding of accounting will benefit from a close reading of this article if for no other reason that to understand what elements of accounting they should study more closely.

While this article focuses on accounting issues all investors should investigate the management team of a company before investing since the management team has such a strong influence of any companies operations and how they report their results.

To this end I would strongly urge all investors to first study the way management treats their shareholders. Do they provide an accurate picture of their business in their annual report? Do they discuss the negative issues in addition to the positive ones? If they treat the shareholders like owners and behave ethically then in the vast majority of cases this accounting red flag list will not be needed.

List of Accounting Red Flags

1. Companies Conducting Large Amounts of Merger Activity

Companies that have experienced a slowdown in the growth of their businesses or that have already been practicing accounting deceptions may use merger activity to mask the slowdown in their core business and/or use the activity to their advantage by attempting to mask ongoing accounting deceptions.

In the case of ongoing accounting deceptions management will often try to continue their deceptions by initiating an aggressive acquisition strategy. The resulting restructuring charges taken as a result of the acquisitions can be inflated and used to keep the accounting deceptions alive. The following quote goes into detail concerning this issue:

"The event provides the acquirer with the opportunity to establish accruals for restructuring the transaction, possibly attribute more expense than necessary for the transaction. The company may also identify certain expenses that are revalued on the seller's balance sheet, increasing goodwill. If the conservative valuations prove to be excessive, the company is able to reduce its operating expenses in the near term by reducing its estimate for the liability. The additional goodwill created would be amortized over a long period of time and not have a significant impact on near term results."[1]

The following story from the <u>Securities Litigation & Regulation Litigation Reporter</u> shows why investors need to watch and study the reasons behind merger activity:

"The Securities and Exchange Commission says that Forbes directed the fraud from its beginning in 1985 and that between 1995 and 1997, pre-tax operating income reported to the public by CUC was inflated by more than $500 million. Shelton also allegedly perpetrated the fraud starting in 1991, when he joined CUC. The SEC asserts that Forbes and Shelton sought out HFS as a merger partner because they believed its reserves would be enough to bury the fraud. Soon after CUC merged with HFS to create Cendant, Forbes and Shelton congratulated each other on being masterful 'financial engineers' who had been able to continue the fraud through the years, the SEC says, and they had assured their continued success by duping HFS into agreeing to the merger."

[1] Earnings Management and Manipulation by Scott McGregor

"After the manipulation was revealed, the stock price fell from more than $40 per share to $19 per share or 47 percent of its value. As a result, the company lost more than $19 billion in market capitalization in one day."

How could the investor have discovered that CUC was using "aggressive" accounting? The easiest method would have been to track the acquisitions they were making. By this I mean that the investor should have monitored the restructuring charges CUC was taking when it was making its frequent acquisitions. By creating these reserves CUC was able to release part of the charges back into income in later periods by "determining" that they had over reserved when they made the initial estimate of the restructuring costs.

2. Companies that Consistently Meet Earnings Targets over an Extended Time Frame or Project High Growth Rates

The course of business activity is never this smooth in reality. The old saying, "If it seems to be good to be true it is" is still applicable. The following comments by Mr. Arthur Levitt are particularly relevant.

"Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common sense business practices. Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation."[2]

In his 2000 Berkshire Hathaway Annual Letter to Shareholders Mr. Buffett had this to say concerning the prediction of high growth rates:

"One further thought while I'm on my soapbox: Charlie and I think it is both deceptive and dangerous for CEOs to predict growth rates for their companies. They are, of course, frequently egged on to do so by both analysts and their own investor relations departments. They should resist, however, because too often these predictions lead to trouble.

It's fine for a CEO to have his own internal goals and, in our view, it's even appropriate for the CEO to publicly express some hopes about the future, if these expectations are accompanied by sensible caveats. But for a major corporation to predict that its per-share earnings will grow over the long term at, say, 15% annually is to court trouble."

3. Watch Companies that take Big Bath Charges

"Big Bath" charges occur when a company allocates written off expenses into quarters where the company would record a loss in any case. This has the effect of boosting income in future quarters, thereby creating an impression of a brighter financial future.

A great example of this occurred in 1997 when Gateway took a $113.8 million big bath charge. Although initially the stock was down approximately 20 percent within the next year its stock price had appreciated approximately 83 percent. In addition the maneuver may have helped the company subsequently report its best gross margins in years, 19.5 percent and 20.6 percent in the first two quarters of 1998. The company stated that the margins had improved due to declining component prices and a better product mix.[3]

The following comments by Mr. Arthur Levitt address this topic in more detail:

"Why are companies tempted to overstate these charges? When earnings take a major hit, the theory goes Wall Street will look beyond a one-time loss and focus only on future earnings. And if these charges are

[2] The "Numbers Game" by Arthur Levitt, www.sec.gov/news/speech/speecharchive/1998/spch220.txt
[3] Gateway's Big Bath by Eric Moskowitz, http://www.thestreet.com/stocks/accounting/19863.html

conservatively estimated with a little extra cushioning, that so-called conservative estimate is miraculously reborn as income when estimates change or future earnings fall short."[4]

""Big Bath" charges are perpetrated under the guise of corporate restructurings or mergers to avoid future charges related to normal operating costs. Companies claim "in-process" research and development instead of showing goodwill, when, in fact, purchased companies previously reported little or no R&D expenditures. Companies stash accruals in "cookie jar" reserves during the good economic times and reach into them when needed in the bad times."[5]

4. Watch the Account Receivables Line on the Balance Sheet Closely

Regardless of what may be happening with a company's top-line revenue number, if the accounts long-term receivables line starts to rise while its revenue shrinks or its growth rate slows, that could be a sign of a sluggish business. This information could drive a company to start using aggressive accounting practices to hide this potential slowdown.

In addition the reserves that are created against the receivables should be monitored. When reserves are declining while gross receivables are growing sailors take warning.

Lucent is a good example of this situation. It reported earnings growth in March 1999 because it decreased its reserves for doubtful accounts. Their reserves dropped by 11 percent in the same period that their gross receivable number increased by 26 percent.

5. Does the Company in Question Use Conservative Depreciation Practices

The investor must try to determine what depreciation charges are common in the industry and also watch for any changes in the length, or type, of depreciation schedule that may increase reported earnings in the short run and not account for the true costs of a particular companies replacement costs.

For example one of the SEC findings against Waste Management alleges that they, "avoided depreciation expenses on their garbage trucks by both assigning unsupported and inflated salvage values and extending their useful lives."

6. Companies that Rely Heavily on Options as Financial Incentives

Waste Management is a good case in point. The SEC alleges that Waste Management officer's: "received performance-based bonuses based on the Company's inflated earnings, retained their high-paying jobs, and received stock options. Some also received enhanced retirement benefits based on the improper bonuses, and some received lucrative employment contracts. Buntrock, Rooney, and Koenig also avoided losses by cashing in their Waste Management stock while the fraud was ongoing."

Here is another relevant quote by Mr. Arthur Levitt on this particular issue:

"This is the pattern earnings management creates: companies try to meet or beat Wall Street earnings projections in order to grow market capitalization and increase the value of stock options. Their ability to do this depends on achieving the earnings expectations of analysts. And analysts seek constant guidance from companies to frame those expectations. Auditors, who want to retain their clients, are under pressure not to stand in the way."[6]

Mr. Buffett in his 1998 Berkshire Hathaway Annual Report also discussed this topic:

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[4] The "Numbers Game" by Arthur Levitt, www.sec.gov/news/speech/speecharchive/1998/spch220.txt
[5] "A Partnership For The Public Trust" by Arthur Levitt, www.sec.gov/news/speech/speecharchive/1998/spch230.txt
[6] The "Numbers Game" by Arthur Levitt, www.sec.gov/news/speech/speecharchive/1998/spch220.txt

"In effect, accounting principles offer management a choice: Pay employees in one form and count the cost, or pay them in another form and ignore the cost. Small wonder then that the use of options has mushroomed. This lop-sided choice has a big downside for owners, however: Though options, if properly structured, can be an appropriate, *and even ideal*, way to compensate and motivate top managers, they are more often wildly capricious in their distribution of rewards, inefficient as motivators, and inordinately expensive for shareholders."

7. Monitor Revenue/Expense Recognition Issues

Since this issue is so hard to detect beforehand the practice of always investing alongside of quality management is particularly relevant.

One of the most common examples of income statement fraud is the failure to properly record expenses. On the balance sheet side, overvaluation of assets is one of the biggest examples of financial fraud and is followed closely by improper capitalization of expenses. Managament can impact the reported revenue by negotiating side letters and rights of return agreements. They can also make up consignment sales, ship unfinished product, book of fictitious sales and make sales to associated companies of undervalued assets at inflated prices to produce excessive profits

"Revenue recognition is an issue that surfaces in a significant number of the Commission's enforcement cases and is the largest single issue involved in restatements of financial statements."[7]

"Lastly, companies try to boost earnings by manipulating the recognition of revenue. Think about a bottle of fine wine. You wouldn't pop the cork on that bottle before it was ready. But some companies are doing this with their revenue -- recognizing it before a sale is complete, before the product is delivered to a customer, or at a time when the customer still has options to terminate, void or delay the sale."[8]

8. Monitor One Time Gains

A quote from a recent Business Week article on Howard Schilit, Author of Financial Shenigans provides the investor with a good example at why they need to closely examine financial statements: 'he recalls looking at IBM's financial statements a few years ago, searching for signs of a one-time $3.7 billion gain. It was nowhere to be found on the cash-flow statement. Instead, Big Blue had included it as a reduction of selling, general, and administrative expenses. That, Schilit charges, gave investors the impression that IBM had greatly reduced costs through improved efficiencies rather than through a big influx of capital."

9. Monitor Pension Plans

During the late 1990s when company's traditional pension plan investments were earning outsize returns they could apply those gains to their bottom lines which increased their reported profits, which worked wonders on their stock prices.

How will this affect reported earnings in the future? Here are two quotes from a February 2002 Business Week story titled The Pension Bomb:

"An even touchier issue is the assumption companies make on how much their pension portfolios will earn. GE decided in November to trim its rate to 8.5% from 9.5%. Sounds small, but that cut could cost GE more than $550 million, a hit of 2% to pretax income."

"Dow Chemical Co. says it cut its assumed rate of return to 9.25% from 9.5% last year, helping knock $100 million off its pretax results in 2002, vs. a $45 million boost in 2000. Whirlpool Corp. (WHR) said in a Feb. 5 conference call that it had cut its rate to 10% for 2002 from 10.5% last year. If the 50 biggest companies with pension plans all sliced one percentage point from their projections, their collective pretax

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[7] Revenue Recognition by Lynn Turner, www.sec.gov/news/speech/spch495.htm
[8] The "Numbers Game" by Arthur Levitt, www.sec.gov/news/speech/speecharchive/1998/spch220.txt

income would fall $5.2 billion, according to consultants Milliman."

Mr. Buffett had this to say in Fortune's article, Warren Buffett on the Stock Market[9], concerning Pension Fund Accounting:

"Now, the higher the expectation rate that a company uses for pensions, the higher its reported earnings will be. That's just the way that pension accounting works--and I hope, for the sake of relative brevity, that you'll just take my word for it."

"Let's take a look at General Electric, the country's most valuable and most admired company. I'm a huge admirer myself. GE has run its pension fund extraordinarily well for decades, and its assumptions about returns are typical of the crowd. I use the company as an example simply because of its prominence.

If we may retreat to 1982 again, GE recorded a pension charge of $570 million. That amount cost the company 20% of its pretax earnings. Last year GE recorded a $1.74 billion pension credit. That was 9% of the company's pretax earnings. And it was 2 1/2 times the appliance division's profit of $684 million. A $1.74 billion credit is simply a lot of money. Reduce that pension assumption enough and you wipe out most of the credit."

10. Monitor Companies that Report Revenues as Part of Cross Company Payments

The investor needs to keep a close eye on companies that become involved in deals in which the company in question receives revenues in the current period but must provide some sort of service or equipment to the counter party sometime in the future. Here are comments on the subject by Mr. Lynn Turner:

"In today's markets, the revenues companies report sometimes drive their market capitalization. As a result, there is increased focus and attention on how revenue transactions are measured and classified in the financial statements. At the same time, companies are increasingly entering into strategic alliances, joint ventures, cross licensing and cross ownership agreements. Often more than one type of these agreements are negotiated and entered into simultaneously. As such, the agreements are complex, and it may be difficult, if not impossible to distinguish and reliably measure the fair values of the separate elements of the contracts."[10]

"For example, a company may simultaneously negotiate and enter into an agreement to:

- Pay an upfront technology fee to obtain technology and related services from another entity for an extended period of time,
- Provide the other entity access to its technology through an annual licensing arrangement with a term of several years, and
- Permit access to each respective company's membership base, based on a per member click or usage fee."

11. Watch for Turnover in the CFO position

Since the CFO is responsible for reporting the numbers a departure may mean that layoffs, disappointing earnings announcements or a broader management shakeup are possibly in the works.

"In a study on fraudulent financial reporting in the United States of publicly held companies for the ten year period, 1987-1997, by Bealsey, Carcello, and Hermanson for the Committee on Sponsoring Organizations of the Treadway Commission, it was found that top senior executives were frequently involved. In 72 percent of the cases, the Accounting and Enforcement Releases (AAER's) by the

[9] http://www.fortune.com/indexw.jhtml?channel=artcol.jhtml&doc_id=205324
[10] Opportunities for Improving Quality by Lynn Turner, www.sec.gov/news/speech/spch451.htm

Securities and Exchange Commission named the CEO, and in 43 percent the CFO was associated with the financial statement fraud."[11]

12. Watch for Inventory Write-downs

Companies have been known to fill their distributors inventory channel with their product in order to increase reported revenues and hence earnings. This stuffing of the inventory channel can lead to problems down the road when distributors stop ordering or accepting new shipments of their products because they have more than enough on hand to sell. This item is hard to determine while the activity is taking place once the activity has been observed the company any management needs to be closely scrutinized to see if they are performing any other type of red flag activity.

Good Questions to Consider:

"Have the write-downs been taken on a timely basis? What changes in the business have occurred that resulted in the write-downs? Were complete and full disclosures made to investors on a timely basis regarding these changes, etc.?" [12]

"It is reasonable to ask, and I would encourage investors to ask, whether management identified on a timely basis increases in inventory levels at the customer or in other segments of the marketing channels. If so, then what steps were taken in the order management and manufacturing process to adjust purchases from suppliers? Were the increases in inventory consistent with increases in bookings and sales? If not, why not? Were supply contracts flexible enough to permit changes to order quantities or were there take-or-pay contracts that had negative implications for inventory balances and purchases? Are inventories still on hand ***after*** any writeoffs reasonable in light of existing backlog or are they still high in light of historical levels? What was discussed with the external auditors and board of directors regarding these significant changes in inventory and the business?" [13]

13. Any Company That Uses Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) to Measure Performance

Why does this item raise an accounting red flag? I think Mr. Warren Buffett said it best in his 2000 Berkshire Hathaway Annual Report:

"When Charlie and I read reports, we have no interest in pictures of personnel, plants or products. References to EBITDA make us shudder — does management think the tooth fairy pays for capital expenditures? We're very suspicious of accounting methodology that is vague or unclear, since too often that means management wishes to hide something."

Conclusion

I hope this quick article will inspire the reader to learn more about accounting in general and forensic accounting in particular. I found the following books to be particularly helpful when conducting my own research into forensic accounting:

1. Financial Shenanigans (2nd Edition) by Howard Schilit
2. The Financial Numbers Game by Charles W. Mulford and Eugene E. Comiskey
3. The Berkshire Hathaway Annual Shareholder Letters
4. Guide to Financial Reporting and Analysis by Charles W. Mulford and Eugene E. Comiskey

Stay Focused!

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[11] A Presentation to the XXXI World Congress of the International Association of Financial Executives Institutes by Doyle Z. Williams
[12] A Menu of Soup du Jour Topics by Lynn Turner, www.sec.gov/news/speech/spch498.htm
[13] ibid.