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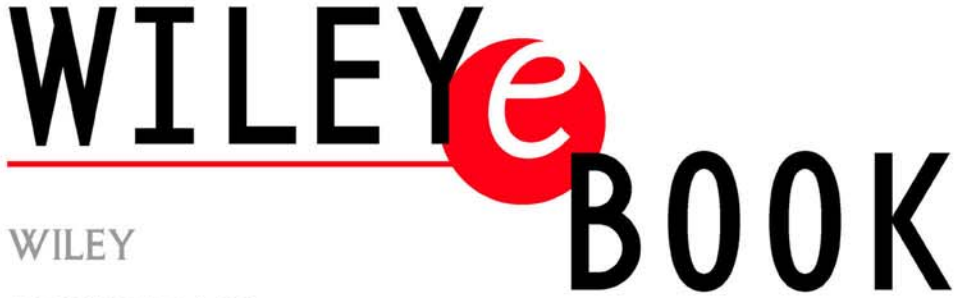

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The Financial Numbers Game

Detecting Creative Accounting Practices

The Financial Numbers Game

Detecting Creative Accounting Practices

Charles W. Mulford
and
Eugene E. Comiskey

JOHN WILEY & SONS, INC.

This title is also available in print as ISBN 0-471-37008-8. Some content that appears in the print version of this book may not be available in this electronic edition.

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To Debby Mulford:
Her strength and courage
are an inspiration for us all.

About the Authors

Charles W. Mulford is the Invesco Chair and Professor of Accounting and Eugene E. Comiskey is the Callaway Chair and Professor of Accounting in the DuPree College of Management at the Georgia Institute of Technology in Atlanta. Both professors have doctorates in accounting and are professionally qualified as certified public accountants. In addition to their work at Georgia Tech, they actively consult with lenders at commercial banks in the United States and abroad. Professors Mulford and Comiskey have published articles on financial reporting and analysis issues in leading academic journals in the accounting and finance fields as well as in such widely read professional journals as the *Commercial Lending Review* and the *Financial Analysts' Journal*.

This is the authors' third book. Their first, *Financial Warnings*, published in 1996, identifies the warning signs of future corporate earnings difficulties. Their second, *Guide to Financial Reporting and Analysis*, seeks to simplify the complexities of current-day generally accepted accounting principles as an aid to practicing financial analysts and other users of financial statements.

Preface

With a certain mind-numbing frequency, users of financial statements—investors and creditors—find themselves buffeted with announcements of accounting irregularities. These irregularities are called many things, including aggressive accounting, earnings management, income smoothing, and fraudulent financial reporting. While they may vary in the degree to which they misreport financial results, they have similar effects—financial statements that serve as a foundation for important investment and credit decisions are incorrect, improper, and worse, misleading.

Companies of all sizes and types, from the start-up to the venerable, from those traded on the "Bulletin Board" to the "Big Board," are susceptible to the problems we refer to here collectively as creative accounting practices. When these acts are discovered, adjustments are needed. Often, prior-year financial statements must be restated, sometimes more than once. Unfortunately, many learn of these accounting problems only after it is too late—after assessments of earning power have been reduced and share prices have fallen precipitously.

Aware that the proper functioning of our capital markets is dependent on the reliability and transparency of financial statements, the Securities and Exchange Commission (SEC) has taken important steps in recent years to rein in the problem. Calling the problem a "numbers game," a former chairman of the SEC increased the enforcement actions taken by the Commission against accounting practices it considered to be errant. As an example of the SEC's newly found diligence, during one month the agency instituted action against 68 individuals at 15 different companies.

Some would say the SEC has gone too far and has begun to question financial reporting practices that are well within the flexibility afforded by generally accepted accounting principles (GAAP). This appears to be a minority view. Moreover, attesting to a need for the SEC's diligence, the problem of companies employing creative accounting practices in their financial reporting is continuing. And the problem will continue as long as there are measurable rewards, including positive effects on share prices, borrowing costs, bonus plans, and corporate regulations, to be gained by those who seek to play this financial numbers game.

The Financial Numbers Game: Detecting Creative Accounting Practices was written, first and foremost, to help readers of financial statements avoid being misled by financial results that have been altered with creative accounting practices. Key chapters conclude with checklists designed to help the reader discern when creative accounting practices have been employed. These checklists, and the text that supports them, were

developed with examples of hundreds of companies that were caught in the act of playing the financial numbers game.

Beyond its primary objective, the book provides a sense of perspective. It looks at the embedded flexibility within generally accepted accounting principles, why it is there, and how companies might use it to their advantage—sometimes pushing their financial reporting within that flexibility and other times pushing it well beyond. It looks at the role of the SEC in enforcing the securities laws and identifies the specific statutes used to prosecute those it considers to have pushed beyond the flexibility inherent in GAAP. It provides the results of a survey of important financial professionals, including equity analysts, lenders, and chief financial officers, among others, on their views of the propriety of many financial reporting practices and on the steps they use to detect creative accounting practices. The results of the survey are not always predictable and show disagreement not only between the groups but also within the groups as to which practices are appropriate and within GAAP boundaries, which ones go beyond them, and which ones actually constitute fraud.

The Financial Numbers Game: Detecting Creative Accounting Practices was written for serious readers of financial statements, whether equity analysts or investors, credit analysts or the credit professionals they serve, serious individual investors, or any parties whose interest in financial statements goes beyond the casual read. The steps outlined here should become a standard component of financial analysis and an important future reference, ultimately helping to answer the question: Do the numbers make sense?

A Special Note to Our Readers

As we went to press, the details of the accounting and reporting shortcomings at Enron Corp. that facilitated the company's demise were only beginning to come to light. Unfortunately, their investors and creditors had not fully discounted the risk associated with the firm's trading activities, its off-balance sheet liabilities, and its related-party transactions. Given our publication deadline, we were unable to incorporate a full accounting of the events that took place at the company. However, we do believe that careful attention to all the steps outlined in the checklists that conclude Chapter 8, "Misreported Assets and Liabilities," and Chapter 11, "Problems with Cash-Flow Reporting," would have provided an early alert to the possibility of developing problems.

Contents

CHAPTER ONE

Financial Numbers Game

> *I'd like to talk to you about another widespread, but too little-challenged custom: earnings management. This process has evolved over the years into what can best be characterized as a game among market participants. A game that, if not addressed soon, will have adverse consequences . . .*[1]

With an all-too-frequent occurrence, users of financial statements are shaken with disclosures by corporate managements that certain "accounting irregularities" have been discovered and, as a result, current- and prior-year financial results will need to be revised downward. Consider these examples:

> Sybase's shares dropped an additional 20% when the company reported improper practices at the Japanese subsidiary, which Sybase said included booking revenue for purported sales that were accompanied by side letters allowing customers to return software later without penalty.[2]
>
> Bausch & Lomb oversupplied distributors with contact lenses and sunglasses at the end of 1993 through an aggressive marketing plan. . . . The company said yesterday that in the fourth quarter of 1993 it "inappropriately recorded as sales" some of the product it sent to distributors.[3]
>
> Nine West Group Inc. said its revenue-booking practices and policies are under investigation by the Securities and Exchange Commission. The company's shares plunged 18% on the news.[4]
>
> MicroStrategy Inc., the high-flying software company . . . announced it would significantly reduce its reported revenue and earnings for the past two years. . . . Shares of MicroStrategy plummeted 62%, slicing about $11 billion off its market value.[5]
>
> In a long-awaited restatement, Sunbeam Corp. slashed its reported earnings for 1997 by 65%. . . . Sunbeam said the robust profit reported for 1997 resulted largely from an overly large restructuring charge in 1996, premature booking of revenue, and a variety of other accounting moves that have been reversed.[6]
>
> California Micro Devices Corp., a highflying chip maker, disclosed that it was writing off half of its accounts receivable, mostly because of product returns. Its stock plunged 40%

after the announcement on August 4, 1994, and shareholders filed suit alleging financial shenanigans.[7]

Waste Management Inc., undoing years of aggressive and tangled accounting, took $3.54 billion of pretax charges and write-downs, and said more conservative bookkeeping going forward would significantly crimp its earnings.[8]

The once-highflying stock of Cendant Corp. plunged 46.5%, knocking $14 billion off the company's market value, after the marketing and franchising concern said accounting problems would require it to reduce last year's earnings and would hurt this year's results.[9]

Aurora Foods Inc.'s chief executive and three other top officers resigned as the company disclosed an investigation into its accounting practices that it said could entirely wipe out 1999 profit.[10]

Baker Hughes Inc. said it discovered accounting problems at a business unit that will result in pretax charges of $40 million to $50 million, a disclosure that sent its stock falling 15% and revived Wall Street's questions about the company's performance.[11]

Every one of the above examples entails, in one form or another, participation in the financial numbers game. The game itself has many different names and takes on many different forms. Common labels, which depend on the scope of the tactics employed, are summarized in Exhibit 1.1.

While the financial numbers game may have many different labels, participation in it has a singular ultimate objective—creating an altered impression of a firm's business performance. By altering financial statement users' impressions of a firm's business performance, managements that play the financial numbers game seek certain desired real outcomes.

REWARDS OF THE GAME

Expected rewards earned by those who play the financial numbers game may be many and varied. Often the desired reward is an upward move in a firm's share price. For others, the incentive may be a desire to improve debt ratings and reduce interest costs on borrowed amounts or create additional slack and reduce restrictions from debt covenants. An interest in boosting a profit-based bonus may drive some. Finally, for high-profile firms, the motivation may be lower political costs, including avoiding more regulation or higher taxes. These rewards are summarized in Exhibit 1.2 and discussed below.

Share Price Effects

Investors seek out and ultimately pay higher prices for corporate earning power—a company's ability to generate a sustainable and likely growing stream of earnings that provides cash flow. That cash flow either must be provided currently, or there must be an expectation among investors that it will be provided in future years.

Firms that communicate higher earning power to investors will tend to see a favorable effect on their share prices. For the firm, a higher share price increases market valuation and reduces its cost of capital. For managers of the firm with outright equity stakes or options on equity stakes, a higher share price increases personal wealth. Playing the finan-

Exhibit 1.1 Common Labels for the Financial Numbers Game

Label	Definition[a]
Aggressive accounting	A forceful and intentional choice and application of accounting principles done in an effort to achieve desired results, typically higher current earnings, whether the practices followed are in accordance with GAAP or not
Earnings management	The active manipulation of earnings toward a predetermined target, which may be set by management, a forecast made by analysts, or an amount that is consistent with a smoother, more sustainable earnings stream
Income smoothing	A form of earnings management designed to remove peaks and valleys from a normal earnings series, including steps to reduce and "store" profits during good years for use during slower years
Fraudulent financial reporting	Intentional misstatements or omissions of amounts or disclosures in financial statements, done to deceive financial statement users, that are determined to be fraudulent by an administrative, civil, or criminal proceeding
Creative accounting practices	Any and all steps used to play the financial numbers game, including the aggressive choice and application of accounting principles, fraudulent financial reporting, and any steps taken toward earnings management or income smoothing

[a]Refer also to the glossary at the end of this Chapter and to Chapter 2 for additional elaboration.

cial numbers game may be one way to communicate to investors that a firm has higher earning power, helping to foster a higher share price.

Strong earning power and higher earnings were expected from Centennial Technologies, Inc., in the quarters and months leading up to a peak share price of $58.25 on December 30, 1996. However, playing a role in the company's supposedly bright future were many creative and fictitious accounting practices that boosted the company's prospects. Among the accounting practices employed were the overstatement of revenue and such assets as accounts receivable, inventory, and investments. As the company's true financial position came to light over a two-month period following its share-price peak, investors bid the share price down 95%.[12]

During 1997 and early 1998, Twinlab Corp. saw a dramatic increase in its share price. From just under $12 per share at the beginning of 1997, the company's share price increased to the high $40s per share in July 1998. However, during that time

Exhibit 1.2 Rewards of the Game

Category	Rewards
Share-price effects	Higher share prices Reduced share-price volatility Increased corporate valuation Lower cost of equity capital Increased value of stock options
Borrowing cost effects	Improved credit quality Higher debt rating Lower borrowing costs Less stringent financial covenants
Bonus plan effects	Increased profit-based bonuses
Political cost effects	Decreased regulations Avoidance of higher taxes

period, the stellar results that investors grew to expect from the company were not entirely real. The company later announced that it would restate its results for 1997 and for the first three quarters of 1998 because "some sales orders were booked but not 'completely shipped' in the same quarter."[13] By the end of 1998, the company's share price had declined back to $12.

In 1997 Sylvan Learning Systems, Inc., received a $28.5 million breakup fee when it was outbid for National Education Corp. The company established two not-for-profit organizations with the proceeds of the breakup fee to avoid paying income taxes on it. That is, the taxable income associated with the proceeds was offset with a contribution to the newly established not-for-profits. The not-for-profits, however, had a link to Sylvan Learning. They contributed to marketing efforts of Sylvan Learning, doing advertising for the company and promoting Sylvan's software training and licensing programs. Had these promotional costs been borne by Sylvan Learning, they would have been reported as expenses on Sylvan's income statement. Under the current arrangement, however, Sylvan was able to keep the marketing and promotion costs off of its income statement, boosting pretax income.[14]

Between January and July 1998, Sylvan Learning's share price rose from the low $20s per share to the high $30s per share. The unusual reporting scheme may have played a role in this share price rise. However, when knowledge of the arrangements made with the not-for-profits became widely known, the company's share price declined rather abruptly to around $20 per share.

The financial numbers game was being played, although to different degrees, at Centennial Technologies, Inc., Twinlab Corp., and Sylvan Learning Systems, Inc. While the game was being played, and before it became evident, all three companies enjoyed higher and rising share prices. Those higher share-price rises may be attributed, at least in part, to the higher earning power implied by the financial results reported by the com-

panies. An interesting aside from the examples provided is just how punishing the markets can be when news of accounting gimmickry becomes widely known.

Investors also seek and ultimately pay higher prices for the shares of firms whose earnings are less volatile. Reduced volatility implies less uncertainty about the direction of earnings, fostering an impression of reduced risk. The financial numbers game can be used to reduce earnings volatility and, in the process, encourage a higher share price.

Borrowing Cost Effects

Higher reported earnings, and the higher assets, lower liabilities, and higher shareholders' equity amounts that accompany higher earnings, can convey an impression of improved credit quality and a higher debt rating to a lender or bond investor. As a result, the use of creative accounting practices to improve reported financial measures may lead to lower corporate borrowing costs.

Sales at Miniscribe Corp. grew from just over $5 million in 1982 to approximately $114 million in its fiscal year ended in 1985. Profits, however, were elusive as the company continued to report losses from operations. In 1986 the company's financial fortunes changed for the better as sales grew to $185 million and the company reported a profit from operations of $24 million. The timing was perfect as the company was able to use the strength of its latest financial statements to successfully issue $98 million in bonds.

Unfortunately for bond investors, the improved financial results of the company were mostly fabricated, including fictitious shipments to boost revenue and manipulated reserves to reduce expenses. Reported net income for 1986 of $22.7 million was later restated to a greatly reduced $12.2 million. Without the altered financial results, it is unlikely that the company would have been able to sell its bonds as successfully as it did, if at all. Unable to recover from the debacle, the company sought bankruptcy protection and sold its assets in 1990.

Miniscribe Corp. was a public company issuing publicly traded debt. The temporary benefit derived from its use of creative accounting practices, including an ability to secure lower interest rates on the debt issued, was clearly evident from the example. Another potential benefit for borrowers derived from playing the financial numbers game is less stringent financial covenants. This benefit can accrue to borrowers whether they are public companies or privately held.

Debt agreements typically carry loan covenants—express stipulations included in the loan agreement, which are designed to monitor corporate performance and restrict corporate acts—that afford added protection to the lender. Positive loan covenants typically express minimum and maximum financial measures that must be met. For example, a positive loan covenant might call for a minimum current ratio (current assets divided by current liabilities) of 2, or a maximum total liabilities to equity ratio of 1, or a times-interest-earned ratio (typically, earnings before interest, taxes, depreciation, and amortization divided by interest) of 5. Failure on the part of a borrower to meet these covenants is a covenant violation. Such violations may be cured with a simple waiver, either temporary or permanent, from the lender. However, they also may give the lender the opportunity to increase the loan's interest rate, to seek loan security or guarantees, or even in extreme cases, to call the loan due.

Negative loan covenants are designed to limit corporate behavior in favor of the lender. For example, a negative covenant might restrict a company's ability to borrow additional amounts, pay cash dividends, or make acquisitions.

Creative accounting practices can play a very direct role in relaxing the restrictive nature of financial covenants. Steps taken to boost revenue will increase earnings, current assets, and shareholders' equity and, in some instances, reduce liabilities. Such changes in a company's financial results and position improve its ability to meet or exceed financial ratios such as the current ratio, liabilities-to-equity ratio, and times interest earned ratio mentioned above. Steps taken to reduce expenses have a similar effect. As creative accounting is used to improve a company's apparent financial position and build a cushion above its existing financial covenants, those covenants become less restrictive.

Bonus Plan Effects

Incentive compensation plans for corporate officers and key employees are typically stock option and/or stock appreciation rights plans. With such plans, employees receive stock or the right to obtain stock, or cash, tied to the company's share price. When properly structured, such plans successfully link the officers' and employees' interests with those of other shareholders'. Occasionally companies use a measure of earnings—for example, pretax income—in calculating a cash or stock bonus. When such bonus schemes are tied to reported earnings, officers and employees have an incentive to employ creative accounting practices in an effort to maximize the bonuses received.

Few bonus plans were as lucrative as the plan in place for Lawrence Coss, chairman of Green Tree Financial Corp., a subprime lender. Mr. Coss's bonus was calculated at 2.5% of Green Tree's pretax profit—a significant amount being paid to a single person. The bonus was paid in shares of stock as opposed to cash. However, helping to increase the amount of the payout, the price used in determining the number of shares of stock to issue to Mr. Coss was set at a much lower, and fixed, historical amount of approximately $3 per share. For example, during 1996, Green Tree's shares traded between the low $20s and low $40s per share. That year, a $3,000 bonus would effectively buy 1,000 shares of Green Tree stock at the fixed price of $3 per share. If the stock were selling at $30 per share, that $3,000 bonus actually would be worth $30,000 (1,000 shares times the current market value of $30 per share).

In the years ended 1994, 1995, and 1996, Green Tree Financial's pretax earnings were $302,131,000, $409,628,000, and $497,961,000, respectively. A bonus computed at 2.5% of this amount would be $7,553,000, $10,241,000, and $12,449,000, respectively, for that three-year period. Yet Mr. Coss received an annual bonus in stock worth $28.5 million in 1994, $65.1 million in 1995, and $102.0 million in 1996. Clearly, with amounts such as these involved, there is considerable motivation to use creative accounting practices in an effort to boost the company's pretax earnings.

Green Tree's business was to make consumer loans, package them into investment pools, and sell interests in the pooled loans to investors in the form of asset-backed securities. The company would receive funds for the securities sold and pay an agreed interest amount to investors in those securities. When its loan-backed securities were sold, the company immediately recorded as profit an amount based on the estimated interest

income it was scheduled to receive on the loans underlying the securities over and above the interest the company had agreed to pay the investors in those securities. The estimate of the amount of interest to be received from the underlying loans was very sensitive to assumptions on such factors as changing interest rates, loan prepayments, and loan charge-offs. Green Tree was aggressive in the assumptions it used, thus increasing the amount of operating profit reported on sales of the loan-backed securities.

In 1997 the company adopted less aggressive assumptions on the repayment of its consumer loans. The company restated its 1996 net income downward to $184.7 million from the previously reported $308.7 million. As a result, Mr. Coss returned a substantial portion of the bonus shares he received for that year.

Another bonus plan that was tied to reported profits and offered a motivation to its management to engage in creative accounting practices was the plan in place at Leslie Fay Companies, Inc. In 1991 the company's plan paid a bonus to certain key officers of the company if net income exceeded $16 million. No bonus was paid if net income fell short of that amount.

Whether it was the bonus plan that encouraged questionable behavior on the part of the company's management is not clear. What is clear in hindsight is that earnings reported by the company in 1991 and 1992 were largely fictitious. Until the company's fictitious profit scheme was uncovered, Leslie Fay's management enjoyed higher bonuses than they would have if the altered amounts had not been reported.

Political Cost Effects

Large and high-profile firms may have the motivation to manage their earnings downward in an effort to be less conspicuous to regulators. Few readers old enough to have experienced firsthand a strong Organization of Petroleum Exporting Countries (OPEC) and the price effects of the oil embargoes of the 1970s will forget the term *obscene profits* as it was applied to the earnings of the oil companies during that period. The earnings of those companies were viewed as sufficiently high that Congress enacted a special "windfall profits tax" in an effort to rein them in. Oil prices moved so quickly during that period that likely there was very little these companies could have done to mitigate the positive earnings effect. Given time, however, they might have been encouraged to take steps, such as deferring revenue or accelerating expenses, in an effort to lower reported income.

A company that has been very clearly in the spotlight of regulators in recent years is Microsoft Corp. Although it has a market share of as much as 90% of the personal computer operating systems market, the company has unsuccessfully argued in federal court that it does not have monopoly power. Like the oil companies in the 1970s, reporting lower profits could actually be in Microsoft's interest. A review of the company's accounting policies does show instances where it has taken a very conservative stance.

Consider, for example, its accounting for software development costs. As is detailed more carefully later, accounting principles for software development costs call for capitalization of these costs as opposed to expensing them once technological feasibility—that the software can be produced to meet its design specifications—is reached. Interestingly, the company expenses 100% of its software development costs, capitaliz-

ing none. This approach is taken even though research and development (R&D) at the company, primarily software development, totaled $1.8 billion, $2.6 billion, and $3.0 billion, or 28%, 29%, and 23%, respectively, in 1997, 1998, and 1999, of operating income before R&D expense. By expensing all of these costs as incurred, the company's earnings are reduced, helping it to appear to be less profitable and, it is hoped, less of a regulatory target.

Microsoft also has taken a conservative approach in the determination of unearned revenue, or the portion of revenue that, while collected, is not yet recognized in earnings. Instead, such unearned revenue is reported as a current liability on the company's balance sheet. The company describes its policy for determining the unearned portion of its software revenue in this way:

> A portion of Microsoft's revenue is earned ratably over the product life cycle or, in the case of subscriptions, over the period of the license agreement. End users receive certain elements of the Company's products over a period of time. These elements include browser technologies and technical support. Consequently, Microsoft's earned revenue reflects the recognition of the fair value of these elements over the product's life cycle.[15]

Under this accounting policy, Microsoft correctly defers or postpones recognition at the time of sale of a portion of the revenue associated with services to be provided over an extended license period. The amount deferred is a function of the value assigned to these undelivered elements. Under this policy, the higher the value assigned to the undelivered elements, the greater the amount of revenue deferred at the time of sale.

Microsoft has deferred significant amounts of revenue under this policy. Unearned revenue reported on the company's balance sheet grew from $1.4 billion in 1997 to $2.9 billion in 1998 and $4.2 billion in 1999. However, late in 1999 the company adopted a new accounting principle and altered how it calculated the amount of revenue to be deferred. Here is how the company described its adoption of the new principle:

> Upon adoption of SOP 98-9 during the fourth quarter of fiscal 1999, the Company was required to change the methodology of attributing the fair value to undelivered elements. The percentages of undelivered elements in relation to the total arrangement decreased, reducing the amount of Windows and Office revenue treated as unearned, and increasing the amount of revenue recognized upon shipment.[16]

Whether the company, before adoption of this new principle, was being overly conservative in its revenue recognition practices cannot be known. However, what is known is that the company was being more conservative than what accounting regulators deemed appropriate.

CLASSIFYING CREATIVE ACCOUNTING PRACTICES

Using creative accounting practices, managements can alter impressions about their firms' business performance. Assessments of corporate earning power can be rendered inaccurate, leading to inappropriate prices for debt and equity securities. When resulting misstatements are discovered, the markets can be unforgiving, causing precipitous de-

clines in debt and equity prices. The objective of this book is to enable the financial statement reader to better detect the use of creative accounting practices. As a result, the reader will be better able to assess corporate earning power and avoid equity-investment and credit-granting mistakes.

A practical classification scheme is especially valuable in determining whether one or more creative accounting practices are being employed. Such a scheme provides order and helps the financial statement reader to become more focused in his or her search for items that may indicate that earning power may not be what is implied by a cursory read.

The classification scheme that is used here begins with groups based on the measurement of revenue and expense and assets and liabilities: Recognizing Premature or Fictitious Revenue, Aggressive Capitalization and Extended Amortization Policies, and Misreported Assets and Liabilities. Additional classes are added for creativity employed in the preparation of the income statement and cash flow statement. These classes are known as Getting Creative with the Income Statement and Problems with Cash Flow Reporting.

These five categories will provide the detail needed to represent the kinds of creative accounting practices employed in contemporary financial statements. They are applied as labels to the accounting practices employed, whether those practices are the result of aggressive policies, both within or beyond the boundaries of generally accepted accounting principles (GAAP), or whether they are the result of fraudulent financial reporting. The classification scheme is summarized in Exhibit 1.3 and explained further below.

Recognizing Premature or Fictitious Revenue

Given the prominence of revenue on the income statement and its direct impact on earnings, it is not surprising that creative accounting practices often begin with revenue recognition. In fact, premature or fictitious revenue recognition is an almost indispensable component of the financial numbers game. This should be clear from the examples already cited because many of them involved some form of premature or fictitious revenue recognition. In those cases, reported revenue was boosted, at least in the near term, positively impacting earnings and communicating higher earning power.

Premature revenue recognition refers to recognizing revenue for a legitimate sale in a period prior to that called for by generally accepted accounting principles. In contrast, fictitious revenue recognition entails the recording of revenue for a nonexistent sale.

Exhibit 1.3 Classification of Creative Accounting Practices

Recognizing Premature or Fictitious Revenue
Aggressive Capitalization and Extended Amortization Policies
Misreported Assets and Liabilities
Getting Creative with the Income Statement
Problems with Cash-flow Reporting

Much like the gray area that exists between the aggressive application of accounting principles and fraudulent financial reporting, however, it is often difficult to distinguish between premature and fictitious revenue recognition. It is a matter of degree.

Revenue for ordered goods that have not left the shipping dock might be recognized as though the goods had already been shipped. Such an act would entail premature revenue recognition. More aggressively, product might be shipped and revenue recognized in advance of an expected order. Given the lack of an order, such an act would, in our view, entail fictitious revenue recognition. However, many financial statement users would reserve the derogatory term, fictitious revenue recognition, for cases of even more blatant abuse of revenue recognition principles. Examples would include recording sales for shipments for which orders are not expected, or worse, recording sales for nonexistent shipments.

For purposes of analysis, a careful demarcation between premature and fictitious revenue recognition is less important than determining that, in both cases, revenue has been reported on the income statement that does not belong. Expectations about earning power will have been influenced accordingly.

In its 1994 annual report, Midisoft Corp. described its accounting policy for revenue recognition in this way: "Revenue from sales to distributors, other resellers and end users is recognized when products are shipped."[17] While the policy, as expressed, and subject to a proper accounting for estimated returns, is consistent with GAAP, the company was recognizing revenue improperly in two ways. First, in an act of premature revenue recognition, the company recognized revenue on goods that were not shipped until after the end of its fiscal year. Second, in an act of fictitious revenue recognition, the company recognized revenue on transactions for which products were shipped on a timely basis, but for which, at the time of shipment, the company had no reasonable expectation that the customer would accept and pay for the products shipped. These shipments were eventually returned to the company as sales returns. However, at the time of shipment, an insufficient provision for returns had been recorded. As a result of these actions, the company overstated revenue for 1994 by approximately $811,000, or 16%.[18]

For firms receiving up-front fees that are earned over an extended period, recognition might be accelerated to the time of receipt. For years prior to 1998, The Vesta Insurance Group, Inc., recognized revenue for reinsurance premiums in the year in which the related reinsurance agreements were contracted. This policy was followed even though the terms of those contracts bridged two years, calling for those premiums to be recognized ratably over the contract period. As a result, over the period from 1995 through the first quarter of 1998, the company had overstated earnings and shareholders' equity by a cumulative $75,200,000.[19]

Premature or fictitious revenue recognition will appear often in examples of the aggressive application of accounting principles and fraudulent financial reporting. As such, the revenue recognition group is an important category of creative accounting practices.

Aggressive Capitalization and Extended Amortization Policies

Rather than taking steps to boost revenue, or in some cases, in addition to taking steps to boost revenue, some firms will increase reported earnings by minimizing expenses. In

this category, Aggressive Capitalization and Extended Amortization Policies, companies will minimize expenses by aggressively capitalizing expenditures that should have been expensed or by amortizing capitalized amounts over extended periods.

In many cases, determining the portion of an expenditure to capitalize is straightforward. For example, amounts paid to purchase equipment and prepare it for use are capitalized into the equipment account and amortized, or depreciated, over the equipment's useful life. Often, however, the items involved are a bit more esoteric, including such items as direct-response advertising, software development, and landfill site acquisition and development costs, entailing judgment in determining whether capitalization is appropriate or not.

When capitalized, an expenditure creates an asset that is amortized over some predetermined useful life. When contrasted with the more conservative expensing option, near-term earnings are increased, implying higher earning power.

American Software, Inc., has historically capitalized software development costs. The practice is consistent with GAAP, which permit capitalization of software development costs, including such costs as software coding, testing, and production, after technological feasibility is reached. As noted earlier, technological feasibility occurs when it is determined that the software can be produced to meet its design specifications.[20] However, the proportion of these costs that was being capitalized by the company was somewhat aggressive. Using figures available in its annual report, for the years ended April 30, 1997, 1998, and 1999, the company capitalized $7,363,000, $12,112,000, and $11,511,000, respectively, of software development costs incurred. During those same years, the company amortized software development costs that had been capitalized previously in the amounts of $4,700,000, $6,706,000, and $6,104,000, respectively. The difference between these amounts each year, the amounts capitalized and the amounts amortized, or $2,663,000 in 1997, $5,406,000 in 1998, and $5,407,000 in 1999, boosted the company's pretax income in each of those years. However, in the year ended April 30, 1999, the company wrote off $24,152,000 in capitalized software development costs, as a result of "ongoing evaluations of the recoverability of its capitalized software projects."[21] The company apparently had capitalized more software development costs than could be realized through operations, and it therefore became necessary for the company to write those costs off. In the intervening years leading up to the write-off, however, the company's capitalization policy had boosted its reported earnings and its apparent earning power.

Before its acquisition, Chambers Development Company, Inc., was in the business of collecting, hauling, and disposing solid waste and of building and operating solid waste sanitary landfills and related operations. During the period 1989 to 1990, the company capitalized significant amounts of landfill development costs. Generally accepted accounting principles permit capitalization where future realization of the costs through anticipated revenue is given careful consideration. In the case of Chambers, however, future realization was not considered in determining the amounts to be capitalized. Instead, Chambers calculated expenses and determined amounts to be capitalized based on targeted profit margins determined in advance. As a result, the company appeared to be more profitable, indicating higher earning power, than it otherwise would have been. In fact, the company's capitalization policy converted it from a loss to a profitable opera-

tion. Using amounts provided by the Securities and Exchange Commission, the company originally reported pretax income of $27.1 million and $34.4 million in 1989 and 1990, respectively. Revised amounts, restated to correct for improperly capitalized landfill development costs, were pretax losses of $16.5 million and $40.6 million, respectively.[22]

Another practice used to reduce expenses and boost earnings is to lengthen amortization periods for costs that have been capitalized previously. This practice might be used for such assets as property, plant, and equipment, or any of the assets, including capitalized software development and capitalized landfill development costs, mentioned above.

In an example provided earlier in this chapter, Waste Management, Inc., took a special charge of $3.54 billion to, among other things, write-down fixed assets that had not been depreciated quickly enough. The company adopted new, more conservative accounting practices that included shorter useful lives for fixed assets. Examples such as Waste Management, and others, where earnings have been boosted through aggressive cost capitalization or through extended amortization periods, are grouped in this category of creative accounting practices.

Misreported Assets and Liabilities

In the category of misreported assets and liabilities, we include assets that are not subject to annual amortization, such as accounts receivable, inventory, and investments. Expenses and losses can be minimized through an overvaluation of such assets. For example, by overestimating the collectibility of accounts receivable, the provision for doubtful accounts, an operating expense, is reduced. Similarly, a loss can be postponed by neglecting to write-down slow-moving inventory or an investment whose value has declined and is not expected to recover. An example noted earlier was that of Centennial Technologies, Inc. The company's fraudulent acts to misreport its earning power included overstatements of all three assets, accounts receivable, inventory, and investments.

Also included in this category are steps taken to boost earnings by understating liabilities. While the example entailed an error and was apparently not deliberate, the direct link between accounts payable and cost of goods sold was apparent in the case of Micro Warehouse, Inc. The company understated inventory purchases and accounts payable, understating cost of goods sold and overstating its operating income by a cumulative amount of $47.3 million.[23] Other liabilities that might be understated, boosting reported earnings, include accrued expenses payable, environmental claims, and derivatives-related losses. All of these liabilities, in addition to assets that are not subject to amortization, such as accounts receivable, inventory, and investments, are included in this group of creative accounting practices.

Getting Creative with the Income Statement

Getting creative with the income statement includes steps taken to communicate a different level of earning power using the format of the income statement rather than through the manner in which transactions are recorded. Companies may report a nonrecurring gain as "other revenue," a recurring revenue caption, or a recurring expense might be labeled as nonrecurring. Such practices result in higher apparent levels of recurring earnings without altering total net income. One example is that of International Business Machines

Corp. (IBM), which in a 1999 interim report netted $4 billion in gains on an investment against selling, general and administrative expense.[24] As a result, the company imparted an impression that recurring operating expenses were being reduced.

Problems with Cash Flow Reporting

A company can communicate higher earning power not only by reporting higher earnings but by reporting higher and more sustainable cash flow. The statement of cash flow divides the total change in cash into three components: cash flow provided or used by operating activities, investing activities, and financing activities. Given the potential recurring quality of operating cash flow, the higher the apparent level of that cash flow statement subtotal, the greater will be a company's apparent earning power.

In order to boost operating cash flow, a company might classify an operating expenditure as an investing or financing item. Similarly, an investing or financing inflow might be classified as an operating item. Such steps will not alter the total change in cash.

Companies that capitalize software development costs will, in most instances, report the amount capitalized as an investing cash outflow, keeping it out of the operating section. Accordingly, a company that capitalizes a greater portion of its software development costs, as American Software did, will report higher amounts of operating cash flow than companies that expense all or most of their software development expenditures. Interestingly, if a company, such as American Software, later writes down its capitalized software development costs, the resulting noncash charge does not penalize operating cash flow.

Certain accounting guidelines for cash flow reporting may result in reported operating cash flow amounts that are misunderstood. For example, cash provided by operating activities includes nonrecurring cash flow arising from the operating income component of discontinued operations. Also, all income taxes are reported as operating cash flow, including taxes related to items properly classified as investing and financing actions.

Accounting rules for cash flow reporting that may be misunderstood combined with steps taken by some managements to boost apparent operating cash flow may result in cash flow amounts that yield misleading signals. All such items that may render operating cash flow a less effective tool in evaluating financial performance are referred to here as problems with cash flow reporting.

PLAN OF THIS BOOK

As noted, the objective of this book is to equip the financial statement reader to better detect the use of creative accounting practices and avoid equity-investment and credit-granting mistakes. This objective is achieved with the chapters detailed below.

In Chapter 2, "How the Game Is Played," we look at the flexibility that is available to those preparing financial statements and how that flexibility can be used, and often stretched, sometimes to the point of fraud, in an effort to achieve desired results. By better understanding this reporting flexibility, the reader will be more prepared to see how it might be used to mislead. Chapter 3, "Earnings Management: A Closer Look," pro-

vides an in-depth look at the use of earnings management and income smoothing techniques, a subset of creative accounting practices. In Chapter 4, "The SEC Responds," we describe how the SEC has become more diligent in recent years in pursuing creative accounting practices. However, even though the commission is more actively pursuing the use of creative accounting practices, it cannot eliminate them. The financial statement reader will need to remain on guard. In Chapter 5, "Financial Professionals Speak Out," we report the findings of a survey of many different groups of financial professionals, including financial analysts, chief financial officers, commercial bankers, certified public accountants, and accounting academics, on their views regarding the detection of creative accounting practices. The objective is to supplement our knowledge on the subject with information gleaned from professionals who prepare, use, and instruct others on the use of financial statements.

In Chapters 6 through 11 we detail our recommendations for detecting creative accounting practices. In Chapter 6, "Recognizing Premature or Fictitious Revenue," we detail certain likely signs that revenue may have been recorded in a premature or fictitious manner. Expenses and losses become the focus in Chapters 7 and 8. In Chapter 7, "Aggressive Capitalization and Extended Amortization Policies," attention is directed to assets that are subject to periodic amortization. In Chapter 8, "Misreported Assets and Liabilities," the focus is directed to assets that are not subject to periodic amortization and to liabilities.

Creative financial statement presentation is the subject for the last three chapters of the book. In Chapter 9, "Getting Creative with the Income Statement: Classification and Disclosure," and Chapter 10, "Getting Creative with the Income Statement: Pro-Forma Measures of Earnings," the focus is on the reporting of earnings, both in accordance with the guidelines of generally accepted accounting principles and in pro-forma reports, where such formal guidelines do not presently exist. The book concludes with Chapter 11, "Problems with Cash Flow Reporting." Even when total cash flow is reported accurately, the manner in which those cash flows are reported can alter a reader's impression of recurring cash flow. Collectively, the final three chapters look at the creative use of reporting formats to alter impressions of earning power.

SUMMARY

This chapter establishes an organization for the entire book. Key points raised include the following:

- Examples of creative accounting practices, attributable to managements engaged in the financial numbers game, occur often in contemporary financial statements.
- Potential rewards for playing the financial numbers game can be substantial. Included among them are positive share-price effects, lower borrowing costs and less-stringent financial covenants, boosted profit-based bonuses, and reduced political costs.
- Markets can be very unforgiving when news of accounting gimmickry becomes widely known.

- Given the various creative accounting practices that can be used to play the financial numbers game, a classification scheme was devised to facilitate their discovery. The scheme has five categories:
  1. Recognizing premature or fictitious revenue
  2. Aggressive capitalization and extended amortization policies
  3. Misreported assets and liabilities
  4. Getting creative with the income statement
  5. Problems with cash flow reporting

  Separate book chapters are devoted to each of these categories of creative accounting practices.

GLOSSARY

Accounting Errors Unintentional mistakes in financial statements. Accounted for by restating the prior-year financial statements that are in error.

Accounting Irregularities Intentional misstatements or omissions of amounts or disclosures in financial statements done to deceive financial statement users. The term is used interchangeably with *fraudulent financial reporting*.

Aggressive Accounting A forceful and intentional choice and application of accounting principles done in an effort to achieve desired results, typically higher current earnings, whether the practices followed are in accordance with generally accepted accounting principles or not. Aggressive accounting practices are not alleged to be fraudulent until an administrative, civil, or criminal proceeding takes that step and alleges, in particular, that an intentional, material misstatement has taken place in an effort to deceive financial statement readers.

Aggressive Capitalization Policies Capitalizing and reporting as assets significant portions of expenditures, the realization of which require unduly optimistic assumptions.

Big Bath A wholesale write-down of assets and accrual of liabilities in an effort to make the balance sheet particularly conservative so that there will be fewer expenses to serve as a drag on future earnings.

Bill and Hold Practices Products that have been sold with an explicit agreement that delivery will occur at a later, often yet-to-be-determined, date.

Capitalize To report an expenditure or accrual as an asset as opposed to expensing it and charging it against earnings currently.

Creative Accounting Practices Any and all steps used to play the financial numbers game, including the aggressive choice and application of accounting principles, both within and beyond the boundaries of generally accepted accounting principles, and fraudulent financial reporting. Also included are steps taken toward earnings management and income smoothing. See *Financial Numbers Game*.

Earning Power A company's ability to generate a sustainable, and likely growing, stream of earnings that provide cash flow.

Earnings Management The active manipulation of earnings toward a predetermined target. That target may be one set by management, a forecast made by analysts, or an amount that is consistent with a smoother, more sustainable earnings stream. Often, although not always, earnings

management entails taking steps to reduce and "store" profits during good years for use during slower years. This more limited form of earnings management is known as income smoothing.

Extended Amortization Periods Amortizing capitalized expenditures over estimated useful lives that are unduly optimistic.

Fictitious Revenue Revenue recognized on a nonexistent sale or service transaction.

Financial Numbers Game The use of creative accounting practices to alter a financial statement reader's impression of a firm's business performance.

Fraudulent Financial Reporting Intentional misstatements or omissions of amounts or disclosures in financial statements done to deceive financial statement users. The term is used interchangeably with *accounting irregularities*. A technical difference exists in that with fraud, it must be shown that a reader of financial statements that contain intentional and material misstatements must have used those financial statements to his or her detriment. In this book, accounting practices are not alleged to be fraudulent until done so by an administrative, civil, or criminal proceeding, such as that of the Securities and Exchange Commission, or a court.

Generally Accepted Accounting Principles (GAAP) A common set of standards and procedures for the preparation of general-purpose financial statements that either have been established by an authoritative accounting rule-making body, such as the Financial Accounting Standards Board (FASB), or over time have become accepted practice because of their universal application.

Income Smoothing A form of earnings management designed to remove peaks and valleys from a normal earnings series. The practice includes taking steps to reduce and "store" profits during good years for use during slower years.

LIFO The last-in, first-out method of inventory cost determination. Assumes that cost of goods sold is comprised of newer goods, the last goods purchased or manufactured by the firm.

Loan Covenants Express stipulations included in loan agreements that are designed to monitor corporate performance and restrict corporate acts, affording added protection to the lender.

Negative Loan Covenants Loan covenants designed to limit a corporate borrower's behavior in favor of the lender.

Political Costs The costs of additional regulation, including higher taxes, borne by large and high-profile firms.

Positive Loan Covenants Loan covenants expressing minimum and maximum financial measures that must be met by a borrower.

Premature Revenue Revenue recognized for a confirmed sale or service transaction in a period prior to that called for by generally accepted accounting principles.

Securities and Exchange Commission (SEC) A federal agency that administers securities legislation, including the Securities Acts of 1933 and 1934. Public companies in the United States must register their securities with the SEC and file with the agency quarterly and annual financial reports.

NOTES

1. A. Levitt, The "Numbers Game," remarks to New York University Center for Law and Business, September 28, 1998, para. 4. Available at: www.sec.gov/news/speeches/spch220.txt.
2. *The Wall Street Journal*, February 26, 1998, p. R3.
3. Ibid., January 26, 1995, p. A4.

4. Ibid., May 7, 1997, p. A4.
5. Ibid., March 21, 2000, p. B1.
6. Ibid., October 21, 1998, p. B6.
7. Ibid., January 6, 2000, p. A1.
8. Ibid., February 25, 1998, p. A4.
9. Ibid., April 17, 1998, p. A3.
10. Ibid., February 22, 2000, p. A3.
11. Ibid., December 10, 1999, p. A4.
12. Accounting and Auditing Enforcement Release No. 883, *Securities and Exchange Commission v. Emanual Pinez* (Washington, DC: Securities and Exchange Commission, February 14, 1997).
13. *The Wall Street Journal*, February 25, 1999, p. B9.
14. Refer to *The Wall Street Journal*, December 22, 1998, p. C2.
15. Microsoft Corp., Form 10-K annual report to the Securities and Exchange Commission, June 1999, Exhibit 13.4.
16. Ibid. SOP 98-9 refers to Statement of Position 98-9, *Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions* (New York: American Institute of CPAs, 1998).
17. Midisoft Corp., annual report, December 1994. Information obtained from Disclosure, Inc., *Compact D/SEC: Corporate Information on Public Companies Filing with the SEC* (Bethesda, MD: Disclosure, Inc., December 1995).
18. Accounting and Auditing Enforcement Release No. 848, *In the Matter of Alan G. Lewis, Respondent* (Washington, DC: Securities and Exchange Commission, October 28, 1996).
19. The Vesta Insurance Group, Inc., Form 10-K annual report to the Securities and Exchange Commission, December 1998, pp. 20–21.
20. SFAS No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed* (Norwalk, CT: Financial Accounting Standards Board, August 1985).
21. American Software, Inc., Form 10-K annual report to the Securities and Exchange Commission, April 1999, p. 35.
22. Accounting and Auditing Enforcement Release No. 767, *In the Matter of John M. Goldberger, CPA and C. Kirk French, CPA, Respondents* (Washington, DC: Securities and Exchange Commission, March 5, 1996).
23. Micro Warehouse, Inc., Form 10-K annual report to the Securities and Exchange Commission, December 1996, Exhibit 11.
24. *The Wall Street Journal*, November 24, 1999, p. C1.