Good companies as well as bad can turn to financial shenanigans if management sets the wrong example. Most companies leave telltale signs of their fraudulent behavior, but auditors and analysts must be independent, imaginative, and skeptical in their examination of company accounts if they expect to find these signs.

During the past few years, I have been shocked and disappointed by the way corporations have increased the use of manipulative accounting gimmicks when their management presents information to investors. Such behavior occurs in both reputable and disreputable companies. In fact, many of the companies that I cite in my examples are highly regarded companies, so I am not pointing fingers at any particular type of company. But all of the companies I cite have at least one thing in common: Their management sets a tone that encourages the use of tricked-up accounting. For example, consider the words spoken at an employee meeting at Qwest Communications International by Joseph Nacchio, the CEO at the time:

The most important thing we do is meet our numbers. It’s more important than any individual product. It’s more important than any individual philosophy. It’s more important than any individual cultural change we’re making. We stop everything else when we don’t make the numbers.\(^1\)

Companies that play games with their accounting mirror this philosophy that nothing is more important than meeting and beating Wall Street’s numbers, and that philosophy begins at the top.

The intention of this presentation, therefore, is not only to share insights about the accounting tricks used by management to manipulate corporations’ apparent earnings and cash flow but also to identify some of the telltale signs and behaviors that can indicate such shenanigans are happening.

**Earnings Manipulation Shenanigans**

The accounting gimmicks used to manipulate earnings can be organized into seven categories:

1. Recording revenue too soon,
2. Recording bogus revenue,
3. Boosting income by using one-time or unsustainable activities,
4. Shifting current expenses to a later period,
5. Employing other techniques to hide expenses or losses,
6. Shifting current income to a later period, and
7. Shifting future expenses to an earlier period.

Categories 1–5 represent earnings manipulation (EM) techniques for inflating profits during a given period, which can be done either by overstating revenue or by hiding expenses. Businesses are most likely to use these five categories. Sometimes, however, businesses want to do just the opposite, particularly when they want to cheat on their taxes. In these instances, they turn to Categories 6 and 7, which represent EM techniques for understating revenue and inflating expenses. Lower income and higher expenses lead to lower taxes.

I will discuss several, but not all seven, of these techniques.

**Recording Revenue Too Soon.** In this EM technique, a company does not fabricate revenue out of thin air; it simply reports revenue sooner than it should. For example, if a company is having difficulty meeting Wall Street’s estimate, it may start signing contracts or shipping out its product during the last few days of the quarter to get additional revenue booked in the current period.

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\(^{1}\)Joseph Nacchio, speech at January 2001 employee meeting, disclosed in a U.S. SEC complaint (March 2005).
■ Recording revenue before completing any obligations. Computer Associates was particularly persistent at recording revenue before any obligations were complete. Its specific technique was to keep open the last month of any given quarter until it was able to produce enough revenue to satisfy Wall Street. Computer Associates was infamous for its 35-day months.

Furthermore, Computer Associates showed billions of dollars of long-term receivables in its accounts, which is a sure sign that something odd is going on. Generally, a receivable is recorded at the same time as the revenue, and one would expect the customer to pay within 30–60 days, not 365 days later. When a company shows long-term receivables, auditors and analysts should scrutinize the data and determine when the revenue for the receivables was recorded. For example, if a software company signs a five-year licensing deal, the company will receive payment over that 60-month period and should not be picking up all of the revenue in the first month. But that is exactly what Computer Associates was doing.

■ Recording revenue far in excess of work completed on the contract. Companies can use this technique in several different ways, one of which is through a contract with several deliverables. Software companies often use this kind of contract. For example, when Apple sells an iPhone, part of its revenue is from selling hardware and part is from the two-year contract for iPhone service. Certainly, this is a legitimate way of doing business, but it can also lead to accounting shenanigans.

Consider the software company Transaction Systems Architects, which became increasingly aggressive at picking up ever larger portions of its revenue at the front end and smaller portions at the back end. One sign that helped me discover this behavior was that new accounts began appearing on the balance sheet. When I see a new account, only two explanations seem logical: The company is creating a new business, or it has decided to account for things in a different way. The second explanation is not a good sign. Such accounts as unbilled receivables and receivables in excess of billing began to show up on the balance sheet of Transaction Systems Architects, a telltale sign of accounting tricks.

Two more brief examples are Xerox Corporation’s tendency to choose an inappropriately low discount rate to accelerate revenue and, more notoriously, Enron Corporation’s use of mark-to-market accounting to accelerate revenue into early years.

■ Recording revenue before the buyer’s final acceptance of the product. A business typically takes certain steps—such as developing a product, shipping it, and providing training for it—before it can record revenue on the sale. The customer must not only order the product but also take possession of it, test it, and approve it as acceptable for its needs. Customer acceptance is an important step in the process, yet some suppliers try to maneuver around this final step. Sunbeam Products was notorious for accelerating revenue by using a strategy called “bill and hold.” For example, Sunbeam would sign contracts with retailers during the winter for products that would not be sold until the summer, such as pool-cleaning products. The retailers would not pay for the products, and Sunbeam would not ship the products. In fact, Sunbeam did not even bill for the products, so the name of the strategy is a misnomer. Yet it allowed Sunbeam to book revenue that was anticipated, not received.

The warning sign that Sunbeam was playing fast and loose with its revenue recognition was detectable in its gross margins, which were initially low and fairly stable. The margins hardly fluctuated, yet Sunbeam was not the manufacturer. It was buying the product from a vendor and was competing on price with companies such as Wal-Mart Stores. When Sunbeam’s gross margins increased by 1,100 bps in one period, I assumed my math was wrong. Because Sunbeam was using the bill-and-hold strategy, however, it continued to hold the product. Inventory was not being converted to cost of goods sold, which resulted in a misleadingly high gross margin. Therefore, beware of gross margins that skyrocket or fluctuate wildly without a reasonable explanation.

■ Recording revenue when the buyer’s payment remains uncertain. Kendall Square Research was notorious for recording revenue even when its customers were unable to pay. Such sales are simply bogus. Therefore, when analysts are trying to determine whether a company is overly aggressive in recording its sales, they should examine not only the practices of the company that is making the sale but also the creditworthiness of the company’s customers.

Another way of carrying out this same trick is to make sales based on extended payment terms. System Software was a company that made a habit of letting customers take possession of a product without making payment until 14 months later. Yet System Software recorded revenue at the time the contract was signed. I have a difficult time seeing such transactions as legitimate sales when the revenue is recorded in one period and the payment is made in another.

One indicator of such behavior is a big increase in receivables.
Recording Bogus Revenue. Companies typically report bogus income by recording revenue in one of four inappropriate ways:

1. From transactions lacking economic substance,
2. From transactions lacking a reasonable arm’s-length process,
3. On receipts from nonrevenue producing transactions, and
4. From appropriate transactions but at inflated amounts.

Some examples of this type of shenanigan include AIG (American International Group) reporting bogus insurance reserves on receipts from Gen Re (General Re Corporation), Global Crossing reporting bogus revenue on round-trip sales, and Overstock.com changing from the net method to the gross method. One of the best examples, though, comes from Lehman Brothers, so I will take special note of that gimmick.

Classifying loans as sales transactions. Lehman Brothers’ particular tactic was to report bank borrowing as if it were a sales, not a borrowing, transaction. For instance, Lehman Brothers might take out a three-day or seven-day loan at the end of a quarter to cover normal operating expenses—to meet payroll, perhaps, or to pay down some of its debt. Such repos, or repurchase agreements, are normal business transactions in which the lender expects collateral. But Lehman Brothers did not treat these transactions as loans but rather as sales of assets. It took the assets that were used as the collateral in the repos off its books and never reported the debt side of the transaction. It did this because the market was getting skittish about Lehman’s growing leverage.

The difference between a loan and a sale of an asset should be clear to any auditor on the planet. Yet Ernst & Young let this behavior slip by without comment.

Learning to be a critical reader. An important lesson I have learned is to be very critical of any press release a company issues. In fact, whenever I receive a press release, I first ask myself, What message is this company trying to sell? The intent of the release is not necessarily devious, but most press releases are crafted to sell a message. It is up to the reader to determine what that message is and to what degree it can be trusted. Lehman’s press releases were often focused on trying to demonstrate how dramatically its net leverage had come down.

Since learning to read press releases with a skeptical eye, I have found that 9 times out of 10, a company that is using accounting gimmicks will inadvertently reveal in its press release where its skeletons are buried. If a press release boasts of the amazing improvement in a company’s DSO (days sales outstanding), then the DSO deserves special attention.

For one case in which I was involved, the company had a DSO that spiked for several consecutive quarters—from 40 days to 47 days, to 60 days, to 75 days. This upward trend was clearly a problem and raised questions during analysts’ conference calls with management, and the stock price came under increasing pressure. Then the DSO suddenly dropped from 70 days to 37 days. The company opened its next press release with a passage emphasizing the dramatic improvement in its DSO. I took this message as a cue to immediately look for accounting shenanigans. I examined the company’s balance sheet, and I found that right after accounts receivable was an account called “prepaid expenses.” The figure in that account had gone from $2 million to $17 million in one period. So, how did the company’s DSO drop so dramatically? It simply reclassified some of those receivables as prepaid expenses.

Bundling a revenue-generating transaction with a new investment. Finally, consider the behavior of software company MicroStrategy. During the height of the internet bubble in early 2000, I began following MicroStrategy, and on 5 October 2000, just five days after the end of the quarter, I noticed that it had issued a press release containing two oddities. First, the timing was too early to include earnings numbers; they usually appear about three weeks after a quarter ends. Second, the press release described a joint venture in which MicroStrategy had invested $20 million with NCR Corporation and then went on to explain that, quite fortuitously, NCR (MicroStrategy’s new best friend) had decided to buy $19.5 million of MicroStrategy’s software. From an accounting perspective, the transaction was recorded on the balance sheet as an investment. It had no effect on the income statement. It struck me, and should strike any analyst, as unusual that MicroStrategy was engaging in investment-related activity with the same party that was becoming a customer. This sort of activity muddies the waters and almost always indicates that something bad is about to happen.

I called an executive at MicroStrategy and asked if this was a transaction of the third quarter or the fourth quarter. I was told that the transaction was booked in the last week of the third quarter but that MicroStrategy employees had been too busy to issue the press release until after the quarter had ended. I accepted the explanation, and although I continued to have second thoughts, I wrote a report on the
company, and the stock price went quickly from $50 to $90. Nevertheless, I continued to have questions about the company. Then during the first week of January 2001, lo and behold, MicroStrategy issued a press release stating that it had invested approximately $12 million in Exchange Applications, a British company. Exchange Applications became MicroStrategy’s new best friend; it had contracted to buy software from MicroStrategy. Once again I called, and once again a MicroStrategy executive said that the transactions had occurred in the previous quarter. In essence, however, MicroStrategy was booking revenue for doing nothing at all.

Any unusual bundling of a revenue-generating transaction with the same party with which a company has another relationship, such as an investor relationship, should alert auditors and analysts to the potential of accounting shenanigans.

Boosting Income Using One-Time or Unsustainable Activities. Companies typically use one of two strategies—one-time events or misleading classifications—when undertaking this type of earnings manipulation. For example, Enron inflated its income by pushing losses from its various ventures to its balance sheet. Lucent Technologies pushed normal operating expenses into a one-time charge. Toys “R” Us recorded a normal inventory write-down as a nonrecurring event. Boston Chicken treated interest income from franchisees as revenue, and Oracle Corporation boosted income by changing the structure of an affiliated company—all examples of recording activities in misleading classifications.

The example I want to concentrate on, however, is that of IBM: It inflated operating income by including a big gain from an asset sale, thus mischaracterizing a one-time event as an ongoing activity.

When I notice growth in company sales, I compare that growth with all the important line items on the income statement. I look at the cost of goods sold, SG&A (selling, general, and administrative expenses), and earnings per share. On the balance sheet, I look at receivables. When a company’s sales grow by 10 percent, for example, I expect to see a corresponding change in other operational measures. I do not expect growth of 100 percent or a decline of 25 percent. When changes do not balance out, I begin to investigate. And that is exactly what happened with IBM.

When IBM’s sales went up by 7 percent, my examination of its accounts revealed that operating income was up by 30 percent. Because operating income grew substantially faster than sales, I would have expected that both the cost of goods sold and the SG&A would have grown more slowly than the 7 percent sales increase. Upon closer inspection, I saw that the cost of goods sold surprisingly increased by 9 percent. So, that clearly did not explain how the operating profit grew so rapidly. Then I noted that the SG&A did indeed drop—a whopping 11 percent. Management explained this decline by pointing to its masterful job of controlling costs during a tough economic period. As I went further into the document, however, I read that IBM had sold a business during that period to AT&T for about $4.5 billion. The financials indicated an associated gain of $4 billion, but when I examined the income statement, none of the accounts were large enough to have housed a $4 billion item. IBM, it turns out, had used the $4 billion gain to offset SG&A. Management had not done such a wonderful job controlling costs. It had simply used a one-time event to boost the company’s apparent income.

Shifting Current Expenses to a Later Period. Businesses use a variety of methods to shift expenses and thus improve the appearance of their revenue numbers. Four methods bear noting:

1. Improperly capitalizing normal operating expenses,
2. Amortizing costs too slowly,
3. Failing to write down costs with impaired value, and
4. Failing to record expenses for uncollectible receivables and devalued investments.

WorldCom is the champion of this type of earnings manipulation. It treated as much as $12 billion in line costs as an asset, thus capitalizing normal operating expenses. But I will highlight a company with numbers that were smaller and, therefore, much easier to spot.

In the mid-1990s, AOL was a rocket ship. It was on its way to becoming an enormous company, but one big problem impeded its growth: It lacked a one big problem impeded its growth: It lacked a continuing infusion of capital from Wall Street. By the late 1990s, Wall Street was willing to throw money at anything, but at the time AOL was looking for capital, Wall Street still retained such old-fashioned attitudes as expecting businesses to show a healthy profit before investing in them. Unfortunately for AOL, because of its advertising and solicitation expenses, the company was regularly showing losses. So in 1994–1995, AOL began capitalizing marketing costs. An account called “deferred subscriber acquisition costs” appeared on its balance sheet as if from nowhere. It started out as a relatively small item; AOL began by amortizing it over a 12-month period. Then it expanded the amortization period to 24 months. AOL continued this activity for about three years, and throughout that period, I wrote reports noting that
the company was not playing fair. Had the company been expensing its marketing costs, it would have shown a loss, but AOL was hiding its expenses by moving them onto its balance sheet. I warned my clients that this behavior would catch up with AOL. I pointed out that if AOL amortized $50 million per quarter for eight quarters, its deferred subscriber acquisition costs would soon reach $400 million. Eventually, I warned, either the U.S. SEC or an auditor would force AOL to stop this behavior, thereby creating a tremendous hit to AOL’s earnings.

In October 1996, the day of reckoning arrived. AOL issued a press release in which it described a change in its accounting and announced that it would take a $385 million one-time restructuring charge. But a closer look at the details showed that it was restructuring nothing. It was laying off no employees; it was writing off no plant, no equipment, no inventory. It was simply pulling those troublesome expenses that it had pushed to tomorrow back into the current period as a one-time expense. It had gone from manipulating earnings by shifting current expenses to a later period to manipulating them again by shifting what had been future expenses to an earlier period. All of this, AOL asserted, it had been forced to do by its auditors. Whenever management complains that the auditor is responsible, investors should short that stock immediately: Management is lying.

Other specific examples of this category of earnings manipulation include Time Warner Telecom increasing depreciable life from 15 to 20 years and Fannie Mae failing to properly amortize loan origination cost changes. In two other variations of this type of shenanigan, Orion Pictures Corporation did not write off the costs of films that lost money and New Century Financial Corporation reduced loan loss reserves to boost income.

**Shifting Current Income to a Later Period.**

Businesses have several reasons for taking income out of the current period, and Microsoft Corporation and Freddie Mac provide two excellent examples of this behavior.

■ **Microsoft and antitrust investigation.** About a decade ago, Microsoft was being investigated by the antitrust division of the U.S. Department of Justice. So, the last thing Microsoft wanted was to demonstrate how dominant its business was in terms of revenue. It had plenty of incentive, therefore, to push some of its current revenue into deferred revenue accounts. For three years, I watched and reported on Microsoft’s behavior as its deferred revenue grew by about $400 million per quarter for 10 straight quarters, which is a very conservative accounting stance. Then in the 11th quarter, deferred revenue grew by only $40 million, and in the 12th quarter, it actually shrank by more than $100 million, a dramatic change in the trend. At this point, Microsoft apparently decided that it no longer needed to defer revenue and thus recorded its period sales in their entirety.

■ **Freddie Mac and derivatives accounting.** Even more interesting than Microsoft is the example of Freddie Mac’s behavior when the Financial Accounting Standards Board (FASB) came out with new rules on accounting for derivatives in the year 2000. (Whenever changes in accounting policies occur, whether initiated by the company itself or mandated by legislation or the FASB, the likelihood of accounting shenanigans tends to increase.)

By virtue of its business, Freddie Mac has large interest rate exposure, but a decade ago, it nevertheless had a reputation for giving predictably steady earnings. For years, in fact, its nickname was “Steady Freddie,” but when the FASB adopted new rules on accounting for derivatives, that changed. Suddenly, Freddie Mac would have to account for the volatility in interest rate movements, and management could see in the very first year that it would have to report a tremendous gain. So, it formed a committee to determine what to do, and the committee’s solution was to avoid recognizing most of the company’s derivatives gains on its income statement by moving them to deferred revenue on the balance sheet and thereby improperly smoothing income. Management’s intention was to gradually recharacterize the derivatives gains as income as they were needed. This was done for a few years, and then the music stopped. Freddie Mac was caught with more than $4.5 billion of deferred revenue that it had never picked up as income.

This case stands in a class by itself because in every other story of accounting shenanigans, the guilty party has tried to show more earnings than it really had. Freddie Mac, however, ended up cheating itself out of more than $4 billion of income.

**Cash Flow Shenanigans**

Cash flow shenanigans usually fall into one of four categories:

1. Shifting financing cash inflows to the operating section of the income statement,
2. Shifting normal operating cash outflows to the investing section of the income statement,
3. Inflating operating cash flow using acquisitions or disposals, and
4. Boosting operating cash flow using unsustainable activities.
When I was writing the first edition of my book in the early 1990s, I assumed that the tricks management had up its sleeve were focused entirely on manipulating profits. Then I started studying Tyco Electronics Corporation.

**Tyco and Cash Flow Shenanigans.** Tyco always seemed suspicious to me. Early in my study of Tyco, I received a phone call from the company’s CFO (who is now in jail) that should have made me even more suspicious. He was terribly upset because he had learned that I was about to publish a report on his company. Analysts write reports on companies all the time, so the fact that the CFO of Tyco was worried simply because some analyst was writing a report should have set off alarms in my head. At the time, however, I did not understand the significance of the call. Nevertheless, I continued my research of the company’s financials.

One of the best research methods I have found during my years of work is to take a company’s cash flow from operations, which shows the company’s performance on a cash basis, and compare that with net income, which shows the company’s performance on an accrual basis. Both items measure the same basic thing. Most auditors know how easy it is to manipulate accrual-based numbers, but I did not realize at first exactly how easy it also is to manipulate cash flow numbers. But Tyco taught me a lesson. The management of Tyco understood that auditors and analysts quickly see red flags when a company’s profits and cash flow are out of balance. That is, if a company reports $1 billion of profit but only $200 million of cash flow, analysts will quickly smell a skunk. So, Tyco always made sure that its cash flow was appropriately proportioned to its profits. If it reported $1 billion in profit, it showed a similarly large cash flow, such as $1.5 billion. Thus, it could always point out how conservative its accounting was, although, of course, it was not. And the gimmick Tyco used was inflating operating cash flow by making acquisitions.

During a period of about four years, Tyco made more than 700 acquisitions. When a company makes an acquisition, it is expected to disclose information about that transaction unless the acquisition is deemed immaterial, in which case almost no information is required. Every time Tyco made an acquisition, it was deemed immaterial. Therefore, little information was ever disclosed about any of these 700 acquisitions.

When a business buys another company, it obtains all of that company’s balance sheet items—receivables, inventory, everything. It then records the value of all those assets (that is, the amount it paid for the company) not in the operations section of the cashflow statement but in the investments section of the cashflow statement. Therefore, whatever the negative impact of acquiring working capital might be, it does not show up in the operating cash flow. The company appears to have gotten the capital for free. That is the first half of the process.

Next, once the purchasing business owns the purchased business’s assets, it begins collecting on the purchased receivables, and the collections are recorded in the cash flow statement, in operations. The money comes in from sales of inventory, and the purchasing company has a win–win situation. It enjoys a windfall in cash flow and pays no penalty on outflows of working capital. And all of this activity is completely legitimate under GAAP. It is up to the analyst to figure out how much more went into the investing section than should have.

**Acquisition Accounting with No Acquisitions.** Tyco loved acquisition accounting so much that even when it did not make an acquisition, it used acquisition accounting. For example, it had a division called “ADT Security Services.” Instead of having an employed sales staff solicit new contracts, it hired independent contractors who paid for the privilege of selling ADT products. Tyco recorded the payments from its contractors in operating income on both the statement of cash flow and on the income statement. But when its contractors began making sales and needed to be paid for their work, Tyco recorded those payments as capital expenditures, as if it were buying a company. Thus, the money coming in went into the operating section of its financial statement and the money going out went into the investing section.

Other examples of cash flow manipulations include the following:

- Delphi Automotive accounted for the collateral on a bank loan as the sale of an asset.
- Global Crossing tried to hide its cash crunch by selling receivables.
- Xerox Corporation failed to disclose the sale of receivables—and was cited by the SEC.
- Biovail Corporation listed noncash purchases of product rights in its investing section.
- The Home Depot inflated cash flow from operations by paying vendors much too slowly.
- Sun Microsystems included a litigation-related windfall as cash flow from operations.

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Conclusion
Numerous factors help create a breeding ground for accounting shenanigans. The factor I mentioned at the beginning of this presentation remains a powerful one: management’s ability to create a culture of fear and intimidation when pressing employees to make the numbers at any cost.

Other factors that analysts should be aware of include the absence of checks and balances among executive ranks and inappropriate compensation structures for executives. There is often a lack of independence, either in fact or in behavior, among boards of directors, and too many boards lack enough investor-centric members. Lack of independent auditors is another problem, and businesses changing auditors is a sure sign of trouble.

Finally, the dynamic and changing market environment in which businesses operate creates pressures to manipulate the numbers. Factors to look for in this respect include companies that engage in the following behaviors:

- Making frequent changes in key personnel;
- Changing accounting principles, estimates, or presentations;
- Becoming unusually acquisitive; and
- Requiring frequent equity or debt infusions.

This article qualifies for 0.5 CE credits.
Question and Answer Session

Howard M. Schilit

**Question:** As accounting standards become increasingly complicated, does the auditing process itself provoke fraud?

**Schilit:** Auditors can be blamed for a lot of things, but saying that auditing itself provokes fraud is quite a stretch. Perhaps the growing complexity of accounting makes it easier for tempted people to do bad things.

As an accounting professor, I have always been disappointed that accountants and auditors tend not to have the intellectual curiosity to ask the penetrating questions that bring manipulations to light. Without going into a sermon, I think auditors should be more helpful to the businesses they audit. For example, Ernst & Young should have noted in its audits that the loans Lehman Brothers was taking out were not sales of assets, but Ernst & Young said nothing.

Auditors could certainly be more helpful, but investors would be well advised to take matters into their own hands and conduct more of their own research. Each company that I have discussed here and written about in my book has at one time or another received a clean opinion from one of the big accounting firms. It seems that although the bad people have gotten better at their shenanigans, the good people have not gotten better at their craft, and that is a shame.

**Question:** Is the SEC making it easier to identify these shenanigans?

**Schilit:** I read recently that the one lesson we have learned from history is that we have learned nothing from history. Yet my mantra remains that in order to find fraud, we must study the history of fraud. A common element in all the frauds I have described is that their warning signs were not hard to find; in fact, they were hard to miss. When Enron’s sales jumped in four years from less than $10 billion to $100 billion, thus making it one of the six or seven biggest companies in the United States, everyone should have been suspicious. Typically, it takes a quarter of a century to achieve that kind of growth.

Every investor has access to a wonderful historical database contained in the SEC’s accounting and auditing enforcement releases. Documents going back to the late 1930s are available on the SEC’s website. Each of us can become better analysts and better investors simply by studying the peculiar trends contained in those documents. People sometimes ask me if I have plans to write another book, but each time I prepare a new edition of *Financial Shenanigans,* I feel like I am writing a new book. The players are new, and the creativity of management is simply astounding. Yet certain themes remain consistent, and the manipulations remain within the same parameters.