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FRAUD

Managed Earnings Attract Increased Scrutiny

Historically Accepted, But Is It Fraud?

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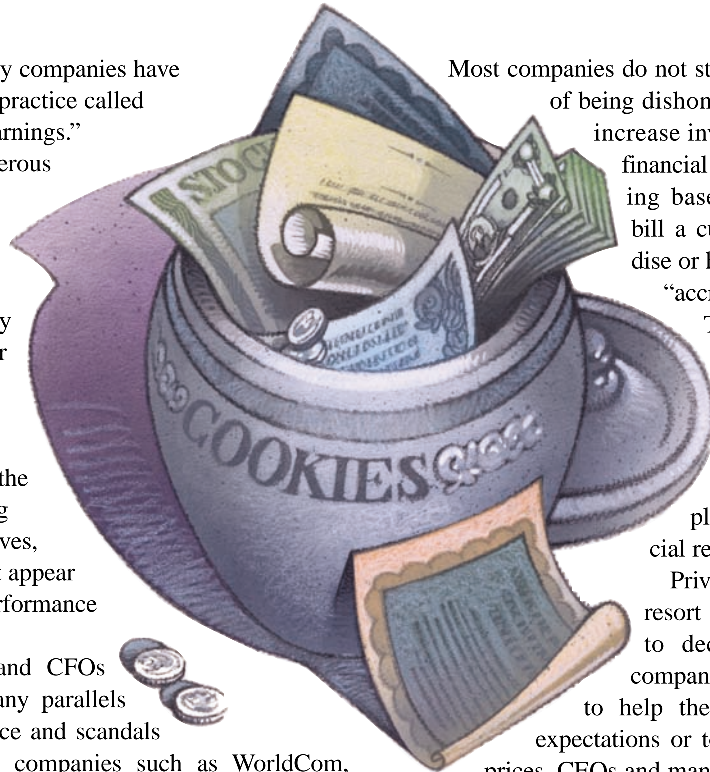
While giants such as Enron and WorldCom have dominated headlines in the past, tomorrow's news is likely to focus on the proliferation of fraud committed in the guise of earnings management by middle-market companies.

For years, many companies have engaged in a practice called "managing earnings." During prosperous times, when results are better than expected, they view their balance sheets conservatively and over-reserve for problems, thereby reducing reported earnings. In lean years, they reverse the process by releasing some of these reserves, creating results that appear better than their performance actually warrants.



Many CEOs and CFOs vehemently deny any parallels between this practice and scandals in recent years at companies such as WorldCom, Enron, and Global Crossings. W.R. Grace & Co., for example, bristled when the U.S. Securities and Exchange Commission (SEC) took exception to the company dipping into its $60 million in cookie jar reserves to bolster earnings when income was down, according to an article in the February 2, 1999, issue of *Fortune* magazine. "If you think what my client did constitutes fraud, then every company in the Fortune 500 is engaged in fraud," argued an attorney for the former CFO of the company.

Although historically an accepted practice, earnings management misleads lenders and investors and is often the first step a company takes on a slippery slope that leads to fraud. Rationalizing increasingly serious misstatements, management may eventually go well beyond acceptable practices. While giants such as Enron and WorldCom have dominated headlines in the past, tomorrow's news is likely to focus on the proliferation of fraud committed in the guise of earnings management by middle-market companies.

Most companies do not start out with the intent of being dishonest. A company may increase inventory on a monthly financial statement or borrowing base report. It may pre-bill a customer for merchandise or hold some expenses to "accrue" the next month. These activities can segue quickly into a pattern of misstating assets and earnings, leaving a company with completely erroneous financial records.

Private companies usually resort to managing earnings to decrease taxes; public companies rely on the practice to help them meet Wall Street expectations or to increase their stock prices. CEOs and managers want to give the impression that business is smooth and on-course. Delivering bad news can not only hurt a company, but also an individual's career. The dollars involved in options, bonuses, and other compensation put intense pressure on today's managers to demonstrate only positive results. Those who have limited accounting knowledge sometimes assume that a little ambiguity on their books is acceptable.

Many CEOs believe that managing earnings is not only their prerogative, but also their right. A former communications director for a Fortune 500 company quoted in the *Fortune* magazine article remembered his CEO's irate reaction to a financial manager and attorneys who contended that the quarterly earnings results he proposed to announce weren't accurate. "Stop fooling around with my numbers!" the CEO responded. "The No. 1 job of management is to smooth out earnings."

The same article told how another Fortune 500 CEO warned his CFO, who had argued against holding

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back earnings that had exceeded Wall Street expectations, that he was in "career limiting" territory. A Wall Street analyst, speaking at an investor-relations conference, was quoted as boldly urging companies to consider "hiding earnings" for future use. "If you don't play the game," he said, "you're going to get hurt."

Clients typically like to whisper into ears of bankers or investors that they have been conservative in their reserve computations. When their reserves are reduced or depleted, however, those same clients neglect to mention that to those who suddenly find themselves relying on fictitious financial statements to invest or to extend credit. Wall Street and lenders have accepted managed earnings during good times, but how will they know when a company's profitability turns red?

If Wall Street supports managing earnings, no wonder CEOs think it is acceptable. This perception must change.

Red Flags

The SEC reported its findings from a study of 200 instances of fraud committed between 1987 and 1997 in an Accounting and Auditing Enforcement Release (AAER). The study revealed that:

- Most frauds involved companies with less than $20 million in assets and annual revenues (median) that were under financial strain.
- Top management was usually involved in the fraudulent activity. Of the cases reviewed, 72 percent involved a company's CEO, 43 percent involved its CFO, and 83 percent involved either the CEO or CFO.
- Boards were weak. Sixty percent of directors were insiders or "gray" directors, and 39 percent had no previous experience as board members. Founder CEOs headed the companies in 45 percent of the cases.
- The frauds were relatively large and covered several years. The median misstatement was $4.1 million, and the average period of the fraud was 24 months.

The study identified several red flags that investors and bankers should look for before putting money into a company. It is important to analyze a CEO's business ethics and to insist that a strong outside board of directors be in place. In addition, it is essential that some members of an independent board have financial knowledge so they can properly analyze the company's financial statements.

The AAER identified inventory and revenue recognition as two of the largest areas for accounting fraud **(Figure 1)**. The path to improper revenue recognition may start out innocuously enough. A company may cut deals with customers at the end of the month to ship large amounts of merchandise to meet revenue projections. Although legally this is not a problem, it can hurt a company's profit margins in future periods and therefore provide incentive to misstate numbers.

Customers who learn the company's tendencies may begin waiting until the end of the month before placing their orders to ensure that they get the best deals. This puts additional pressure on the company to compensate for lost margins and sales in future periods. Before long, deals are made at the end of the month, and the books remain open — first for a few days, then weeks, and so on, all in an effort to meet the numbers.

Sometimes, a company may bill a customer but hold the goods in the warehouse. If the company does not take title to the products, the transaction is not defined as a sale under generally accepted accounting principles (GAAP). However, if the company includes those goods in inventory and records the receivable as an asset, phantom assets are created.

Consignment sales do not qualify as sales under GAAP. Software contract recognition is a problematic area because management often uses side letters and other gimmicks to record sales.

Another common area in which companies hide expenses is in their prepaid/deferred assets. The reasoning senior management uses to defer costs sometimes defies logic. Management rationalizes that costs will benefit a future period to justify showing them as assets rather than as a current-period cost. WorldCom appears to be the largest example of this type of abuse.

A company that is committed to closing a plant or exiting a business in the near future may also use the occasion to manipulate its numbers. Such a company is required under GAAP to reserve for the cost of restructuring at the time that the decision is made, not when the funds are expended. Often, management becomes "creative" by reserving legal, accounting, and other costs that are not directly related to the restructuring. This results in an overstated restructuring charge, which investors and lenders view differently than operating losses.

Restructuring costs are reflected after operating profit in the operating statement. Those cookie jar reserves reduce future operating costs and overstate future profits. As a result, an investor or lender does not know the true earnings for the period. Management tells investors, board members, and lenders that it has been a great quarter, and costs have been cut. Investors, board members, and bankers leave such a meeting thinking that everything is going well, when, in reality, costs have not been reduced at all.

Although the problem can be identified by a review of a company's cash-flow statement, outsiders are not likely to spend the time studying cash

Figure 1: Areas of Fraud Identified in AAER Study

Types of Fraud Identified	% of Companies Studied
Revenue Recognition	**50%**
Fictitious Revenue	26%
Premature Recording	24%
Overstatement of Assets	**50%**
Existing Assets • Inventory (24%) • Accounts Receivable (21%) • Property, Plant & Equipment (15%) • Loans or Notes Receivable (11%) • Patents (7%)	37%
Fictitious Assets or Assets Not Owned	12%
Capitalized Assets Not Owned	50%
Understatement of Expenses/Liabilities	**18%**

flows and asking for documentation for the reduction in reserves. They will not know if the company overstated the reserves or whether the auditor has passed on any recommended adjustments because of immateriality.

GAAP requires that companies state assets at cost or fair market value, whichever is lower. In good times, it is not unusual for a company to take a more liberal view of accounts receivable reserves and inventory valuations, a practice once referred to as "tax planning through inventory." By lowering ending inventories, which decreases gross and net profits, a company, in turn, lowers the amount of tax it owes.

In bad years, the company takes a more conservative view of those reserves and reduces them or leaves them as they are. This creates additional write-offs and allows the company to overstate profits. Someone reading the company's financial statements would have to ask some pointed questions to determine what really has occurred including:

- Have gross profits fluctuated from year to year? Was gross profit up in the most recent year? If so, what did the company do differently to increase its margins?
- How did the company compute its reserve for bad debts? Did it apply a percentage to the entire pool of receivables? Did it use the exact method of identifying potentially uncollectible accounts or partially uncollectible accounts?
- What is the change in the dollar amount of reserves? What is the percentage of reserves to total receivables from year to year?
- How healthy is the economic sector into which the company sells? What are the collection trends within that sector?

Ethics, Strong Controls

Under former Chairman Arthur Levitt, the SEC declared war on the practice of managing earnings. Levitt spoke out against improper revenue recognition, unjustified restructuring charges, cookie jar reserves, and abusive use of materiality.

The SEC has set its sights on the problem of managed earnings by taking on companies that historically have used the practice and investigating others that more recently have followed suit. The Sarbanes-Oxley Act outlines a number of reforms for SEC-reporting companies and provides for potential incarceration for offending officers.

Only time will tell to what extent the new law will impact closely held companies that are not regulated by SEC rules. It is possible that in the future, a CEO will go to jail for managing earnings.

Ethics are at the heart of what troubles American companies. Entrepreneurship and open capitalism drive one of the world's greatest economies, but abuses of the free-enterprise system, perpetuated by a lack of ethics at the top of many institutions, cost millions of people billions of dollars.

Unethical managers will go to any lengths to deliver good news, limited solely by their imagination and a propensity to misrepresent the facts. Fearing for their jobs, few people are able to prevent the boss from cooking the books. With 82 percent of the frauds involving the CEO and CFO, the integrity of top management should be the number one priority to investors and lenders in minimizing their exposure.

To minimize opportunities for fraud, companies must be professionally managed and put strong controls and systems in place. A demonstration of strong business ethics by those at the top is critical. To assist client companies in preventing fraud, turnaround professionals might want to suggest the following strategies:

- Appoint strong outside board members
- Have boards/executive committees review the CEO
- Institute a strong control environment
- Hire a strong CFO
- Ensure that the CEO can deflect and handle the pressure to produce earnings and manage cash

A report issued in February 1999 by the Blue Ribbon Committee appointed by the New York Stock Exchange and the National Association of Securities Dealers (NASD) recommended changes to audit committees intended to improve the validity of financial information and to minimize instances of cooking the books. Middle-market companies should consider adopting the recommendations which grew out of the committee's work:

- At least three members of the audit committee must be independent. As such, these members must not have been an employee of the company in the last three years or a partner, consultant, or officer in a company transacting significant business with the company (exceptions require unanimous board approval); have been employed as an executive of another entity on whose compensation committee any of the company's executives serve; or be an immediate family member of an individual who was an executive officer of the company within the past three years.
- The audit committee must be comprised solely of independent directors, with few exceptions.
- At least three directors must be "financially literate," and at least one should possess an expertise in the field.
- A written audit committee charter should be assessed annually. Auditors report to the board and to the committee, which is responsible for ensuring that auditors are independent.
- The audit committee must receive information on the quality of financial systems and accounting principles. There should be three-way communication among management, the audit committee, and the auditors

Audit committees structured in this way reduce the ability of management to negotiate large cookie jar reserves, as well as matters

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such as hidden material accounting and controls, without holding independent people accountable. This should help rectify some common reporting issues. While this will not stop fraud entirely, it will expose information found by the auditors earlier in the process.

As a result of recent scandals and newly enacted legislation aimed at reducing wrongdoing, boards and audit committees will undoubtedly face extreme pressure to ensure the accuracy of financial information, which may increase the challenge of recruiting capable directors and board members.

Conclusions

Good ethics have always been — and will always be — the essence of a solid business. However, because it is unwise to assume that every CEO or manager practices good business ethics, accounting controls and strong outside boards are essential. Lessons learned from WorldCom, Enron, and Global Crossing may change the corporate climate in the short term.

Congress is passing laws designed to have long-term impact on how publicly held companies operate. Despite changes in the legal environment, human nature remains constant. The next big fraud case is likely to be just around the corner. Public pressure may slow the onslaught of fraud for now, but ultimately, pushing the boundaries of acceptable behavior is an inherent part of a capitalistic system.

The best way for turnaround professionals to root out fraud is to get to know their clients and to examine companies' ethics and business practices. Many companies that were previously on an economic roll have reported flat earnings lately. Perhaps it's time to ask if those earnings are actually flat, or if there is a much larger problem. CR

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Identifying Fraud

Fraudulent Concealment/Other	Tip-offs
Non-Recording of Assets: • Off-balance-sheet sales: cash is sent to a separate checking account • Assets purchased, expensed, and diverted for private use	• Decreased sales • Lower gross profit margins • Merchandise appearing at flea markets
Inventory Concealment: • Goods shipped to offsite location • Goods shipped directly to non-company warehouse	• Large write-offs during the year or at year-end • Salespeople selling same goods for another company • Decrease in gross profit • Decrease in sales • Merchandise appearing in small off-priced retailers or at flea markets
Payments to Fictitious Vendors or Ghost Employees	• Decreased margins • Increased payroll costs • No receiving reports attached to vendor invoices
Consignment Sales: • Merchandise shipped to a customer on a contingency basis – Company tells the customer that they don't have to pay right away but can return the product if dissatisfied	• Large amount of debit memos • Goods are sold with long dating • Aging of Accounts Receivable deteriorate
Bill and Hold • Customers billed and goods held on loading dock or in the warehouse • Sales are increased but cost of sales remains the same	• Year-end increase in gross profit percentage • Year-end adjustment to perpetual records • Increased G & A expenses combined with increased gross profit

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