

# PROFITS YOU CAN TRUST—AND THE PROFITS YOU CAN'T

**I**t was as if the world had turned upside down. For a dizzying stretch in 2001 and 2002, nearly every day brought fresh, front-page news of multibillion-dollar financial deceptions, spectacular bankruptcies, and executives in handcuffs. Public disgust grew with every sordid revelation. Yet just a few months earlier, business people had been celebrities, objects of public fascination, adulation, and envy. The CEO of Amazon.com, Jeffrey Bezos, was *Time* magazine's 1999 man of the year. Bill Gates, Jack Welch, and Warren Buffett were leading celebrities—when they entered a room, necks craned and flashbulbs popped, as if the men were rock stars and not the chairmen, respectively, of Microsoft, General Electric, and Berkshire Hathaway. Men such as Enron's Jeffrey Skilling, WorldCom's Bernard Ebbers, and John Chambers of Cisco morphed from obscure corporate executives to celebrated pillars of something called “the New Economy,” a technological revolution that was going to generate more wealth than the world had ever known—and transform society in the bargain.

These and other executives were the heroes of a bull market in stocks of unprecedented strength and duration. In March 2000, the Nasdaq stock market index closed at 5132, climaxing a 15-year run during which it gained 2000 percent. From January 1999 to March 2000, the combined market value of just two corporations, General Electric and Microsoft, climbed by more than \$240 billion. A staggering \$309 billion flowed into U.S. equity mutual funds in 2000, up sharply from 1999, when the new-money flow reached \$188 billion, and an even sharper contrast with 1990, when U.S. equity funds booked only \$13 billion in new money. The market's seemingly insatiable appetite for new shares encouraged a record 554 companies to launch initial public offerings in 1999, raising more than \$550 billion, more than 19 times the IPO funds raised in 1998.

American and foreign investors alike demonstrated their faith in U.S. corporations and American-style capitalism in the sincerest fashion possible: with their dollars. Business-school professors and market pundits alike assured them their money was safe in the United States—no other markets were so transparent, no other financial reporting system more rigorous or sophisticated, no market watchdogs quicker to sniff out deception and hype. Investors could trust the reports of strong sales and profit growth emanating from seemingly every company in those exuberant days. If there had been a problem with the numbers, someone would have caught it already.

According to this triumphalist ideology, the stock market was a perfected democracy, a radically egalitarian realm where barriers of wealth, education, race, and gender were erased by information that was reliable and equally accessible to all. A group of elderly ladies from Beardstown, Missouri, enjoyed a brief spell of renown as purveyors of down-home investment wisdom, while television advertisements for one online brokerage firm featured “Stuart,” a multiply pierced, tattooed, pink-haired young man whose preferred form of self-expression wasn't rock music or performance art but stock trading. As much as their styles diverged, Stuart and the Beardstown ladies both embodied the late-1990s populist faith that amateur investors, armed with nothing more than common sense and a personal computer, could hold their own against highly paid professional stock pickers. In this best of all possible markets, everyone stood an equal chance to prosper.

That faith was shattered by a stock-market collapse that began in March 2000. There are many ways to measure the damage, starting with

the estimated \$16 trillion in market value vaporized in the slide. But how should we measure the loss of belief, the obliteration of confidence in the market's basic fairness? If the corporate scandals have taught us anything, it is that the U.S. stock market of the late 1990s was anything but a level playing field. The leaders of Computer Associates used dubious accounting to pump up the price of their company's stock long enough to earn themselves a \$1 billion bonus; then they changed their accounting method and forecast a sharp drop in sales. Top executives at Enron frantically dumped their shares even as they urged the public and their own employees to buy the company's stock. Securities analysts at Merrill Lynch, probably America's most respected investment firm, routinely derided in private the stocks that they tirelessly hyped to the public. Accounting firms signed off on financial statements they knew to be riddled with errors and unrealistic assumptions, and law firms devised and abetted transactions that existed for no other reason than to lend a false glow of profitability to sickly enterprises. Investment bankers offered hard-to-get shares in lucrative initial public offerings (IPOs) to the senior executives of companies whose business they were soliciting. The New Economy's promise of small-investor paradise turned out to be as phony as the financial results posted by some of its leading companies.

The revelations of corporate dishonesty and executive excess have prompted an angry public backlash against business. Approval ratings of corporate executives briefly fell to levels normally visited only by journalists, members of Congress, and child molesters. Even Jack Welch, the former General Electric chairman who long enjoyed almost universal acclaim for his business prowess, came under fire for the lavish retirement package he extracted from GE and then renounced when the benefits were revealed in a court filing in his divorce case. Antibusiness sentiment reached such a pitch during the summer of 2002 that President George W. Bush, a Harvard MBA whose administration prides itself on its quasi-corporate operating style, found it politic to rail against corporate crooks. But as they searched for someone to blame, more than a few investors found themselves looking in the mirror and asking some hard questions. Could they have seen the train wreck coming? Were there red flags hidden in the corporate accounts, warning signs lurking among the figures and footnotes?

There were, in most cases. Not every piece of shady accounting was detectable to outsiders: WorldCom's shift of operating expenses into capital accounts was all but invisible to anyone who wasn't a party

to the fraud. But various financial filings by Enron revealed—in opaque, convoluted prose—the existence of the “off-balance-sheet” partnerships that were to prove its undoing. The company’s earnings report (known as the 10-Q, after the Securities and Exchange Commission form it’s filed on) for the summer quarter of 1999 noted that Enron was doing business with a private partnership led by “a senior officer of Enron.” A later filing identified that senior executive as chief financial officer Andrew S. Fastow, now under indictment for fraud. When a sharp-eyed reporter for the *Wall Street Journal* started making inquiries about the partnership, the company’s financial fictions began to unravel, and its collapse followed with shocking speed.

Warning signs could also be found in the books of Kendall Square Research (KSR), a high-end computer maker whose deceptive accounting, revealed in 1993, presaged the chicanery employed by technology companies later in the decade. (In the chapter on revenue recognition we’ll take a closer look at Kendall Square, its accounting, and the damage it did.) In its 1992 financial filing, Kendall Square reported annual sales of \$21 million. At the same time it disclosed cash collected from customers of only \$8.5 million. Ordinarily, sales and cash track closely together. When these two numbers diverge, it may be a sign that a company is booking sales too aggressively—that is, reporting sales that will ultimately realize less cash than initially claimed as revenue. Such was the case with KSR, which was reporting far more in sales than it could ever hope to recover from its customers. In June 1993, following an investigation prompted by a reporter’s inquiries, KSR issued a revised report of its sales and earnings. The correction—known in accounting parlance as a restatement—showed sales of only \$10.1 million and a loss that had expanded to \$21.6 million from the \$12.7 million originally reported for 1992. Following the restatement, KSR stock nose-dived, losing almost two-thirds of its value in a single day of trading. The company never recovered from the blow.

The warning signs were there. Investors missed them because of their avid and uncritical focus on corporate revenue and earnings as the sole determinants of market value. Knowing how lavishly investors rewarded companies that delivered steady revenue and earnings growth (and knowing how lavishly those companies rewarded their senior executives), corporate managers became adept at exploiting the vulnerabilities, ambiguities, and gray areas of the accounting system to produce earnings on demand. Priceline, an online shopping service that enjoyed

a brief vogue during the Internet boom, promised consumers that they could “name their own price.” Far more common in the 1990s were companies that named their own profits. Many continue to do so, even in today’s more cautious and skeptical environment.

We hasten to note here that none of the accounting games we discuss in this book are confined to the United States. Just ask the French: The collapse of Credit Lyonnais laid bare a financial fraud that dwarfed even Enron, with staggering costs ultimately borne by French taxpayers. Accounting systems come in many different flavors, and they all offer wide scope for mischief. From Australia to Asia, from Moscow to Brussels, companies have collapsed and fortunes have been lost because of shoddy governance, executive greed, slipshod auditing, and overly aggressive accounting. Many of these collapses, and the frauds that preceded them, make the Enron and WorldCom debacles look like Sunday picnics. Because accounting trickery knows no borders, and because business is increasingly global, this book will include a generous helping of examples of deceptive or fraudulent reporting from both the United States and the rest of the world.

We note as well that most instances of inappropriate, overaggressive, or otherwise misleading financial reporting fall somewhere short of outright fraud. In fact, most financial frauds lie outside the scope of this book, which is concerned with accounting games that can be spotted with a trained eye. Fraud is by definition designed to escape detection, as the phony journal entries at WorldCom misled corporate insiders as well as outside investors, analysts, and regulators. This book can help you spot aggressive, self-serving, or misleading accounting judgments; outright fiction is far more difficult to detect.

This book is primarily concerned with the abuse of the discretion that managers are afforded under most national and international accounting systems. What makes Enron a mega-scandal is not that the company’s managers, trained at places such as the Harvard Business School and McKinsey and Co., used their skills to distort the company’s financial condition beyond all recognition. Company managements do that all the time. What makes Enron so sobering is that the company’s funhouse-mirror accounting had the blessing of a prestigious accounting firm and a sophisticated audit committee. The financial scandals that emerged from the bursting of the New Economy bubble served to remind the public that the so-called fiduciaries who were supposed to protect their interests—corporate directors, legal and accounting

professionals, securities analysts and investment bankers — were instead management’s enablers, accomplices, and collaborators. The real lesson of the scandals is that investors are on their own. If they’re going to risk their funds in the stock market, they’re going to need to defend themselves. This book is intended as a general guide through the accounting minefield for corporate executives, securities analysts, auditors, journalists, investors, and anyone else with an interest in corporate financial reporting. But for investors, especially, this book may have some additional value as a self-defense manual.

## **Blast Radius: The Damage Accounting Landmines Do**

The strategies and maneuvers that Enron, KSR, and others used to name their own profits are examples of what we call *accounting landmines*—destructive devices buried in the books of corporations large and small, well known and obscure. Like actual landmines, they may never detonate—auditors, investors, and regulators may never discover the deception, and catastrophe may be averted, or at least postponed. But when an accounting landmine does blow up—when the markets learn an auditor has uncovered a phony entry, or when a company can no longer hide ballooning debt or “borrow” sales from future quarters—the explosion can blight businesses, portfolios, and human lives.

There might be little to lament if the wreckage included only false-front enterprises like Enron. The fewer such outfits contaminating the business environment, the better. But accounting landmines have also taken down businesses such as Kendall Square Research, whose computers were genuinely innovative and valuable. KSR could have been a contender in the technology sector if its management had kept honest books. Instead, KSR management played fast and loose with the definition of sales, a strategy that was expedient in the short term but ultimately lethal to the company.

Like most of the other companies whose deceptive financial reporting we will examine in this book, Kendall Square took advantage of the flexibility that is both the genius of U.S.-style accounting and its greatest vulnerability. Accounting as practiced in the United States and most of the developed world not only allows, it *requires* management to make judgments about the future—about the likelihood that a customer will be able to pay its bills, about the return a pension fund will earn in

the coming year, about the revenue a fiber-optic network will generate in twenty years' time. It is no exaggeration to say that there is room for mischief in accounting because *we cannot wait to see what the future will reveal*. Accounting allows us to make an educated guess—a prudent, conservative, honest guess—about the future. But it also allows us to make self-serving, unfounded, dishonest guesses, as Enron and KSR did. Books like this one may be useful, even necessary, in the battle for honest accounting, but they can never be sufficient. Ultimately, honest accounting requires corporate managers committed to giving investors an accurate portrayal of the health of their enterprise.

Honest financial reporting also requires vigilant corporate directors, lawyers, investors, analysts, and, yes, auditors, who are willing to look closely and skeptically into corporate financial reporting. Unfortunately, under the present system all those parties have powerful incentives to ignore or even abet deceptive financial reporting. Managers and employees want to retain their jobs and enhance the value of the options or share grants. Outside lawyers, accountants, and consultants want to preserve and enhance lucrative relationships with a fast-growing enterprise. Money managers and securities analysts want to see a share-price increase to keep their jobs and confirm the wisdom of their investment decisions. Venture capitalists want to make a killing, and lenders want to keep their creditor in business, if only because it's easier to be repaid by a going concern than by a bankrupt enterprise.

The bulk of this book will be devoted to the many ways the accounting system can be gamed to fabricate an inaccurate, misleading, or even fraudulent depiction of a corporation's financial and operational well-being. Accounting can be deployed as a kind of funhouse mirror, exaggerating some features of the business—its sales or earnings, for example—and obscuring others, such as costs, perhaps, or the extent of its indebtedness. There are many reasons why corporate managers would permit or encourage such distortions. Certainly job security plays a part: Managers who fail to “make their number”—that is, meet their sales and earnings targets—often find themselves out of work, or at least out of favor with their bosses, investors, and the business press. On the other hand, they stand to collect sizable rewards if they do make their number. But the motivation to cheat is not always selfish—or at least, not always personal. Managers distort their numbers to maintain their company's access to the capital markets, to meet lending requirements, and to gain an edge in recruiting.

But whatever the motivation, the end result is to send inaccurate, misleading signals to investors and the public at large. The distorted numbers produce distortions in the allocation of capital, steering money away from productive enterprises toward operations that go begging, once their true condition is known. Accounting games do further harm to the process of capital formation by driving investors, especially individuals, away from the stock market. Disgusted by the corporate community's failure to tell an honest story in exchange for investors' dollars, many individuals have abandoned the stock market altogether in favor of bonds, real estate, commodities, and other competing investments. Investor cynicism drives up the cost of capital for all businesses and shuts some of them out of the market entirely. What's more, the revelations of widespread corporate game playing make it difficult for companies to recruit the talented and trustworthy people that business needs to right itself. Investors and business people love to rail against interfering legislators and bureaucrats, but dishonest financial reporting may have done more to impede innovation and wealth creation than any law or regulation.

## **The Oldest Tricks in the Book**

Sometimes it seems that accounting games came into existence around the same time as the Internet. Many of the most spectacular corporate flameouts of recent years were so-called New Economy companies: Enron, the "asset-lite" energy company that said it was creating a market for bandwidth; WorldCom, the acquisitive giant that would satisfy the supposedly endless demand for telecommunications services; Lernout & Hauspie, the Belgian developer of voice-recognition software that was to all appearances growing at breathtaking speed. At the same time that all three companies were reporting their most impressive financial results, they were collapsing from within, their management scrambling to sustain the illusion of a healthy business for another quarter. An emblematic instance of this scramble occurred in 2000, when the chief financial officer of Lernout & Hauspie traveled to the offices of the company's South Korean affiliate. His mission: to collect \$100 million, which the Korean subsidiary reported as cash on hand. The parent company was facing a liquidity crunch, and the money, had it been real, would have eased the crisis. But as Lernout & Hauspie's

CFO learned, the \$100 million was nothing but an illusion created by a massive accounting fraud. At that moment, Lernout & Hauspie's demise was inevitable.

The Belgian software maker fell victim to the same kind of deceptive accounting that had, over the decades, destroyed hundreds of companies. New variations on the old games sprang up in the 1990s—indeed, innovations in financial trickery sometimes seem to be the most lasting legacy of the New Economy. But even new-style accounting dodges such as EBITDA and pro forma earnings aren't really all that new. EBITDA purports to separate a company's cash earnings from its paper profits, but there is little evidence that it does and much evidence that it is highly susceptible to manipulation. So-called pro forma earnings amount to little more than an attempt to avoid the profit-reducing impact of expenses. (When he was chief accountant of the Securities and Exchange Commission in the late 1990s, Lynn Turner mocked pro forma profits as “earnings with all the bad stuff taken out.”) As we shall see in a later chapter, both EBITDA and pro forma earnings had honorable origins as attempts to render a truer picture of corporate financial performance than could be obtained using conventional accounting. But in the 1990s, those alternative performance measures came to serve virtually no purpose but to whip up illusory profits.

Most of the other loopholes and ambiguities that the New Economy companies exploited were the same ones that rogue companies had exploited for decades. In the 1980s, Cascade International and ZZZZ Best defrauded investors of millions of dollars on the strength of wildly overstated revenue. Derivatives were the villains in several financial scandals in the 1990s, including the near-collapse of Metallgesellschaft AG, the venerable German metals firm. The value of assets such as inventory, plant and equipment, and receivables has always been subject to judgment. In the 1980s, the managers of savings and loans routinely overvalued their assets in order to stay in business and continue gambling with taxpayer money long after they were, in actuality, insolvent. The same sort of accounting kept many Japanese banks open in the 1990s, even though their assets were for all intents and purposes worthless. In short, as long as there have been accounting systems, there have been accounting games. What was different about the Internet bubble was the size of the incentives to play, which considerably broadened the set of companies in the game.

Although the New Economy companies didn't invent accounting trickery, they had many of the characteristics of companies that are more likely than others to succumb to the temptation to manipulate. Among those especially prone to push the accounting envelope are:

- ***High-growth firms whose growth is slowing.*** Rapid growth can be a company's worst enemy. Investors who pile into the company's stock when sales and profits are expanding every quarter are usually also the first to bail out as soon as results start to flag. Fearing a stock collapse, corporate managers may resort to deceptive accounting to mask a decline in their business.
- ***High-profile glamor companies with extensive coverage in the business and popular press.*** At bellwether companies like General Electric and Cisco Systems, even small problems attract widespread press coverage. Facing intense pressure not to deliver disappointing results, managers may view earnings manipulation as the lesser of two evils.
- ***New businesses that engage in unorthodox transactions.*** Businesses in emerging industries sometimes have unconventional ways of doing business, such as the advertising barter arrangements common between Internet companies. Traditional accounting standards, geared to more conventional exchanges of goods and services, may offer little guidance as to how to treat those transactions. Corporate insiders and outsiders alike must scrutinize the accounting issues raised by new businesses and new transactions. For example, should a computer-equipment supplier whose customers are mostly startups expect and prepare for more bad debts than a supplier that sells mostly to established businesses?

This problem will only increase as the Internet further blurs the line between manufacturers and middlemen. How, for example, should Dell Computer account for the sale of a computer monitor purchased via the Dell Web

site but manufactured at and shipped from the plant of one of Dell's suppliers? Should Dell report as revenue the customer's full purchase price, or just its cut? Which party is responsible in case of a warranty claim? Does Dell need a new accounting treatment for this sort of deal? If it has adopted a new accounting treatment, is it suitable to the transaction in question?

- ***Companies in weak legal and regulatory environments.*** In emerging markets and industries, where the central government and legal institutions are weak and corrupt, managers can often skirt rules and regulations with little fear of punishment. But the high-level looting at Tyco, Enron, and other companies shows that U.S. managers can be just as contemptuous of the law as the most cynical Third-World oligarch. Indeed, weak control systems may be harder to detect at U.S. companies, where efficiency and honesty at lower levels may obscure high-level corruption and greed. The core problem at Tyco, for example, wasn't with the financial controls employed by the conglomerate's many individual businesses. The control environment broke down in the senior executive ranks and at the board level, where managers and directors abandoned the disciplines practiced on the operating level.
- ***Companies that are followed by a small number of analysts.*** Out of sight, out of mind: If a company's performance and financial statements receive little scrutiny from reporters, analysts, and sophisticated investors, managers may decide there is little risk to cheating.
- ***Companies with complex ownership and financial structures*** that make key transactions less transparent and give rise to related-party transactions and conflicts of interest. Complexity is a dishonest manager's best friend. Enron didn't completely hide the existence of the partnerships that triggered its collapse. Instead, it obscured them in a barrage of information.

- ***Companies whose survival requires them to attract the next round of financing.*** If a company needs to meet certain revenue or earnings targets in order to avoid technical default on its debt, the temptation to cheat “just this once” may be irresistible.
- ***Companies that strongly link executive compensation to short-term business goals.*** Short-term goals such as sales, net income, or stock price generate intense pressure to make one or more key measures appear to be stellar, even when they may in truth be anything but.

The presence of these characteristics does not necessarily mean that a given company engages in questionable accounting practices. But the burden is on the management, directors, and outside auditors of these companies to subject their financial reporting practices to extra scrutiny.

Such scrutiny may not be forthcoming, however. Investors can no longer take for granted the honesty of those responsible for the quality and accuracy of a company’s financial reports, not when some of the business world’s most respected names—Merrill Lynch, Merck, Xerox—have been caught being less than completely forthcoming with the public. Reputation is no guarantee of integrity, as investors have learned to their cost. Enron’s most dubious feats of bookkeeping legerdemain bore the seal of approval of Arthur Andersen, the accounting firm that was once the industry’s gold standard for ethical dealing. No CEO, no board, no auditor is above suspicion, and no company’s books can be considered off-limits to skeptical, aggressive inquiry.

## Who Needs This Guide?

This book cannot produce the honest managers who will restore the public’s confidence in corporate financial reporting. But it offers a defense against the less-than-honest ones. It is written for almost anyone involved in business—anyone who manages a company, serves on its board, audits it, analyzes it, reports on it, invests in it, or works for it. All have a stake in the integrity of the financial record keeping of the firm they’re associated with. When two of us, H. David Sherman and S. David Young, broached the subject of accounting minefields in an article proposal to the *Harvard Business Review* in late 2000, we addressed

ourselves strictly to corporate directors. The major stock exchanges had recently instituted a requirement that a minimum number of directors be “financially literate,” able to understand a balance sheet, a statement of cash flows, and an income statement. (Regulators have never offered a satisfactory definition of financial literacy, which is one reason why U.S. accountants and regulators are now engaged in creating a different definition for board use: that of “financial expert.”) The exchanges further decreed that those directors must be able to judge whether a proposed accounting treatment is appropriate for the transaction in question. Our idea was to develop a guide to the accounting landmines a financially literate board member ought to be able to recognize.

We broadened our ambitions after discussing our proposal with Harris Collingwood, then a senior editor at *HBR*. We agreed that we should not limit our audience to corporate directors. The finished article (H. David Sherman and S. David Young, “Tread Lightly Through These Accounting Minefields,” *Harvard Business Review*, July–August 2001) was addressed to a much wider readership. Of course, we hoped the article would be read by corporate insiders—the “iron triangle” of managers, directors, and auditors responsible for preparing, reviewing, and disclosing a corporation’s financial data. Without the ability to detect accounting landmines, insiders lack the skills required to fulfill their fiduciary duty to shareholders, creditors, pensioners, and employees.

But we also wanted our message to reach beyond the corporate inner circle. Collingwood had written a pair of articles (“The Earnings Game,” *Harvard Business Review*, June 2001; and “The Earnings Cult,” *The New York Times Magazine*, June 8, 2002) making it painfully clear that those on the outside depend even more than insiders on a guide through the accounting minefield. Lacking access to the data, debates, and deliberations that go into corporate financial reports, outsiders such as securities analysts, shareholders, journalists, and lower-level employees might be unable to uncover incontrovertible evidence of deceptive accounting. But they can learn to recognize where deception is most likely to occur and the forms it is likely to take. They can learn the areas of the balance sheet or income statement most subject to managerial discretion—and thus most vulnerable to managerial manipulation. They can learn to question the assumptions that go into certain numbers, and they can respond appropriately if those assumptions seem unfounded, self-serving, or otherwise at odds with reality.

The nature of that response depends on the position the outsider occupies. The securities analyst, suspecting the existence of an accounting minefield, can challenge management and raise questions in research reports—and in the process restore to the profession some of the skepticism and independence missing during the see-no-evil 1990s. Financial journalists can call their readers' attention to questionable accounting and ask corporate managers to explain their choices. In the process they can redeem some of journalism's failures during the 1990s, when too many reporters preferred to cheer executives rather than aggressively question them or their numbers. Shareholders can demonstrate their confidence—or lack of confidence—in management's financial reporting by speaking up at annual meetings, contesting the election of board members who lack financial literacy or fail to exercise it on behalf of shareholders, and selling the stock of companies whose management cannot explain clearly how the company makes its money or what it does with the cash. In so doing, shareholders could go some way toward atoning for their part in inflating the 1990s stock-market bubble. Employees can emulate Enron whistleblower Sherron Watkins and call management's attention to deceptive financial reporting.

As indicated by the date of our original proposal to the *Harvard Business Review*, we were pursuing this subject well before Enron's collapse in the fall of 2001, which ushered in the present era of corporate scandal. The continuing exposure of the rot within the U.S. financial reporting system has convinced us of the value of addressing readers who don't ordinarily pick up the *Harvard Business Review* but want to know more about the accounting chicanery that has produced so many headlines recently. In the present book we explain how accounting trickery works, show how it can be detected or inferred, and suggest how the financial reporting system might be improved. We hasten to point out that this book is not a treatise on corporate governance, a system for picking stocks, or a collection of advice for managers. It is not an introduction to accounting, though it assumes no more than a rudimentary knowledge of the subject. It is, simply, a guide through the accounting minefield for anyone with a stake in corporate financial reporting—and in one way or another, that includes most people of working age.

Regular readers of the business press will probably recognize many of the examples and illustrations we use in this book. As educators, we recognize that examples drawn from everyday life are a powerful teaching tool. And there has been no shortage of pertinent examples

of deceptive accounting in recent years. We draw freely from press accounts, regulatory filings, and court documents, as well as our own experience in education, consulting, and journalism. The facts are a matter of public record; the interpretations and analyses of the facts are, of course, our own.

But can a nonspecialist really expect to understand the arcane complexities of modern-day corporate accounting? After all, understanding the financial statement of a corporation requires a grasp of the accounting principles, rules, and guidelines. It also requires familiarity with complex topics such as derivatives, pensions, taxes, goodwill, merger valuations, stock options, foreign-currency translation, and comprehensive income. Then there's the need to be aware of industry-specific transactions and the conventions for recording them. And as business becomes increasingly global, financial literacy requires awareness of the differing accounting standards that prevail in other countries—and for that matter, in different offices of the same company.

We do not presume to minimize the complexities of accounting, nor do we claim that this book will create expert financial sleuths overnight. We agree that the vagaries of various international accounting regimes significantly complicate any analysis. But our collective experience in academia, journalism, and business has convinced us that, just as in literature there are only five basic plots, there is a basic and quite limited repertoire of accounting games. For all their variety, the games fall into seven broad categories, and they take forms that anyone of ordinary intelligence and common sense can learn to recognize—in their outlines if not in every detail. You don't need an accounting degree, for example, to know that when a company reports \$21 million in sales but only \$8.5 million in cash payments from customers, something is out of whack. The discrepancy is sufficient in itself to prompt demands for an explanation. In fact, we propose a general rule when examining financial reports: If you can't tell how a company makes its money or when it gets paid, or how and when it pays its bills, it's time to start asking questions.

In the chapters that follow we will examine seven financial landmines—seven areas in a financial report where accounting mischief is most likely to occur. In largely nontechnical language we will describe the rules and principles governing each of the seven categories, and how those rules can be evaded, misapplied, stretched, or, in some cases, simply ignored. In each case, we will show how real companies—including

Coca-Cola, Enron, Qwest, WorldCom, and Xerox in the United States, Lernout & Hauspie in Belgium, and Metallgesellschaft in Germany—bent or broke the rules, fudged their numbers, and did grave damage to their companies, shareholders, employees, and ultimately the global financial system itself.

We will do more than offer after-the-fact analysis and explanation. We will also point out how to recognize accounting landmines *before* they explode. Where we see opportunities to improve accounting practices, we will point them out. There is certainly room for improvement. In the United States, alone, from 1990 through 1997, an average of 49 public companies a year filed earnings restatements. In 1999, the number of restatements more than tripled, to 150, climbed to 156 in 2000, and then leaped to 270 in 2001. Preliminary figures for 2002 indicate a staggering 330 restatements. Interestingly, 185 of these occurred after the passage of the Sarbanes-Oxley Act, which substantially increases the criminal penalties for financial reporting fraud.

Much as we would like to believe that dishonest financial reporting is a marginal practice engaged in by only a handful of “bad apples,” the volume of restatements suggests otherwise. On the evidence of the recent accounting scandals and the explosion in restatements, we are forced to conclude that accounting gamesmanship is widespread. The stories in this book will go some way toward explaining why we discount the notion that the scandals were caused by a few overzealous managers—and why there may be many more scandals and restatements to come.

## **New Rules, New Reforms—But Will Anything Change?**

The corporate scandals of 2001 and 2002 spurred Congress, the Securities and Exchange Commission, and the leading stock exchanges to press for reforms in reporting and corporate governance. In particular, outrage over the revelations of widespread, blatant fraud at WorldCom generated the political momentum needed to pass the Sarbanes-Oxley Act of 2002. That law requires, among many other mandates, that the chief executive officer and chief financial officer of every corporation publicly traded in the United States certify the accuracy of their company’s financial statements and the adequacy of its financial controls.

Passage of Sarbanes-Oxley has unleashed frantic activity at the top of nearly every public company in the United States and at the many European and Asian companies whose securities trade in U.S. markets. One corporate director reports that the time he spends in audit committee meetings has tripled since the law's passage. Compensation committees are busy reviewing and revising executive-pay formulas. Financial officers are facing increased pressure, increased workloads, and increased visibility. Boards of directors no longer grant sweetheart loans to executives and fellow board members. Instead, they're issuing new guidelines covering everything from conflicts of interest to protection of whistleblowers. Regulators are issuing new rules that require corporate managers to include a discussion of critical accounting decisions in their annual reports.

Other rules will mandate the treatment of stock options as an expense and already require companies to explain in detail where their nonstandard, "pro forma" profit calculations differ from numbers reached using standard accounting methods. United States accounting regulators are busy trying to close the loopholes that allowed Enron to move debt and losses off its balance sheet and income statement and into "special-purpose vehicles." Auditing firms are now required to rotate the partners leading corporate audits in order to prevent them from getting too cozy with corporate management. And the Securities and Exchange Commission has established a new Public Company Accounting Oversight Board (PCAOB) to review and improve the independent auditor function.

The PCAOB got off to an inauspicious start when the first nominee to head it was himself accused of being a party to deceptive accounting. Then, when the board finally held their first meeting, their first act was to award themselves annual pay of \$452,000, or \$52,000 more than the salary of the President of the United States. But the PCAOB may yet transcend its unsightly origins to become a powerful force for improved governance and accountability. Much depends upon the energy and innovative spirit of the board and its staff, as well as their ability to withstand political pressure. In these respects, they have much in common with corporate boards themselves.

But all this activity and effort, however laudable, will not put an end to misleading financial reporting. Attention to accounting standards may fade as companies return to profitability and growth—even though vigilance should *increase* as profits grow. And a surge in stock prices

will once again tempt companies to fudge their numbers in order to keep up with their high-flying peers. Nearly 100 years of accounting policy making have not eliminated shady accounting practices—and not for lack of trying. When one salad-oil maker was found to have faked the amount of its inventory on hand, accounting rules were revised to require auditors to physically inspect inventory. Companies simply found new ways to deliberately misstate their inventory. When businesses discovered they could understate their indebtedness by leasing equipment instead of borrowing to buy it, the accounting rules were changed to require companies to account for such leases as debt. But instead of preventing companies from hiding their debt, the new rules merely forced companies to find new hiding places. The fact is, it is human nature to create systems, and just as human to devise ways to beat those systems. And no amount of reform will change human nature.

Neither will this book. What it will do, however, is give investors, directors, auditors, analysts, journalists, and employees one more tool for detecting accounting landmines. We will offer instructions for defusing those landmines. Defusing, alas, is not always possible, but at least we can improve your odds of staying out of harm's way when the mines detonate.