

Financial Warnings

Detecting “Creative Accounting” Practices and Avoiding Earnings Surprises

Charles W. Mulford, Ph.D., discusses how to uncover problems posed by creative accounting in this interview with frequent *Journal* contributor Dev Striscek. Mulford addressed this topic with coauthor Eugene Comiskey in a 1996 book *Financial Warnings*, one of four books he has written on accounting practices, including *The Financial Numbers Game* (2002) and *Creative Cash Flow Reporting* (2005).



Striscek: Much of your research and writing has centered on how to look for potential problems in the “creative accounting” of companies. Could you elaborate on the boundaries of creative accounting, particularly when it crosses the line from generally accepted accounting principles to not-so-GAAP?

Mulford: Because GAAP is a rules-based system, for most transactions there is a rather clear line between transactions accounted for within the boundaries of GAAP and those accounted for beyond the boundaries. It gets gray in cases where GAAP permits a particular accounting method, but that method is abused by an overzealous management. For example, one of the requirements for revenue recognition is delivery. A firm may have fulfilled the delivery requirement, but by adding other contingencies to the sales agreement in the form of a side letter (open return, postpone payment,

other services provided), the revenue in question is effectively not earned. As another example, costs that benefit future periods may be capitalized. But some firms stretch the definition of what constitutes a future benefit and capitalize costs that should have been expensed. What these transactions have in common is that other firms in the industry are likely not accounting for them in the same manner.

Striscek: You teach how to avoid earnings surprises hidden away in creative accounting practices. In your experience, what are the top four or five creative accounting practices that lead to earnings surprises?

Mulford: They would be 1) premature revenue recognition—recognizing actual revenues early before being earned; 2) aggressive cost capitalization—capitalizing costs that other firms routinely expense; 3) extended amortization

periods—depreciating fixed assets over periods that extend beyond their useful lives; 4) overstated assets—failure to address asset impairments, for example, receivables, inventory, investments, fixed assets, or goodwill, in a timely manner; and 5) understated operating liabilities—under-accrual of operating expenses that require judgment, like warranty obligations or insurance reserves such as workers' comp.

Striscek: You have a financial warnings checklist for identifying the firms most likely to sustain an earnings surprise. Would you describe how you selected the items on that checklist and how to use the checklist?

Mulford: The checklist is a series of questions that require yes-or-no answers. The purpose is to be a memory-jogger and force the analyst to think more deeply about relationships among financial statement accounts. In creating it, we identified the financial statement items that tend to be misstated when the risk of a particular earnings surprise is increased. It's mostly a matter of identifying which balance sheet accounts are misstated. For example, premature revenue manifests itself in overstated receivables, so increased DSOs [days' sales outstanding] may be an indicator not just of slowing collections but also of aggressive revenue-recognition practices. Fictitious inventory reporting boosts inventory days. But normally, we expect a lower gross margin with slower-turning inventory. When gross margin improves with higher inventory days, it's a sign that something more ominous may be going on. Let me emphasize may.

Striscek: Your "100 Largest Analyst Earnings Surprises" summarizes the following items for each firm on the list: 1) I/B/E/S (Income Before Earnings Surprise), 2) change in income from continuing operations, 3) change in revenue, 4) change in operating profit margin, 5) nonrecurring items, and 6) change in effective tax rate. What is the significance of each item in your "earnings surprises" research? How are they interrelated? And is any one of them more important than the others?

Mulford: We looked for the 100 largest variations between reported earnings and analyst expectations over approximately a 13-year period—that is, on which firms did analysts miss an earnings forecast the most? Our interest was in finding what caused the earnings surprises. What we found was that recessions or major industry-specific events were not the primary culprits. Also, revenue tended to improve even in the "earnings surprise" year, and the effective tax rate tended to decline. So the analyst surprises were not due to sudden sales drops or sudden increases in the effective tax rate. More specifically, the earnings surprises included three common themes: 1) major declines in gross margin

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driven by changes in product mix, excess capacity, foreign currency movements, and unexpected cost overruns; 2) unexpected increases in SG&A [selling, general, and administrative] spending, driven by significant increases in marketing costs and higher administrative costs; and 3) nonrecurring items—write-downs of receivables, inventory, and fixed assets as well as restructuring charges. I think gross margin is most important. It's the profitability of the firm's product line. Drops in gross margin show up with encroaching competition and seem to predict future drops in gross margin. Analysts can anticipate asset write-downs with good analysis—things like increased receivables days, inventory days, or fixed-asset days. Restructuring charges are harder to forecast.

Striscek: Revenue recognition features prominently among your financial warnings. What are the most frequent creative accounting techniques you find companies practicing to improve their revenue line?

Mulford: One is recognizing revenue before delivery to the customer. The recent case against GE and its sale of certain locomotives is a case in point. The company allegedly shipped train engines to a third-party financial intermediary to demonstrate shipment, without shipping to the end customer. However, GE retained the risks and rewards of ownership. It wasn't a sale yet. Another technique is sales that combine product/perpetual-license delivery and service. While product/license delivery can be recognized up-front, the service component should be deferred and recognized as services are provided. Software sales are a prime example. Use of side letters that are contract addendums but are not accounted for may add sales agreement contingencies that render the revenue as unearned. Note that all problems with revenue recognition will manifest with increases in receivables days, unless they move the outstanding receivables to another account.

Striscek: You also cite cost capitalization and amortization as creative accounting practices that enhance earnings. In your opinion, when does a company cross the line into deceptive accounting in its cost capitalization and amortization practices?

Mulford: What are others in the industry doing? If everyone else is expensing the item, I'd say the company's capitalization policy is aggressive. What do the capitalized costs represent? Is there a clear future benefit—an asset—that the firm might sell if it chose to? If not, it sounds

aggressive. How material is the cost capitalization policy? That is, how dependent are earnings to the company's capitalization policy? If the costs in question had been expensed, what would earnings look like?

Striscek: You also have criticized firms for overstating assets and understating liabilities. What are the most common assets to overstate and the most common liabilities to understate, in your experience?

Mulford: Receivables and inventory are first. They're easy to overstate and have such a direct effect on reported earnings. Companies will understate the allowance for doubtful accounts or fail to write down slow-moving receivables or inventory. Fixed assets through over-capitalization or under-depreciation are next, but not as common as receivables and inventory. For liabilities, it would be accrued liabilities like warranty and insurance reserves—for example, workers' comp—as companies under-accrue operating expenses.

Striscek: Bankers find that the risk of fraud rises in recessionary periods. What do you think motivates companies to cross over from aggressive accounting to fraudulent practices? Would you summarize your own list of accounting irregularities that might suggest a higher risk of fraud?

Mulford: I tell my students that fraud, like fire, requires three conditions to be present:

1) *oxygen*, that is, conducive conditions—things like weak internal controls, high management turnover, inexperienced management, or significant assets open to misappropriation; 2) *fuel*, or motivation—a declining industry with many failures, a company having solvency problems, compensation tied very directly to reported financial results, too rapid growth, a struggle for control, adverse legal circumstances, or lavish management lifestyle; and 3) *heat*, the attitude of management—over-aggressiveness, past dishonesty, or disrespect for authorities.

Take one of the three away and there's no fire, no fraud.

Striscek: You have done much work in “creative cash flow” analysis. Would you summarize the most popular three or four methods that companies use to increase their reported operating cash flows?

Mulford: Acquisitions boost reported operating cash flow by allowing companies to increase receivables and inventory with investing cash flow. Their subsequent sale/liquidation boosts operating cash flow. Other methods include 1) slowing in the payment of accounts payable, 2) transferring investments from hold-until-maturity or available-for-sale

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to trading, and 3) classifying increases in book overdrafts as operating cash flow.

Striscek: You suggest the use of an “earnings quality indicator” to detect creative accounting practices. Would you explain the EQI and how to use it?

Mulford: The EQI is calculated as operating cash flow minus earnings divided by revenue. It's a margin measure, the excess of operating cash margin over net margin. The thinking is that steps taken to boost earnings that are aggressive will not result in operating cash flow. As a result, operating cash margin will not grow as fast as net margin, resulting in a declining EQI ratio. We look for trends in EQI. When it is declining, there are noncash assets building up on the balance sheet. The analyst should make sure that he or she knows what those assets are. If they are not realized at some point, write-downs will ensue. A declining EQI cannot decline indefinitely. Either earnings will decline—which is what you're trying to forecast—or cash flow will rise. We're most concerned about declining earnings.

Striscek: FASB [Financial Accounting Standards Board] has agreed to join the rest of the world in adopting international financial reporting standards [IFRS] over the next several years. IFRS is usually described as more principles-oriented and less rules-based than FASB's GAAP, and IFRS relies more heavily on footnotes to explain the financial statements. Do you think IFRS's fuller disclosure will improve the detection of creative accounting and improve monitoring of financial warnings?

Mulford: From a creative accounting point of view, I'm not optimistic regarding our move toward IFRS. I think that a principles-based approach will give unscrupulous managers much more leeway in their application of accounting principles and give them much more room to manage earnings, all within the boundaries of IFRS. I think, too, that a principles-based approach will make comparability of results more problematic.

Striscek: IFRS differs from GAAP in several major ways: fair value accounting, prohibition of LIFO inventory, and capitalization of leases. Do any of these or other changes present new opportunities for creative accounting, in your opinion?

Mulford: The elimination of LIFO will make creative accounting—earnings management—more difficult to do. That is, through the use of well-timed LIFO liquidations and in the way LIFO is applied to interim periods, managers are offered a very useful method for earnings management.

I think that we'll see full capitalization of leases under U.S. GAAP even before we adopt IFRS. While that will reduce one avenue of creative accounting—pursuing operating lease accounting over capital lease accounting—analysts should be aware that capital lease treatment will boost EBITDA and operating cash flow.

Fair value accounting and the subjectivity it presents is an open invitation for managers to manage earnings and the balance sheet.

While not mentioned in your question, I think that the capitalization of development expenditures and other costs incurred in creating intangibles will open up new avenues for creative accounting. It permits judgment and flexibility in deciding whether costs should be capitalized.

Striscek: How soon do you believe American colleges and universities will be ready to teach accounting according to IFRS?

Mulford: I think they'll be ready whenever the change occurs, even if it were this fall. Competition among book publishers is forcing them to incorporate IFRS into texts now. To get an edge on recruiting, accounting firms are providing many resources to help academics get ready. Also, we're talking about people who already understand accounting and should have no problem incorporating changes into their courses. I don't see a problem.

Striscek: Finally, with all the current latitude in accounting practices and the switchover to IFRS taking place, what advice would you give bankers on setting financial covenants?

Mulford: I think the important point to remember is that, in setting covenants, a dated GAAP or IFRS should be specified. That way, any changes in GAAP or IFRS can be adjusted for in determining whether a covenant has been met. ❖



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