The Financial Numbers Game

Detecting Creative Accounting Practices

Charles W. Mulford
and
Eugene E. Comiskey

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About the Authors

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

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

Preface

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

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

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

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

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

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

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

A Special Note to Our Readers

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

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