

How To Recognize Trouble Signs

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They are the heavy hitters of Wall Street and Bay Street, men and women who move markets with words. But when it comes to spotting accounting chicanery, most brokerage analysts strike out. Enron, Livent, Waste Management -- you name it, they didn't see it coming.

In short: you, the investor, have no choice but to do your own spadework. Where do you start? Here are some of the red flags.

Accounts receivable are rising. It's one thing to ship a product, another to get paid for it. If accounts receivable are increasing at a faster rate than sales, it could be a sign the company is having trouble getting the money from its customers, says **Anthony Scilipoti**, vice-president of research of **Veritas Investment Research Corp.**

And if a company can't collect, eventually it has to write off those accounts.

That's what happened to Nortel Networks Corp. when the small telephone companies it serves were caught in a cash crunch; Nortel had to write off almost US\$1-billion in uncollectible debt.

There's another possible explanation for rising receivables: management could be recording revenue too soon. Which leads us to...

Inexplicable, abnormal increases in sales. Remember "Chainsaw" Al Dunlap, the corporate turnaround artist who earned his nickname by firing employees by the thousand? His took the top job at appliance maker Sunbeam Corp. in 1996 and was hailed as a miracle-worker in a slow-growth industry. In the fourth quarter of 1997, Sunbeam's revenue jumped 26%. It was a mirage; Sunbeam had booked sales from barbecues that hadn't been paid for and were, in fact, sitting in Sunbeam's warehouses.

Early revenue recognition, sometimes called "channel stuffing," inevitably catches up with companies -- sometimes with unforeseen consequences. Take the case of Corel Corp., whose former chief executive, Michael Cowpland, became embroiled in an insider-trading investigation.

When Mr. Cowpland learned in August, 1997, that Corel's sales were behind projections, he first ordered his staff to send "as much inventory as possible" to Corel's largest distributor to make up the shortfall, according to a statement of allegations by the Ontario Securities Commission. His employees followed his instructions. But weeks later, Corel determined it couldn't actually record much of that revenue, its profits plunged, and Mr. Cowpland (who had sold \$20-million in stock in the meantime) found himself in trouble with the OSC.

Big increases in "other assets." "You just wonder what's in there," says **Mr. Scilipoti**. "Why isn't it called something?"

Other assets can include capitalized expenses. Let's say a company is developing a new product. Instead of writing off the entire development expense right away, it can record it as an asset and count it as an expense it later, when the product is sold.

There's nothing wrong with that. But when a company begins to capitalize a large proportion of its costs, it can be a warning sign of aggressive accounting. Case study: Livent Inc., the now-infamous live-theatre company, collapsed in 1998 after it was found to have improperly capitalized millions in expenses from its shows.

Restructuring charges and write-offs. Last fall, Toronto-Dominion Bank cut 200 employees from its securities division and announced a restructuring charge of \$160-million. Some of the people who lost their jobs were well-paid investment bankers. But did it really cost \$800,000 each to let them go?

Some analysts suspected TD was engaging in a common accounting trick: pushing ordinary expenses into an "extraordinary" write-off, to make the rest of its operations look better. Eventually, the bank cut its restructuring charge to \$130-million -- and admitted that \$34-million of it represented bonuses it would have paid anyway.

There's another variation of this, which **Mr. Scilipoti** calls the "liability cookie jar." Let's say a company makes electronic equipment that is sold under warranty. Company management believes it will spend \$60-million honouring warranties -- taking back or fixing defective equipment. But it takes a \$100-million charge to cover the cost. If its management's lower estimate proves correct, it will later be able to return the extra \$40-million to earnings -- perhaps during a weak quarter, to help disguise falling sales.

This is not an exhaustive list of the games CEOs play with the financial statements. Investors also need to keep an eye on inventory levels -- if they're rising, it could be an indication that a new product isn't selling as well as anticipated. Watch the debt-to-equity ratio, which sometimes tells a different story from rosy "pro forma" earnings reports. But the most important lesson is this: "You can't find conclusive answers from the financial statements," says **Mr. Scilipoti**. "All they do is raise questions, so you know you need to do further work."