Trying To Restore Confidence In The Books

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On the kitchen counter top, Sunbeam Corp. was king. Its toasters and mixers were celebrated by cooks and coveted by home makers. But all that changed when it was revealed that chief executive officer Al Dunlap, known as Chainsaw Al for cutting costs by firing employees, had worked a ploy to keep sales figures up, even as actual sales were shriveling. Sunbeam found itself blended into bankruptcy, providing lasting business lessons for all.

In November, 1996, Dunlap wanted to boost barbecue sales. To do that, he had to persuade his immediate customers -- retailers -- to buy six months before the cookers were needed. In exchange for major discounts, retailers agreed to buy grills that they would not receive for six months and would not pay for until six months after billing. The tale of creative accounting is told by Howard Schilit in Financial Shenanigans, a best-selling management book published earlier this year by McGraw-Hill.

To make the plan work, Sunbeam leased warehouses where it stored $35-million (U.S.) worth of what are called bill-and-hold transactions. Outside auditor Arthur Andersen questioned the deal because, when recorded, the sales were more tentative than final. About $29-million of the sales were reversed, then shifted to future financial quarters. But Andersen let the ploy pass with only a footnote in a 1997 statutory filing.

What Sunbeam did was only one move in a bag of accounting tricks companies can use to record future or even speculative sales as current and real. As Schilit explains, revenue can be recorded at shipment but before goods are received; quarter dating can be changed; goods may be recorded as sold even though customers can return the products; sales can be recorded as final even though customers are under no obligation to pay; customers may not have the cash to pay; sales may be made to affiliated parties; and sales may really just be exchanges for similar goods -- a ploy in the Enron Corp. scandal.

More exotic moves may involve sales that have no economic substance and sales that are able to be cancelled through what are called "side letters," not known to accountants or shareholders. Finally, there's a move that has been used in show business: Repayments of loans may be shown as sales and investment income may be recorded as revenue.

Watching the decline and fall of senior managers at major telecom companies and, of course, the problems of decorating doyenne Martha Stewart, one is tempted to condemn wealth generation by business as a fraud, with only a few islands of honesty. In fact, much of the current wave of frauds planned at the top is a consequence of the fashion of paying managers with stock options. Boost the value of the stock and you can be rich.

Options were given to less than a third of CEOs of public companies in 1980, but by 1994, seven out of 10 CEOs got them. The rush to options was, in fact, the unintended consequence of a pitch by the Democratic presidential ticket in the 1992 U.S. election. Bill Clinton and Al Gore deplored multimilliondollar salaries and insisted that high pay be based on performance. Because options were not counted as compensation and, therefore, were not expensed, they were good for companies, good for those getting them, but bad for ordinary stockholders whose shares were diluted when the options were turned intostock.

The U.S. Financial Standards Accounting Board wanted to require expensing of options, but big high-tech companies opposed the move. The board relented and the rest is history, reports John Cassidy.

He's a financial reporter for The New Yorker. It was an example of unintended consequences creating a problem bigger than the one that seemed to have been solved.

The current wave of accounting scandals is still substantially an issue for U.S. companies. Canadian frauds such as Bre-X Minerals Ltd. are relatively old-fashioned affairs of salting plain dirt with a pocketful of gold dust.

Still, the issues raised in the U.S. accounting scandals are relevant to Canadian corporate governance. In a general sense, says **Anthony Scilipoti**, a forensic accountant who is executive vice-president of **Veritas Investment Research Corp**. in Toronto, there are two problems.

"The rules themselves are extremely lax and offer a great deal of judgment. And on the investor side, there is poor general understanding of the loopholes that exist within accounting," **Scilipoti** says.

Generally accepted accounting principles, or GAAP, say that revenue can be recognized when a thing is earned or sold, he explains. "When a price can be known or estimated and costs can be estimated and when collection can be reasonably assured, then revenue can be recognized," **Scilipoti** says.

But the rules break down with interpretation. Costs, for example, can be operating, unusual or extraordinary. Even in this deconstruction, there is room for interpretation. Different people must be satisfied, so that the application of guidelines can meet with resistance, he says.

The incentive to cross the line between rule interpretation and rule-breaking can be a fine one. If the senior managerial incentive to manipulate accounts is removed by making options an expense, then temptation will be better controlled.

Scilipoti notes that options must be disclosed under Canadian and U.S. accounting rules. But in Canada, the rule is only that they should be expensed. It's not mandatory. There are complexities in expensing options and, once expensed, the accounts may have to be adjusted annually, he says. Accounting, however, is here to stay, and there is no substitute yet for public funding and ownership of business.
"Accounting is like democracy," **Scilipoti** says. Quoting Winston Churchill, he adds: "Democracy is not the best form of government, but it is the best one we've got."

Beware:

How corporate accounts can be manipulated to smooth or boost earnings, increase or decrease losses:*

1. Recording revenue prematurely

Revenue can be booked before goods are shipped, before the customer expects them, before payment is made, or in spite of a right of return. As well, the seller may provide the financing even if the customer may not pay or the seller may transact for improperly valued barter.

2. Recording bogus sales

There may be no economic substance to sales; sales may be revocable by so-called side letters; credit terms may exceed 12 months; cash received in lending or from investments may be recorded as a sale; or partnership advances may be recorded as revenue.

3. Boosting income with one-time gains

Undervalued assets may be sold and the revenue recorded as sales; there may be windfall gains

from pension assets.

4. Shifting current expenses to a later or earlier period

Normal costs may be capitalized rather than expensed, resulting in a false boost to profit; costs may be amortized too slowly; impaired assets may not be written down; and bad loans may not be written off.

5. Failing to record or improperly reducing liabilities

Expenses and related liabilities may not be recorded even when future obligations remain; liabilities may be reduced by changing accounting assumptions; and questionable reserves may be released into income.

6. Shifting revenue to a later period

Reserves may be created and held to be released into a later period.

7. Shifting future expenses to the present as a special charge

Discretionary expenses may be shifted into the present period.

** Adapted from Howard Schilit, Financial Shenanigans: How to Detect Accounting Gimmicks & Fraud in Financial Reports *2d ed.; McGraw-Hill, 2002*