How Financial Executives Cooked the Books

Iyad Mourtada

Why do smart managers make bad financial decisions?

A company has more cash today when:

A. Accounts receivable increases.
B. Profit increases.
C. Customers pay their bills sooner.
D. Retained earnings increases.

Income Statement

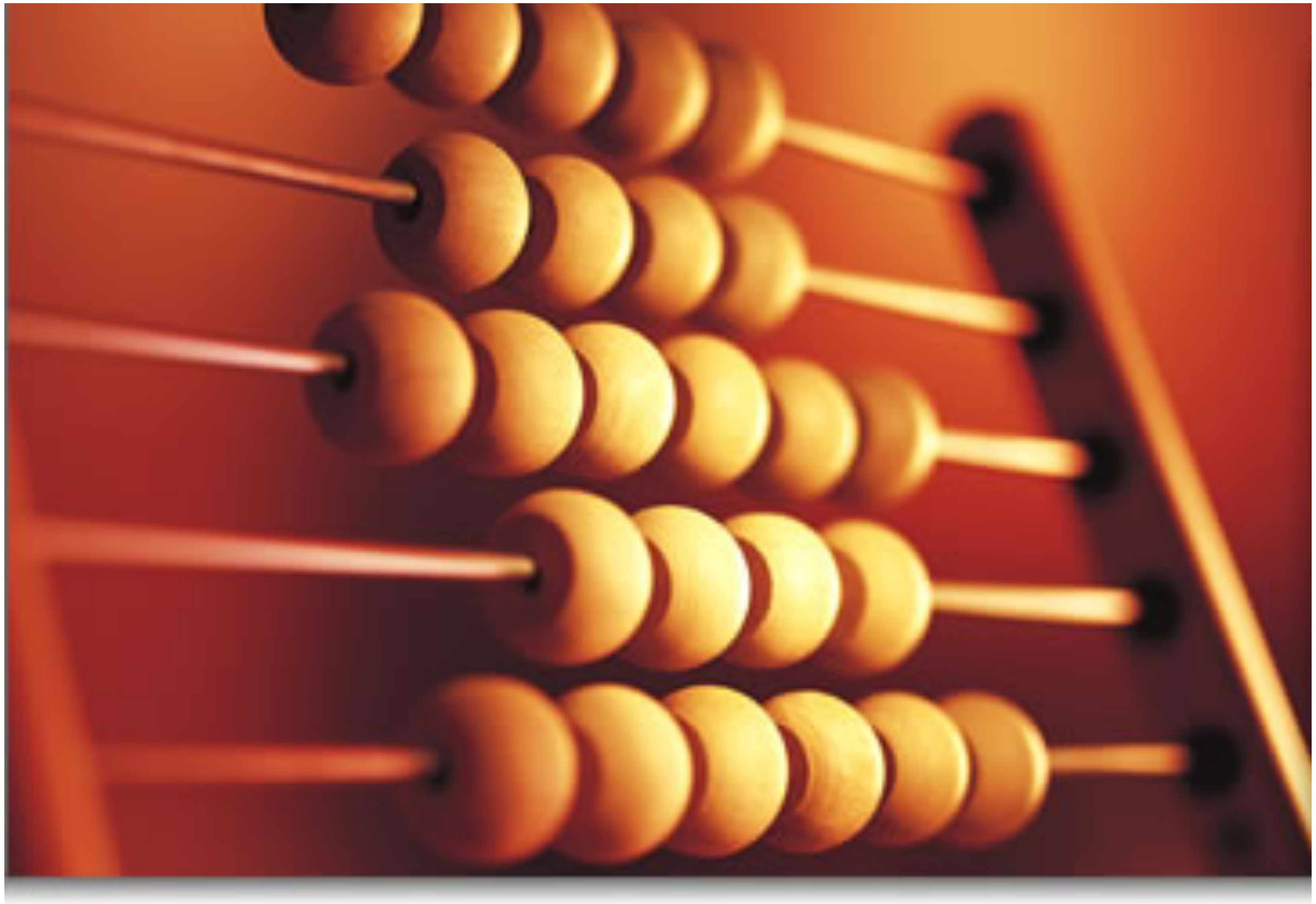
INCOME STATEMENT *(in millions)*	Year ended Dec. 31, 2005
Sales	$8,689
Cost of goods sold	6,756
Gross profit	**$1,933**
Selling, general, and admin. (SG&A)	$1,061
Depreciation	239
Other income	19
EBIT	**$ 652**
Interest expense	191
Taxes	213
Net profit	**$ 248**

– How do you account for any expenses and revenues?

– Who decides how you should account for any expenses and revenues? The management!

– How do they know? They don't! They guess. Lots of accounting decisions are just that – guesses.

Profit is an Estimate



Accountants had to make judgments decisions when they record financial transaction and financial managers needs to make objective decisions based on these numbers that they get from accountants

It is very important that you ask questions about the numbers to make sure that they are what you think they are.

As financial professionals your roles in your organization is to make everyone know how numbers are affecting their job and what parts they are involved with.

Accountants should give the most accurate picture of the company's performance. (read footnotes)

All financial decisions are based on judgment: Different methods produce different results.

- There is always accounting judgment involved and that can lead to manipulation
- Manipulation can benefited the company (It is not illegal)

- Accounting change that is material to the bottom line should be footnoted but who decide what is material and what isn't? Accountants
- GAAP only provide guidelines

Cooking the Financial Books

Assumptions (What ingredients to include)
Estimates (How much to include)

You may assume that they're accurate down to the last dollar. Not true! The balance in the cash account is exact, but virtually every other number you see in a financial report is based on an estimate.

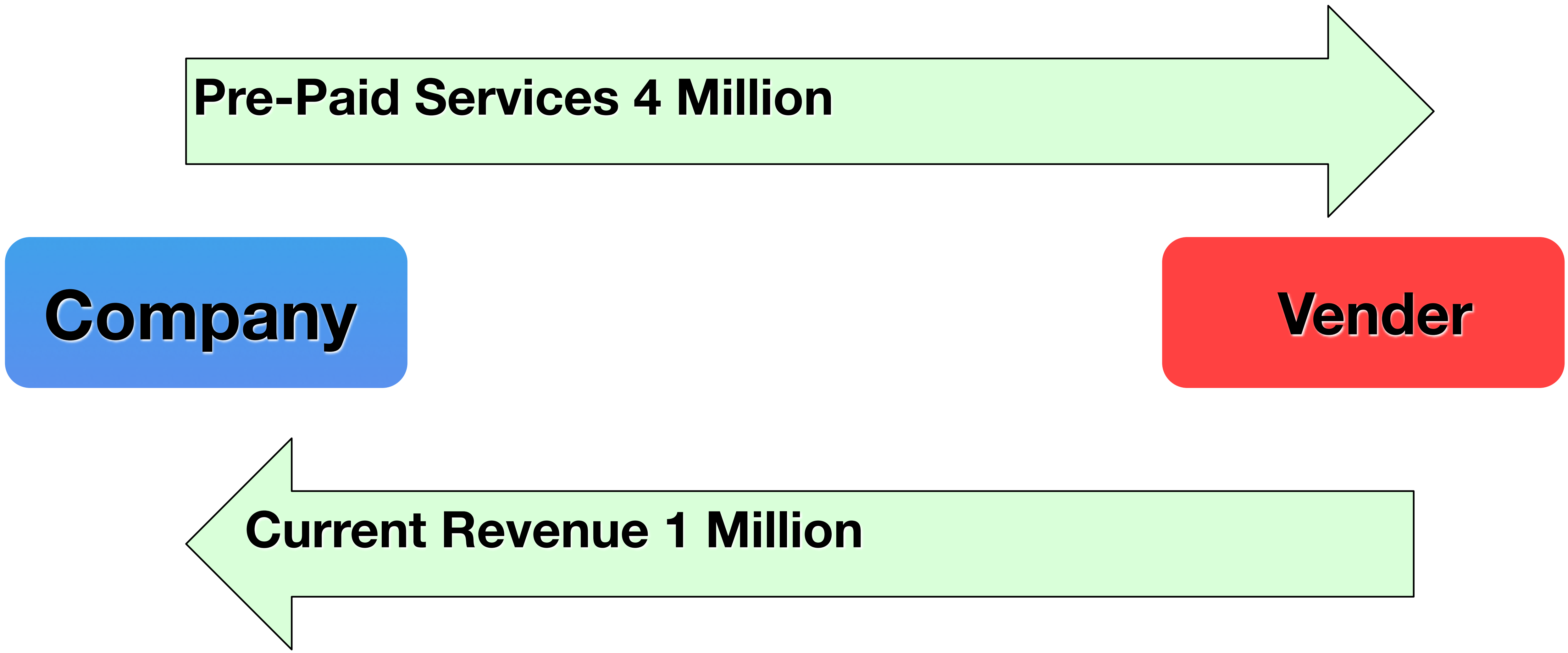
Income Statement

INCOME STATEMENT *(in millions)*	**Year ended Dec. 31, 2005**
Sales	$8,689
Cost of goods sold	6,756
Gross profit	**$1,933**
Selling, general, and admin. (SG&A)	$1,061
Depreciation	239
Other income	19
EBIT	**$ 652**
Interest expense	191
Taxes	213
Net profit	**$ 248**

Increase Revenue

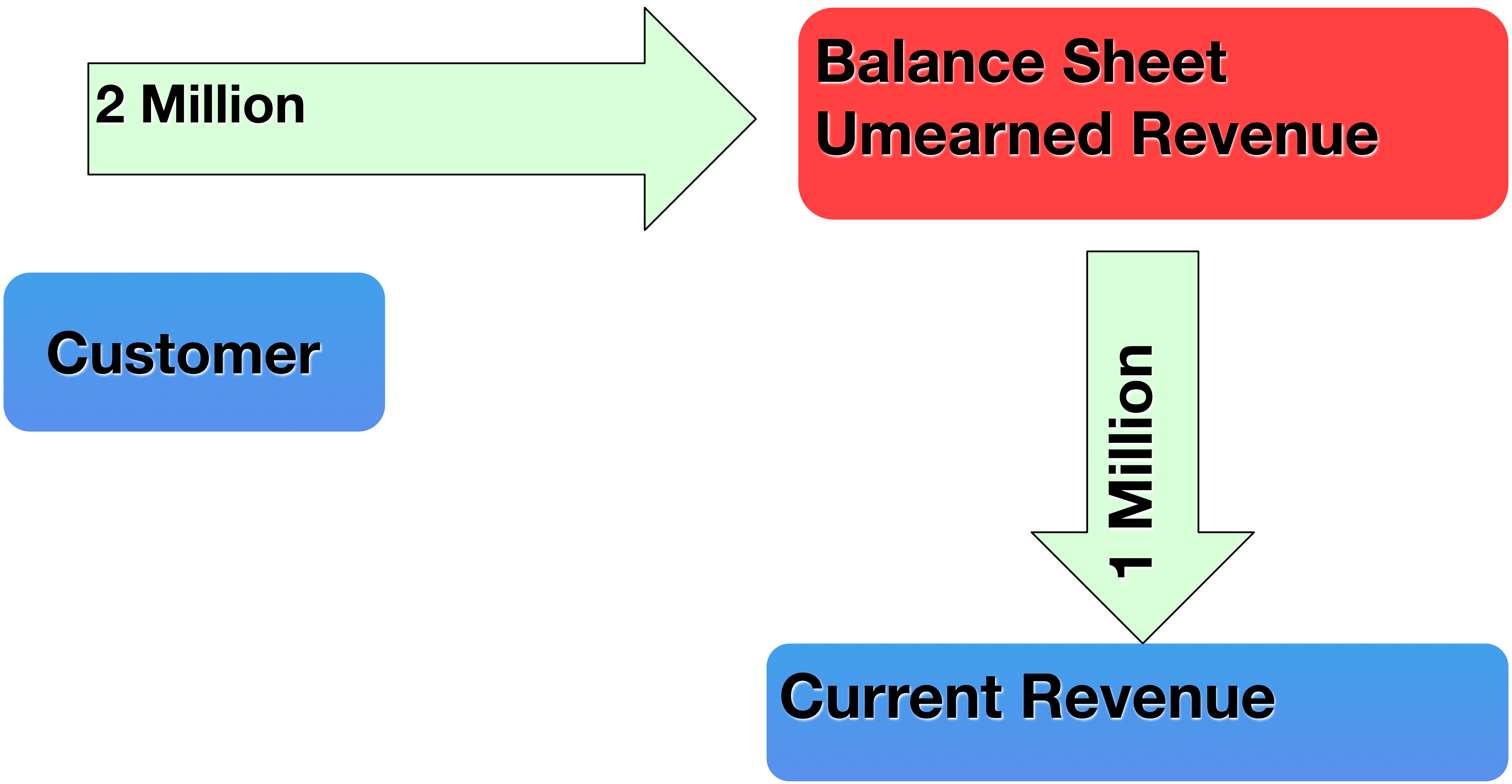
(Revenue Recognition)

Round Trip Recipe



Reporting more revenue

Deferral of Revenue Recipe



Manipulating revenue

XEROX®

- Sold equipment on four-year leases, including service and maintenance.
- Booked all the revenues up front.

- Xerox mis-stated four years' worth of profits, resulting in an overstatement of close to $6bn.

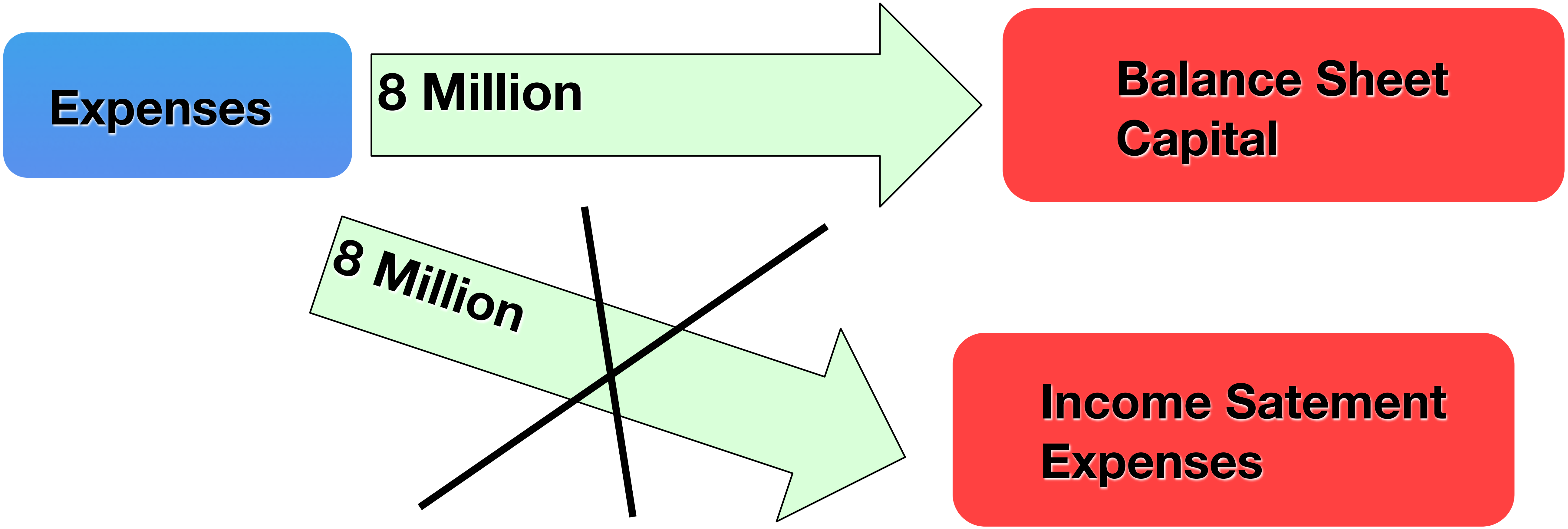
Channel Stuffing

Company inflates sales figures by forcing more products through a distribution channel than the channel is capable of selling to the world at large.

Reduce Expenses

(Matching Principle)

Capitalize Expenses Recipe



- Grow rapidly by buying other garbage companies. But didn't know to run them.

- Changed the depreciation of their 20,000 tracks from 8-10 years to 12-15 years and did the same for their 1.5 million dumpsters

- Took a pretax charge -a one-time write off- of 3.54 billion against its earnings

Which is more important?

A. How much you make
B. How much you keep
C. How much you borrow
D. How much you spend

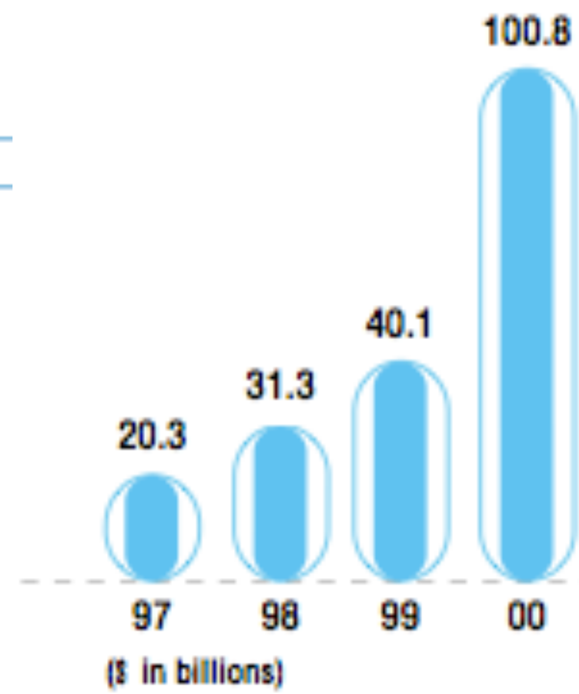
Which is more important?

A. How much you make
B. How much you keep
C. How much you borrow
D. How much you spend

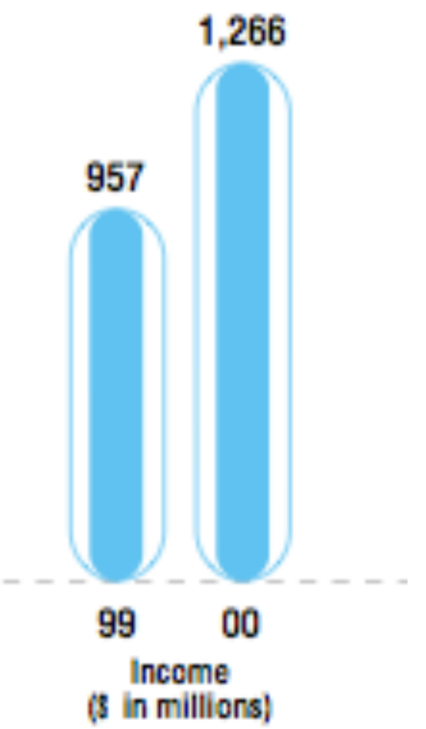
Net Profit

FINANCIAL HIGHLIGHTS

(Unaudited: in millions, except per share data)	2000	1999	1998	1997	1996
Revenues	$ 100,789	$ 40,112	$ 31,260	$ 20,273	$ 13,289
Net income:					
Operating results	$ 1,266	957	698	515	493
Items impacting comparability	(287)	(64)	5	(410)	91
Total	$ 979	893	703	105	584
Earnings per diluted common share:					
Operating results	$ 1.47				
Items impacting comparability	(0.35)				
Total	$ 1.12				
Dividends paid per common share	$ 0.50				
Total assets	$ 65,503				
Cash from operating activities (excluding working capital)	$ 3,010				
Capital expenditures and equity investments	$ 3,314				



REVENUES

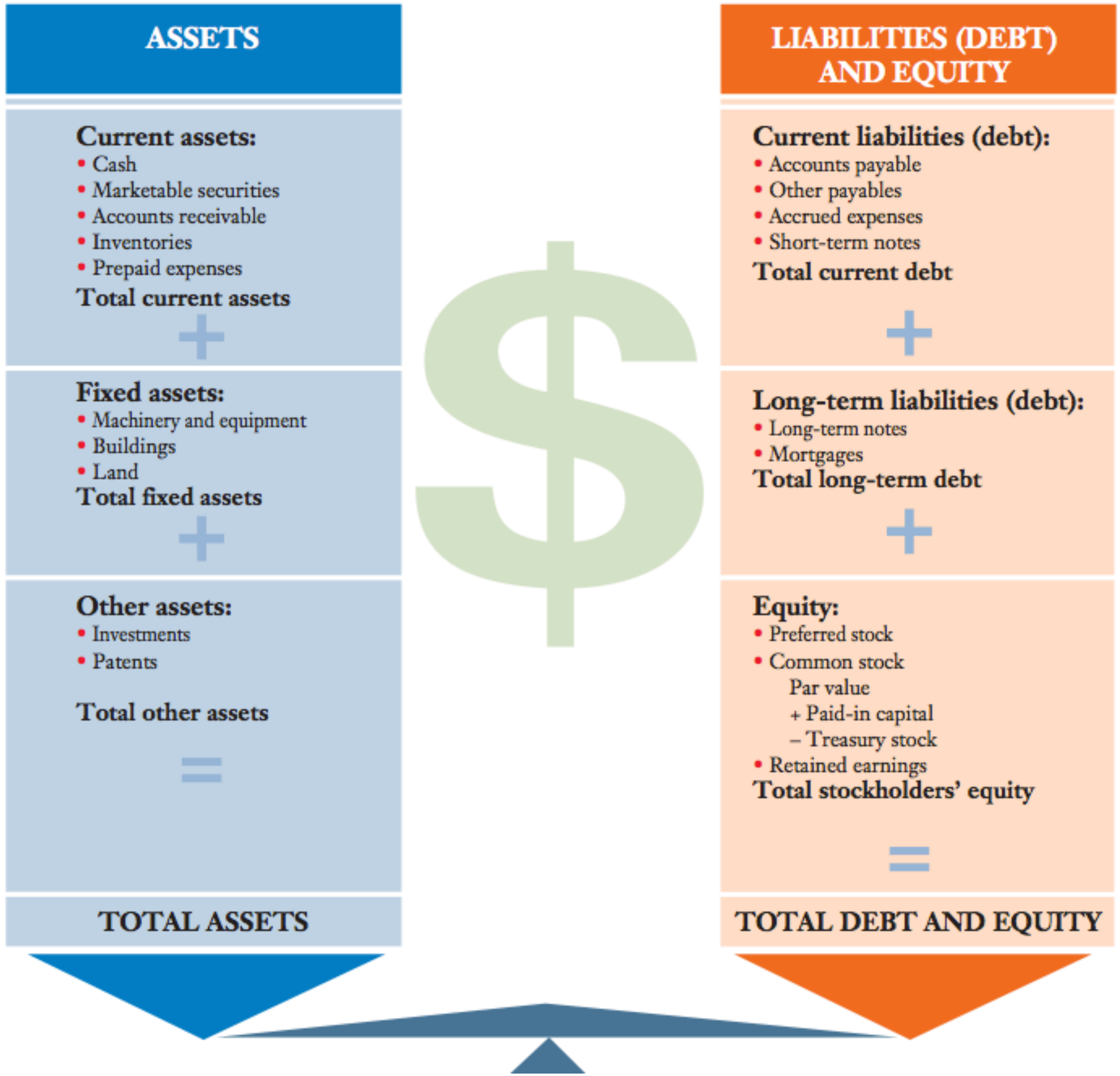


OPERATING RESULTS

If you own more than 50% of a company it must be consolidated on the parent company balance sheet, but if you own less than 50 percent, it typically stays off the balance sheet as an unconsolidated affiliate.

Enron established partnerships that enabled them to move some of their debt into affiliate companies that should have been independent but weren't. Ultimately, the partnerships were doing the borrowing, which protected Enron's credit ratings.

Balance Sheet



Underreporting ‘line costs’ (interconnection expenses with other telecommunication companies) by capitalizing these costs on the balance sheet rather than properly expensing them.

In June 2002, the company admitted it had inflated its profits by $3.8bn between January 2001 and March 2002.

By the end of 2003, it was estimated that the company's total assets had been inflated by around $11 billion

Goodwill

Goodwill =
Price paid - net assets (Assets - Liability)

Goodwill could be amortized over a maximum of forty years or the estimated useful life of the acquired business. (Rule changed)

Goodwill

Goodwill =
Price paid - net assets (Assets - Liability)

Goodwill could be amortized over a maximum of forty years or the estimated useful life of the acquired business. (Rule changed)

- Bought 600 companies in 2000 and 2001 (undervalued the assets and increase the goodwill) = Higher profit

- Tyco suffered more than a $9 billion loss in 2002, which included the asset impairment write-down by over $3 billion, losses of nearly $2 billion for the two restructuring charges, and over $1 billion from the two goodwill impairment charges. In all, the net charges totaled nearly $7 billion of the loss that year.

Cash is King

Warren Buffett

Profit ≠ Cash

Profit will be turned into cash

Profit without cash

Cash without profit

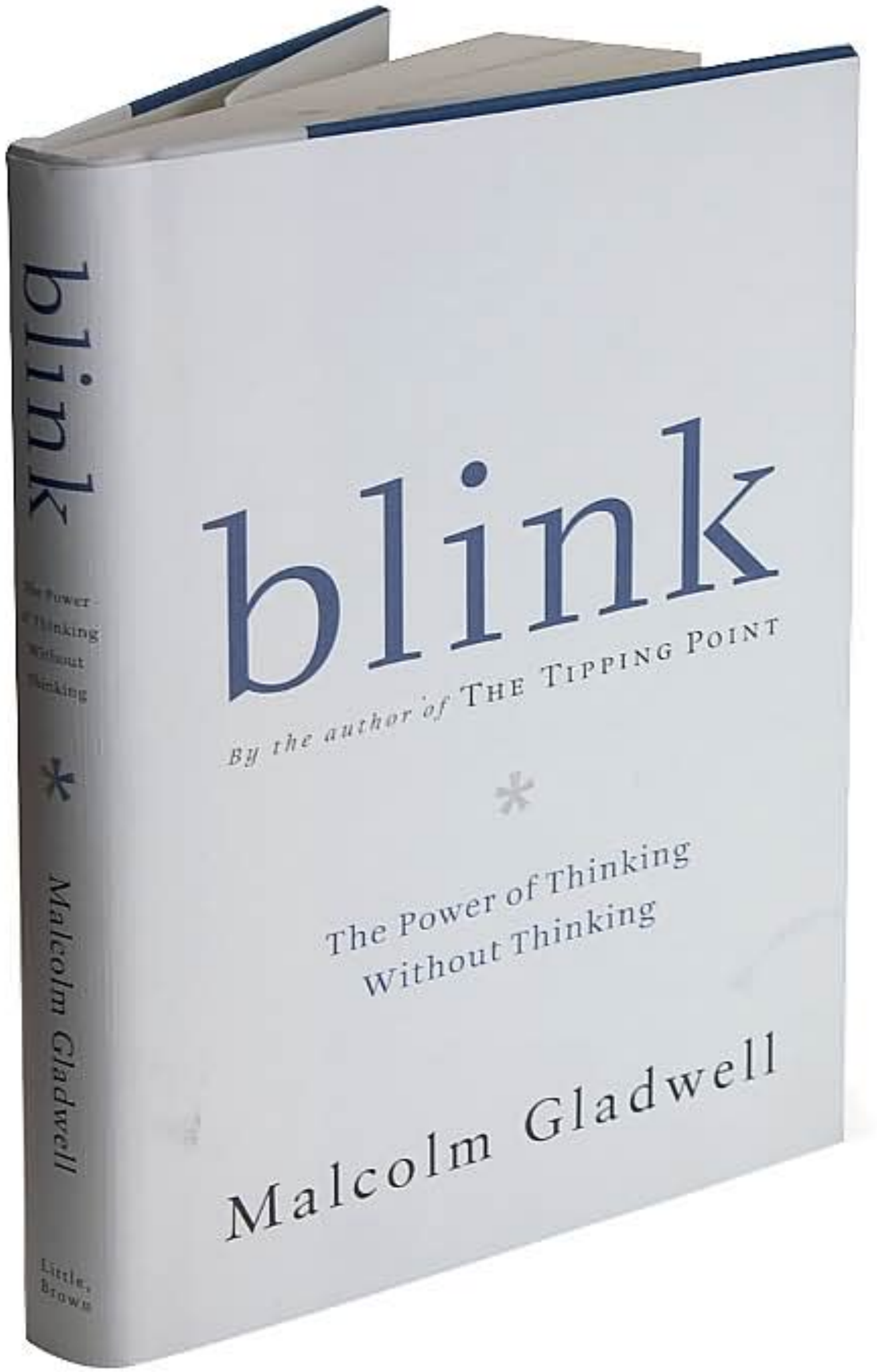
Cash Flow Statement:

- Cash In

- Cash Out

Cash Flow Statement:

	2009	2008
Cash Provided by (Used for) Operating Activities		
Net income	$ 465,000	$ 272,000
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	479,000	300,000
Deferred income taxes	317,000	69,000
Gain on sale of property and equipment	(28,000)	(59,000)
Changes in operating assets and liabilities		
Accounts receivable	(3,000)	(64,000)
Inventories	(34,000)	129,000
Prepaid expenses	11,000	32,000
Accounts payable	13,000	22,000
Accrued expenses	108,000	(110,000)
Net cash provided by operating activities	1,328,000	591,000
Cash Provided by (Used for) Investing Activities		
Purchase of property and equipment	(1,010,000)	(1,430,000)
Proceeds from disposal of property and equipment	38,000	7,000
Purchase of investments	(22,000)	—
Net cash used for investing activities	(994,000)	(1,423,000)
Cash Provided by (Used for) Financing Activities		
Additional long-term debt	137,000	863,000
Retirement of long-term debt	(322,000)	(560,000)
Issuance of common stock	68,000	466,000
Purchase of treasury stock	—	(18,000)
Dividends paid	(154,000)	(133,000)
Net cash provided by (used for) financing activities	(271,000)	618,000
Increase (decrease) in cash and cash equivalents	63,000	(214,000)
Cash and cash equivalents, beginning of year	314,000	528,000
Cash and cash equivalents, end of year	$ 377,000	$ 314,000



Professionals, who have knowledge and experience, may think they can make decisions without really using their minds. They don’t expect new things and they make miss them. They look at the details and forget the big picture.

Are the accountants making the right judgment decisions?

Questions:

- What were the assumptions in this number?
- Are there any estimates in the numbers?
- What is the bias those assumptions and estimates lead to?
- What are the implications?

Who control your organization?