Are your company’s accounting practices aggressive—or downright illegal?

Tread Lightly Through These Accounting Minefields
by H. David Sherman and S. David Young

New sections to guide you through the article:
• The Idea in Brief
• The Idea at Work
• Exploring Further...
The nightmare of risky accounting is growing more frightening. Facing tremendous pressure—and personal incentive—to report sales growth and meet investors’ revenue expectations, managers are issuing increasingly misleading financial reports, especially regarding earnings. Though not necessarily illegal, these aggressive accounting strategies often hurt shareholders most—leaving them with worthless stock when a company’s problems come to light.

Your company’s defense against creative accounting calamities? Use reporting practices that are consistent with industry norms and that present a reasonable picture of earnings. And beware of dangerous accounting minefields.

**THE IDEA AT WORK**

Investors, corporate boards, and managers can spot accounting minefields by asking pointed questions, including:

1. **Revenue measurement and recognition.** For some businesses, pinpointing when revenue has been earned—and even what constitutes revenue—requires judgment. Some firms record revenue they don’t expect to receive until later.

   **EXAMPLE:**
   Software producer MicroStrategy immediately recorded revenues it expected to earn over multi-year consulting engagements—rather than spreading revenues over the life of the contract. When the company restated its 1998–1999 earnings, its $12.6 million profit became a $34 million loss. Share price plummeted 62% in one day, destroying $12 billion of market value.

   **Ask:** How is revenue defined? Is this a reasonable measure of the revenue earned during the reporting period? Is it consistent with competitors’ measures?

2. **Provisions for uncertain future costs.** Companies can’t precisely estimate future costs, such as obsolete inventory, uncollectible accounts, or product returns. So they may diminish costs to enhance reported profits. Or, they may overstate restructuring costs. **Repeatedly** classifying charges as nonrecurring masks management errors and overstates profitability.

   Managers may also play with “comprehensive income”—gains and losses that don’t appear on income statements because their true impact on earnings isn’t certain yet. For example, Coca-Cola added $965 million of translation losses to its comprehensive income—and deferred the impact on earnings of the euro’s declining value.

   **Ask:** Do financial statements include estimates for uncertain events? Do estimate footnotes provide sufficient disclosure? Should gains and losses in comprehensive income be included in net income instead?

3. **Asset valuation.** Assets are carried at cost minus amortization or depreciation—which requires estimates of assets’ useful life. Changing estimates can raise questions about a company’s motivations. When Delta Airlines revised the useful life of its aircraft—twice in ten years—its reported profits soared.

   **Ask:** Do asset write-downs reflect real values? Are value adjustments fully disclosed? Is the accounting consistent with industry standards?

4. **Related-party transactions.** Firms make these transactions with entities they control or that control them—other businesses, shareholders, vendors, or customers. Using these transactions, companies can arbitrarily increase or decrease earnings or divert profits, enriching shareholder or manager subgroups.

   **EXAMPLE:**
   Speech-recognition software company Lernout & Haupsie Speech Products helped create 30 customers—all start-ups—that became responsible for one-fourth of L&H’s revenues. Many received funding from a venture-capital firm linked to L&H’s founders. When investors learned of the deal, L&H restated earnings, suffered bankruptcy, and saw its stock delisted from the Nasdaq.

   **Ask:** Are all significant related-party transactions disclosed? Do conflicts of interest exist that could benefit or damage shareholder groups?
Illegal? Maybe not, but many of today’s accounting moves are clearly aggressive. Shareholders—and their representatives on corporate boards—need to be aware of six danger zones.

by H. David Sherman and S. David Young

Back in the 1980s, Tandem Computers’ robust earning reports made it a darling of Wall Street. Its CEO and cofounder James Treybig had pioneered a superhot technology, a way to make “fault tolerant” computers for companies like banks and telecommunications businesses running data-processing operations around the clock. But in 1983, it came to light that Tandem had counted a chicken or two before they’d hatched. Some of the revenue reported in its most recent financial statements had not actually materialized, and earnings had to be restated. The Street’s retribution was swift: Tandem’s share price immediately dropped 30%. In time, the company recovered (it was ultimately acquired by Compaq), but the event left a lasting impression. When a Wall Street Journal reporter asked Treybig to recall his most exciting day at Tandem, he couldn’t. But when asked to pick his worst day, he answered without pause: “The day we restated.”

The nightmare of risky accounting is on the increase. In the current economic climate, there is tremendous pressure—and personal financial incentive for managers—to report sales growth and meet investors’ revenue expectations. According to the SEC, misleading financial reports, especially...
involving game playing around earnings, are being issued at an alarming rate. Needless to say, it’s a nightmare that affects more than CEOs’ sleep. The shareholders suffer most—and today’s stock price volatility makes Tandem’s 30% hit look mild. Little wonder that lawsuits related to financial reporting are on the rise. Back in 1991, 55 security class-action suits alleging accounting fraud were filed in the United States. By 1998, the number had nearly tripled.

To avoid such a calamity, shareholders and their representatives on corporate boards should keep their eyes peeled for common abuses in six areas: revenue measurement and recognition, provisions for uncertain future costs, asset valuation, derivatives, related-party transactions, and information used for benchmarking performance. If disaster strikes, it will most likely occur in one of these accounting minefields.

**MINEFIELD 1**

**Revenue Measurement and Recognition**

Determining when a sale is complete or a service fully rendered is simple for many businesses: revenue is most often recorded when the product is shipped or received or when the service is performed. But for some businesses, pinpointing exactly when revenue has been earned requires considerable judgment.

For example, how should revenue be recognized if a customer takes delivery of a product but makes payments on it over several years? One approach is to consider all of the revenue as earned upon product delivery. But an alternative approach is to consider the customer’s ability to pay its commitment in the future. What if the customer is a dot-com that might not survive?

Judgment is also required on the question of what constitutes revenue. Suppose an auction business sells an item for $100. Of that amount, $5 goes to the auctioneer as commission. On its financial statements, should the auctioneer include the total amount of the sale as revenue and call the $95 payment to the item’s original owner an expense? Or should it count only the commission as revenue and show no expense? Most accountants would say the latter approach is preferable. But some Internet companies, recognizing the importance investors place on sales growth, have taken advantage of ambiguities in revenue recognition rules to effectively do the former.

By contrast, suppose Dell sells a computer monitor it purchased from an independent manufacturer. Does it call only its profit margin revenue, or the full price? Obviously, revenue is recognized on the full price, with the cost of the monitor treated as an expense. But what if Dell were to arrange for the monitor to be shipped directly from the manufacturer to the customer (as it often does)? Should Dell include the monitor’s selling price in its revenue, or only the profit on the transaction? In other words, should Dell’s sales figures suffer just because of an efficient logistics arrangement? Or should the decision hinge on some technical legal question, such as who would be responsible if the goods were damaged in shipping?

The ambiguities suggested in just these simple examples begin to explain how one of the biggest accounting debacles in recent history could have happened. MicroStrategy, a producer of data-mining software, announced in March 2000 that it was restating its revenues and earnings for fiscal years 1998 and 1999. A change in revenue recognition policies transformed its reported profit of $12.6 million into a loss of more than $34 million.

What could account for such a drastic shift? The problem developed because MicroStrategy usually sells its software bundled with multiyear consulting en-
engagements; customizing the software to a client's unique circumstances is a complex undertaking. But rather than spreading the revenue from the software sale over the life of the contract, the company was recording it immediately. It was a tactic the SEC had begun to see more often in software companies and had complained about. When MicroStrategy announced the restatement, it emphasized that it anticipated no reduction in the revenue it would ultimately realize. Even so, its stock price plummeted by a staggering 62% in a single day, destroying $12 billion of market value—and it kept on falling. All told, shares fell from $333 in March 2000 to less than $22 in May 2000, at which time MicroStrategy faced at least three class-action lawsuits by shareholders and investigations by the SEC.

Evidently, no one on MicroStrategy's board asked the right questions—or what came to be called the "MicroTragedy" never would have occurred. Shareholders who want to avoid the same fate should pass along these questions to the board audit committee:

• How is revenue defined? And what event triggers its recognition?
• Does this present a reasonable measure of the revenue earned by the business during the reporting period? Is it consistent with revenue measures used by domestic and global competitors? And is it clearly described in the financial statement footnotes?
• If revenue is measured in an unusual or new way, is that disclosed? Is the approach justified in terms of its risks and advantages?

MINEFIELD
Provisions for Uncertain Future Costs

Companies must make provisions for costs they know will arise, even if the amounts can't be known with any certainty: losses from inventory obsolescence, uncollectible accounts, product returns, restructuring costs, damages from product recalls—the list goes on. But precisely because there's so much latitude in this area, it can be a minefield of earnings management. Estimates can either be inflated to create hidden reserves so that profits can be boosted in some future period to project a misleading earnings stream, or they can be diminished to enhance reported profits.

Xerox has found itself in this minefield lately; despite evidence of a growing number of slow payments, the company made no greater allowance for bad debts. Could someone on the board have spotted this and alerted the crisis? Xerox's former assistant treasurer thought so and told the Wall Street Journal as much in a highly damaging story.

A second common form of mischief is to watch for involves overstated restructuring costs. Restructuring expenses are segregated from other expenses on the typical income statement. The idea is to isolate the impact of nonrecurring items on net income, thus helping the reader to better understand the profitability of normal, recurring business activities. But what are readers to think when restructuring charges appear for several years running? Digital, now part of Compaq, reported restructuring expenses for three consecutive years in the early 1990s. It seems obvious that classifying charges as nonrecurring is designed to mask management error and overstate operating (recurring) profitability. It's become common for companies to employ a "big bath" strategy with their restructuring charges, making them so large as to flush out any possible future impact on earnings. And while companies are eager to highlight these nonrecurring business losses, they call for less attention to their actions when they need to reverse restructuring charges. Heinz, for example, overestimated the costs of its restructuring in 1997 by some $25 million. When it subsequently reversed that amount, it did not disclose the fact on the face of its income statement, allowing the adjustment to enhance operating income. The SEC took a dim view of this type of reporting. In fact, the SEC sued WR Grace for fraud in 1999 because the company failed to highlight just such a reversal.

And finally, managers play just as creatively with what's known as "comprehensive income." This category, which appears in the shareholders' equity section of the balance sheet, is designed to cover a variety of gains or losses that do not appear on the income statement because their true impact on earnings is not yet certain and irreversible. Examples include gains or losses caused by translating financial statements of subsidiaries from local currency to the parent company's currency, and unrealized gains and losses on investments in financial securities. Judgment calls are required on which gains and losses should be reflected on the income statement and which should be captured in comprehensive income. But there is definitely an incentive to park losses in the comprehensive income category, because the only income incorporated into the highly visible earnings per share figure (the basis of a company's price-earnings ratio) is that shown on the income statement.

For instance, in 2000, Coca-Cola added $965 million of translation losses to its comprehensive income, bringing the cumulative comprehensive loss to $2.5 billion. Indeed, as the euro's decline in value throughout 2000 reduced the dollar earnings of U.S. companies with large European sales, many of them managed to defer the impact on earnings through clever use of the comprehensive income line.

A prudent director would certainly consider how such treatment affects
investors’ perceptions of the business’s profitability. To discover if a company is wandering into one of these minefields, ask these pointed questions:

- Are estimates for uncertain events (such as doubtful accounts and restructuring reserves) included in the financial statements?
- Do the financial statements present a reasonable measure of current period operating expenses and revenues, with sufficient disclosure in the footnotes of these estimates and the accounting treatment?
- Should gains and losses included in comprehensive income (foreign currency, investment gains and losses) and in the footnotes instead be included in the current period’s net income?

### Asset Valuation

On the most basic level, an asset is something that has current or intrinsic value, like cash, or that can be used to generate future revenues—such as a building that is used to produce or manufacture a product, for example, or inventory that will be sold for a profit. Assets are generally carried at cost less estimated amortization or depreciation—and depreciation requires an estimate of its useful life. But the latitude given to management in making such estimates can raise questions about motivation when estimates are changed.

For example, Delta Airlines revised the useful life of aircraft in its fleet twice in ten years; in both cases, the change created sizable increases in reported profits. Were these adjustments motivated by any real change in the airplanes’ life spans, by a desire to match competitors’ accounting methods, or by some other reason?

Companies that use accounting methods to keep their research and development expenses from reducing earnings also frequently find themselves in this minefield. One common approach, in cases where an acquisition has been made, is to accelerate the write-off of all R&D in process at the acquired company.
Another is to conduct R&D through investments in partners to avoid treating the costs as current expenses. If analysts interpret such moves as being motivated by a desire to manage earnings, companies can seriously damage their reputations in the capital markets. Elan, an Irish pharmaceutical company and the subject of SEC reviews, scared off some analysts when it used just this kind of treatment on its R&D costs. A board member at Elan would have done well to ask whether the accounting practices being used by an otherwise strong company really provided a more complete earnings picture for shareholders. In the same spirit, you should ask the following:

- Do tangible and intangible asset values and write-downs of assets reflect real values and changes in value during the current period?
- Are these value adjustments fully disclosed?
- Is the accounting treatment consistent with industry and global competitors? If not, are the differences justifiable and adequately discussed in the financial statements?

### MINEFIELD 4: Derivatives

The use of derivatives to manage financial risk deserves careful and constant scrutiny. These complex financial instruments were famously implicated in the downfall of Barings Bank, in the travails of Bankers Trust, and in the near bankruptcy of Orange County, California—but the heightened awareness of them has not made them any easier for nonexperts to judge. Derivatives have, in fact, been usefully employed for decades to hedge risks related to commodity prices, foreign exchange fluctuations, and interest on debt. The great difficulty for board members, managers, and shareholders is in recognizing when their use introduces more risk than it mitigates.

For German conglomerate Metallgesellschaft, that risk equation came down on the wrong side. The company's energy group had contracted with customers to sell petroleum at prices fixed in 1992 for a maximum of ten years. Because the company would lose money if oil prices rose, it decided to hedge away the risk by using a “stack” hedging strategy, which employs derivatives. In doing so, it stacked the deck in the opposite direction, so that when the price of oil suddenly declined, the losses started to mount. The situation cost the company some $1.5 billion, leading the Economist to observe: “As Chernobyl was to nuclear power, so Metallgesellschaft has become to financial derivatives.”

Still, derivatives remain in wide use for all kinds of good reasons, and in many companies their potential impact on income is substantial. These companies should continually scrutinize their use to ensure that the risks are managed responsibly, to determine whether realized and unrealized gains and losses should be included in the earnings, and to ensure that the risks and accounting treatments are clearly disclosed so that shareholders can understand their potential impact. How can a sharp-eyed director defend the interests of shareholders in this regard? Again, the process begins with some basic questions:

- What hedging programs are in place?
- To what extent are derivatives used?
- Are proper safeguards in place to protect against their abuse?
- What are the worst-case scenarios of the company’s use of derivatives?
- Is the accounting treatment complete and in the spirit of generally accepted accounting principles (GAAP)? Is GAAP treatment sufficient to describe the business value and risks of the derivative program?

### MINEFIELD 5: Related-Party Transactions

Related-party transactions are those made with entities that are controlled by the company or that have control over the company, including other businesses, shareholders, directors, lenders, vendors, and customers. Disclosure of these transactions varies based on the regulatory environment and each company’s policies. But investors always have an interest in knowing about them because they can allow a company to arbitrarily increase or decrease earnings or to divert profits, sometimes enriching a subgroup of shareholders or managers.

Investors in the Belgian company Lernout & Hauspie Speech Products, a maker of speech recognition software, learned about this minefield when their shares dropped from $65 to $9 in the spring of 2000. An internal audit discovered that 30 customers, all start-ups and most based in Singapore, were responsible for about a quarter of the company's revenues. It turned out L&H had helped create these companies—and many had received seed money from a venture capital firm linked to L&H's founders. The story has since featured earnings restatements, bankruptcy, and the delisting of L&H stock from the Nasdaq.

This particular field is most heavily mined for companies that operate in countries where business practices and disclosure requirements are less regulated than in the United States or Western Europe. Some Korean companies, for example, have engaged in shady practices like purchasing assets unrelated to their business needs for future sale at a discount to related companies or shareholders, writing off loans to friendly parties in order to move corporate cash to select related parties, or selling products at discounts—or above market prices—to related businesses to transfer profits between parties.

Although the more egregious forms of abuse might be identified under U.S. reporting and auditing standards, the potential for manipulation is very real in subsidiaries of U.S. companies or in companies being considered for mergers or acquisitions. Even within countries, though, differences in the practices and disclosures of competitors can create misleading financial results. To avoid presenting information that may lead to erroneous conclusions and faulty evaluations, investors and their representatives on boards should ask the following questions:

- Are all significant related-party transactions and commitments disclosed?
- What policy determines which transactions will be disclosed and what
level of detail will be included in the financial statements?
• Are there conflicts of interest that could damage or benefit specific groups of shareholders that should be disclosed?

**MINEFIELD 6**
**Information Used for Benchmarking Performance**

The last accounting minefield has to do with manipulating a company’s performance numbers in relation to prior periods, investor expectations, and competitors. This minefield becomes more explosive as more businesses go global.

Imagine the difficulty a U.S. telecommunications business would have in comparing performance with, considering acquisition of, or trying to understand the business model of Deutsche Telekom in Germany. According to its financial reports, prepared under German accounting rules, Deutsche Telekom’s earnings stream has risen “smoothly” – but under U.S. accounting principles, its progress has been more erratic. Using German principles, earnings nearly doubled from 1996 to 1997; using U.S. principles, they declined. Thus, if a U.S. competitor, parent, or partner experienced 50% earnings growth, that might be considered poor compared to Deutsche Telekom with German accounting – or outstanding with U.S. accounting. In an increasingly global industry, should investors be allowed to misunderstand this, or should it be explicitly discussed in the financial statements?

Microsoft is one company that believes the differences should be transparent, so it voluntarily provides earnings information under several different accounting methods. Should more businesses follow its lead? Naturally, the challenge is to present a fair view of financial results while not providing so much information as to damage the company’s competitive position.

Equally important are the needs to understand the performance of a business compared with its competitors and to develop stock price-related reward systems that motivate executives to excel. Performance comparisons require an understanding of how profits and assets are measured in domestic and foreign competitors. If Wal-Mart, the world’s largest retailer, wants to compare its financial performance with Carrefour, the second largest retailer, it will have to convert Carrefour’s earnings, assets, and liabilities to U.S. accounting methods – or restate its own reports using reporting policies consistent with Carrefour’s.

Worldwide, companies have different reporting standards with respect to frequency, detail, and audit requirements, and it’s unlikely that even board members with financial backgrounds can be fully apprised of them all. But investors must be able to benchmark performance against prior periods and budgets, and against domestic and global competitors. To serve those interests, it’s reasonable to expect board members to ask:

• Are there aspects of the accounting methods used that may cause investors, security analysts, compensation committees of the board, or others to under- or overassess the business’s financial performance during the current reporting period?
• Are there differences between the company’s financial reports and its competitors’ that need to be disclosed?

**Financial Literacy**

Accounting game players are adroit, to be sure, and most investors and board members believe it takes one to know one. But it’s foolish – and dangerous – to declare oneself ignorant and hence powerless against their machinations.

We don’t argue that board members and senior managers must become experts on all aspects of financial reporting. That would be an unreasonable goal. However, to be effective, board members – particularly those serving on audit committees – must have enough knowledge of financial reporting issues to draw on experts as needed and have the ability to raise key questions to determine whether shareholder interests are adequately protected. Indeed, it is now a formal requirement. In 1999, the NYSE, Amex, and Nasdaq all revised their requirements for listing companies, explicitly stating that some board members must be “financially literate.”

Financial literacy is defined as the “ability to read and understand fundamental financial statements, including a company’s balance sheet, income statement, and cash flow statement.” It also requires understanding the supporting notes found at the back of corporate annual reports. But financial literacy extends beyond comprehension of financial reports. Financially literate business people can make well-reasoned judgments about the quality of a company’s financial reporting, the clarity of its financial disclosures, and the appropriate degree of aggressiveness or conservatism of its accounting policies.

This article aims to arm more managers and board members with this kind of literacy – and also to remind them of their obligations. The issue facing any business is whether or not its accounting methods present a reasonable picture of earnings compared with prior periods and compared with domestic and foreign competitors. Do yours?

Product no. 1997
To place an order, call 1-800-988-0886.
To further explore the topic of this article, go to http://explore.hbr.org.
Shareholders and regulators aren’t the only ones in the dark because companies are reporting their performance in opaque ways. Aggressive accounting practices also leave middle managers with only the vaguest understanding of how their companies create shareholder value.

Fuller argues that companies using more transparent accounting practices can help managers better understand how their actions affect companywide performance. That understanding, in turn, will translate into a greater sense of responsibility, more motivation, and smarter decisions.

The solution? Augment Generally Accepted Accounting Principles (GAAP) by including in accounting statements whatever data is necessary to answer three questions: 1) How much is this company worth? 2) How likely is it to meet its future obligations? 3) How good are its managers? To answer this last question, CEOs must evaluate and report manager performance on the basis of those financial variables most closely tied to the operating-value drivers (e.g., factory orders or shipments to distribution centers) controlled by individual managers.

Visit us on the Web at:
Harvard Business Online
THE WEBSITE OF HARVARD BUSINESS SCHOOL PUBLISHING
U.S. and Canada: 800-988-0886
617-783-7500 • Fax: 617-783-7555