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Magic Tricks on the Corporate Books

With the stroke of a pen, companies can make themselves appear more financially fit than they are

By Mara Der Hovanesian

Accounting shenanigans bubble to the surface every few years. In the dot-com days the trick was to book virtual revenues. After the tech bust, tinkering with expenses was all the rage. Now forensic auditors and analysts worry that troubled companies are playing fast and loose with asset valuations and cash management.

These recent numbers games, which rely on some familiar techniques, may be the most troublesome yet. Companies that employ aggressive accounting tactics aren't just inflating earnings and cash flow—their motive may also be to hide a true financial picture from lenders to avoid losing credit and other lifelines. "It's not like a penny of earnings-per-share problem," says Mark LaMonte, chief credit officer at ratings agency Moody's Investors Service (MCO). "These things will knock you off the cliff completely." And the gimmicks only underscore the tenuous nature of the earnings recovery, which currently is lifting investors' spirits.

New discretionary accounting rules have made it easier for companies to engage in such behavior. In recent years companies have moved to "fair value" accounting, in which assets are based on current market conditions rather than on historical prices. With many markets like real estate drying up and buyers fleeing, the exercise isn't an exact science. "When it comes to valuation, what one person thinks can be completely different from the next," says John P. Glynn, a partner at PricewaterhouseCoopers who heads the firm's valuation practice. The fear is that companies may be relying on inflated estimates for all sorts of assets, including contracts, commodities, and real estate. If so, some nasty surprises for investors and lenders may be lurking on the books.

DELAYING WRITEDOWNS?

Consider the accounting for boom-time acquisitions. When a company purchases another business, it books any premium paid as an asset called goodwill. Amid the bust, many deals have eroded in value. But corporate accountants, who have a lot of leeway under the accounting rules, may be delaying writedowns until the last possible moment. When they recognize the acquisition-related loss, the hit could be substantial. "We won't see the problem until it's clearly worse than expected," says Richard G. Sloan, a professor at University of California at Berkeley Haas School of Business.

That's just the kind of situation investors in Huron Consulting Group (HURN) could face. The firm, launched by former consultants of the defunct Arthur Andersen Group, snapped up several companies after going public in 2004. Huron's related goodwill: $506.5 million, according to research firm Audit Integrity. But the researchers figure goodwill shouldn't be that high, and estimate Huron has inflated its earnings over the years by $56 million.

The company already restated three years of earnings for compensation issues related to those acquisitions, revising profits during the period from $120 million to $63 million on July 31. The Securities & Exchange Commission is investigating the restatement, according to the company's Aug. 19 earnings conference. Huron says it's cooperating.

To ferret out potential problems, accountants look for companies whose goodwill assets amount to 20% or more of total assets. That's a sign that goodwill is making up an increasingly large portion of the balance sheet—and profits may get whacked later. Goodwill represents more than 65% of Huron's assets. In January, Gannett (GCI) announced a

$7.46 billion writedown on goodwill, which at the time represented 45% of assets.

More companies may run into problems. An Audit Integrity report found that of the 5,514 companies with a market value of more than $100 million, 668 have goodwill assets above the 20% mark. The list includes such debt-burdened businesses as Virgin Media (VMED) and TicketMaster Entertainment (TKTM). Both declined to comment.

ACCRUAL ACCOUNTING

Another warning sign may be a growing pile of "accrued" assets. In so-called accrual accounting, companies recognize a sale or expense when the transaction is made rather than when the cash is exchanged. As a result, cash flows and profits don't always match up. "If it's not cash, there's a high level of uncertainty and subjectivity," says Brent Miller, a forensic analyst at Gradient Analytics.

The concern is that companies are dressing up results by using these tactics. Take Amazon.com (AMZN). Its mainstay business of selling books, DVDs, and CDs was flat in the second quarter. But cash flow looked healthy. (Amazon was set to report third-quarter earnings after *BusinessWeek* went to press.)

Why weren't profits and cash flow in sync? Some analysts speculate that Amazon may be managing its accounts payable, the money it owes suppliers. Analyst Jeffrey B. Middleswart of Behind the Numbers, a research firm for short-sellers, figures that accounts payable amount to 195% of Amazon's inventory—meaning the company is selling the goods to customers long before it pays suppliers. As of the second quarter, Amazon was taking 65 days to pay bills, vs. 58 at the start of the year. Says Colin W. Gillis of research firm Brigantine Advisors: "They make money on the backs of suppliers."

Such moves, Middleswart estimates, accounted for 70% of Amazon's cash flow in the most recent 12 months. "Think of this as a rubber band being stretched," he says. "[The company] cannot maintain the situation." Eventually the company has to pay up, which could crimp cash flow. One analyst said Amazon doesn't have any accounting problems, and "there's some aggressive shorts out there who want to knock it down." Amazon declined to comment.

"DOUBTFUL" REVENUES

On the flip side, some companies may be too optimistic about their delinquent customers. Managers classify those accounts receivables as "doubtful" if they think they won't get paid. They then take a related loss to build reserves. But analysts say some companies are pushing off the day of reckoning by extending the number of days the accounts are considered current.

First Solar (FSLR), an energy equipment manufacturer, may be among those doing so. Roughly one-fifth of its clients are renegotiating contracts to get lower prices, says Middleswart. But First Solar doesn't seem to be recording those accounts as doubtful. The company didn't set aside any reserves for the contracts until the second quarter, when it took a tiny $7 million charge related to accounts receivables. "There is not that much transparency about how they book revenues," says analyst Ben Pang of research firm Caris & Co. "We're concerned if [First Solar] is making the pricing look better near term." First Solar declined to comment.

Pundits can't decide whether the recession is prompting such games or whether these are longtime transgressions just coming to light during tough times. Either way, the problems raise questions about the quality of corporate profits—a situation regulators likely will watch closely. "One of the things people misunderstand is that manipulating accounts doesn't have to be complicated," says Toby J.F. Bishop, director of the Deloitte Forensic Center, an arm of the accounting firm. "It can be done simply with the stroke of a pen."

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