Columbia University
Graduate School of Business
B7313
Securities Analysis

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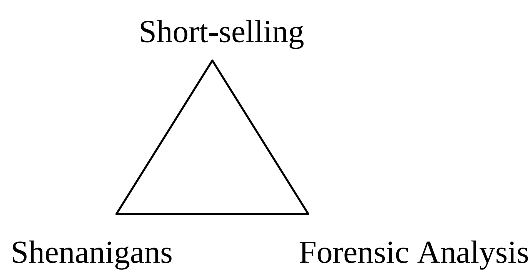
Professor Paul Johnson — pauljohnsonnyc@yahoo.com
Office Hours: By appointment and by telephone. — Office Phone: (212) 293-3402

Shenanigans, Forensic Analysis and Short-selling

Crooks are exposed when they run out of money.
Chris Brown – Tweedy, Brown

The following diagram depicts the interrelation between shenanigans, forensic analysis and short-selling.



Management has the option (and sometimes because of misguided incentive plans, the inclination) to produce misleading financial statements, forcing analysis to be prepared to conduct forensic analysis to uncover the misdeed. When found, the discovery can lead to the decision to sell the stock, possibly even selling the stock short.

The following is how the three pieces fit together.

Shenanigans:

> *Financial shenanigans are actions or omissions intended to hide or distort the real financial performance or financial condition of an entity. They range from minor deceptions to more serious misapplications of accounting principles.* (Schilit)

Management has many options under GAAP from which to choose to record certain economic events. These options are called accounting rules and, when used, are referred to as accounting events. Because the various choices will have differing effects on reported earnings, management may have the opportunity to manipulate their financial results—although they may not exercise that option. Because most management incentive plans have unintended consequences, managements sometimes have the economic inclination to cheat. These transgressions, when the option is exercised, allow companies to enjoy short-term gain, often at the expense of dramatic long-term pain. Not withstanding the recent barrage of news reports on this topic, the majority of all companies do not “cook-the-books;” these transgressions are the exception to the rule. However, the impact from these misstatements (potentially even fraudulent behavior) can be quite painful to shareholders; therefore, it is critical to understand these shenanigans so that when they do appear the analyst can identify them quickly.

The following “shenanigans” all enable management to manipulate net income—an accounting event; although they have no impact on the underlying economic events.

Seven Major Shenanigans (from Schilit):

1. Recording revenue before it is earned
    A. Shipping goods before a sale is finalized
    B. Recording revenue when important uncertainties exist
    C. Recording revenue when future services are still to be done
2. Creating fictitious revenue
    A. Recording income on the exchange of similar assets
    B. Recording refunds from suppliers as revenue
    C. Using bogus estimates on interim financial reports
3. Boosting profits with non-recurring transactions
    A. Boosting profits by selling undervalued assets
    B. Boosting profits by retiring debt
    C. Failing to segregating unusual and nonrecurring gains or losses from recurring income
    D. Burting losses under non-continuing operations
4. Shifting current expenses to a later period
    A. Improperly capitalizing costs
    B. Depreciating or amortizing costs too slowly
    C. Failing to write-off worthless assets
5. Failing to record or disclose liabilities
    A. Reporting revenue rather than a liability when cash is received
    B. Failure to accrue expected or contingent liabilities
    C. Failure to disclose commitments and contingencies
    D. Engaging in transactions to keep debt off the books
6. Shifting current income to a later period
    A. Creating reserves to shift sales revenue to a later period
7. Shifting future expenses to an earlier period
    A. Accelerating discretionary expenses into the current period
    B. Writing off future years’ depreciation or amortization

One of the most powerful insights used in forensic analysis is that accounting events can be manipulated more easily that the cash transaction that accompanies the economic event. Therefore, in most cases (with the possible exception of fraud), "cash flows" tell the true story of the economics and the discrepancy between the "accounting event" and "cash flows" from the event expose all sins. In addition, remember that it is much easier to manipulate the income statement or the balance sheet in any given accounting period; it is exceedly difficult to manipulate <u>both</u> statements at the same time.

Costs and liabilities are rarely overstated.
Seth Klarman

Forensic Analysis

> *Management's behavior is affected by rewards and punishments. Since many companies offer bonuses and stock options based on financial statement measures, executives and managers are motivated to report more favorable financial results.* (Schilit)
>
> *Detection is, or ought to be, an exact science, and should be treated in the same cold and unemotional way. When you have eliminated the impossible, whatever remains, however improbable, must be the truth.* (Sir Arthur Conan Doyle)

Managers select accounting methods from a variety of acceptable choices. As a direct consequence of the "flexibility" inherent in GAAP, accounting numbers can never be taken on face value. Forensic analysis is the art of dissecting these numbers in search of the true economic events at a company. In general, companies which elect to take a more conservative stance toward their accounting policies cause few problems for investors. In general, managements rarely understate their performance since compensation usually is based on financial performance. Therefore, much of the focus of the forensic analysis will be on trying to detect the slippage toward sloppy, misleading and inaccurate, possibly even fraudulent, accounting practices. Analysts must maintain a healthy skepticism toward all financial reporting in order to make prudent economic decisions. Shenanigans can occur in companies of any size, public or private, young and old. Therefore, analysts must be on the look-out at all time.

The most likely candidates for shenanigans: fast-growth companies whose real growth is beginning to slow; basket-case companies trying to survive; newly public companies; and private companies.

Why is it called forensic analysis? The following quote highlights the origin of the name.

> *It seems to me that there is a close analogy between the education of a medical doctor and the education of a professional accountant. The objective of a medical autopsy is simply to learn what went wrong, and to make a judgment as to what might have been done differently. The medical profession tries to learn from those failures, to expand the list of answers. Unfortunately, the financial reporting process sometimes fails too… We*

must find a way for accounts to use those financial reporting failures in the expansion of our knowledge base.[1]

Major areas for forensic analysis (from O'Glove):

1. Differential disclosure
2. Nonoperating and/or nonrecurring income
3. Revenue recognition
4. Operating expenses and accruals
5. Taxes – paid versus reporting
6. Accounts Receivables and Inventories
7. Cash flow analysis – NOPAT
8. Accounting changes
9. Restructuring – the "Big Bath"

Because of the tight linkage between cash generation and "real" economic events, tracking cash flows from a business may be the most effective tool in the forensic toolbox. It is exceedingly difficult for management to manipulate (short of fraud) a company's reported cash flows.

FOLLOW THE CASH!

Short-selling

> *Bears can make money only if the bulls push up stocks to where they are overpriced and unsound. Bulls always have been more popular than bears in this country because optimism is so strong a part of our heritage. Still, over-optimism is capable of doing more damage than pessimism since caution tends to be thrown aside. To enjoy the advantage of a free market, one must have both buyers and sellers, both bulls and bears. A market without bears would be like a nation without a free press. There would be no one to criticize and restrain the false optimism that always leads to disaster. (*Bernard Baruch[2])

As a direct link to the search for the misleading accounting practices, much of the result of the forensic analysis will be aimed at selling or selling-short securities, primarily equities. If the analysis leads to the conclusion that expectations are too high and the analysis has uncovered potential shenanigans, the stock should be sold. If the behavior involved is egregious, the analysis may lead to the decision to short the stock. Think of the final step as selling the stock twice!

See additional handout for specific details on short-selling.

History:

The history of financial shenanigans is colorful, but somewhat scarce.

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[1] Robert J. Sack, former chief accountant of the Division of Enforcement at the SEC.
[2] From The Art of Short Selling

The father of forensic analysis is Abraham J. Briloff, Emmanuel Saxe Distinguished Professor of Accountancy, Bernard M. Baruch College of the City University of New York. His three books are:

Unaccountable Accounting (1972)
More Debits than Credits (1976)
The Truth about Corporate Accounting (1976)

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Schilit, Howard M., Financial Shenanigans, (McGraw-Hill, Inc., 1993)

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O'Glove, Thornton L., Quality of Earnings, (The Free Press, 1987)

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Hagstrom, Robert G., The Detective and the Investor, (Texere, 2002)

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Staley, Katherine F., The Art of Short Selling, (Wiley, 1997)
Arsenio, Manuel P., Sold Short, (Wiley, 2001)
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Still:

Cash – Mumford
Governance – Lew Simpson
Short-selling – develop