

## It's all about CHOICE

When the going gets tough, some companies open a new bag of accounting tricks.

**E**xperience has told us that when the economy turns bad, it's time to expect more accounting shenanigans from public companies. This can happen in three ways.

Sometimes, a company has been using aggressive accounting for years, and a dismal economic picture makes it difficult to hide the old chicanery any further. Other times, a firm decides to use accounting tricks to mitigate the impact of poor operating results. And then there are the opportunists, who use financial reporting to make bad times seem even worse, knowing that when the economy turns around, they can undo some of their overly negative accounting assumptions—and look all the better moving forward.

This makes it an ideal time to review some of the potential accounting misfortunes that might befall investors as the economy sours. It is not possible to recall all the accounting tricks that have appeared in this column over the past decade. However, there is a very useful mnemonic we provide to our investment adviser clients to remind them of the major areas in which to expect accounting manipulation. The acronym we use with them is CHOICE, which stands for:

- Capitalized expenses
- Hidden asset impairments
- Off-balance-sheet liabilities
- Inflated revenue
- Cookie jar liabilities
- Executive compensation

Start with capitalized expenses. Companies can easily inflate income by taking interest, overhead and customer acquisition expenses, and turning them into assets on the balance sheet. It's simple and easy to do, so beware.

With hidden asset impairments, executives can choose valuation techniques that continue to keep inflated figures on



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and benefit through share-based compensation. Now that we're in a bear market, however, we might see the opposite take place: making the situation look worse than it is. The purpose would be to have new performance targets set at artificially low levels, which can then be easily met by reversing some liability reserves or resetting some key accounting assumptions.

The key to uncovering potential accounting manipulation in the stocks that you or your clients own is to remember the amount of CHOICE that executives have when it comes to reporting financial results. ■■

the balance sheet, whether it's intangible assets and goodwill, or financial instruments that have been valued using internal models instead of market prices. The aim is to keep income and the balance sheet inflated.

Off-balance-sheet liabilities are a major area that investors tend to ignore, because they incorrectly believe that loopholes were closed post-Enron. In fact, this area has the biggest impact when it comes to valuation, and includes operating leases, pension liabilities, asset securitization and other obligations that make balance sheets appear healthier than they should.

Inflated revenue can be a hornets' nest, because it is one of the less transparent accounting areas. Nevertheless, it represents a high risk to investors when companies decide to stuff the channels, carry uncollectible receivables, set inadequate return allowances or engage in other questionable practices.

Cookie jar liabilities include the oldest, most widely known and most easily employed accounting tricks in the book. What could be simpler than taking an overly negative liability reserve or valuation allowance in good times, and storing it for an artificial boost during a down quarter?

Executive compensation is actually the key to the whole process. Without the ability of management to benefit from their shenanigans, most misleading financial reporting would not exist. In a bull market, dishonest executives will attempt to continue pumping up results to meet accounting-based performance targets, or to inflate their company's stock price

