# Detecting Financial Shenanigans[1]

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Financial irregularity cases are big business for plaintiffs and destroy an insurer's loss ratio like no others, with a median cost of $10 million for improper accounting practices cases, $8.8 million for revenue recognition cases, and $4.5 million for revenue restatement cases.[3] Yet the pressures on financials have never been greater- privately held companies are looking to cash in by going pubic; publicly traded companies are under pressure to meet street expectations and analyst predictions; and the prospects of mergers and acquisitions raises the stakes even more.

For these and other reasons, accounting cases are on the rise; approximately half of all lawsuits brought against companies and executives are brought by shareholders, and over half of the cases arise out of financial irregularities.[4] Hence, these claims are very much a reality today, characterized by increasing volume and cost.

Compounding matters, accounting irregularities are the harbinger of other claims. Companies in financial trouble may well undertake other sensitive activities such as employee reductions in force, reduction in benefits or pay, termination of outside contracts, or reversion of assets from E.R.I.S.A. plans, all of which can lead to claims under directors' and officers', employment practices liability, fiduciary liability and employment practices liability policies, not to mention other forms of errors and omissions liability policies.

As such, it is imperative that underwriters identify accounting trouble before binding coverage. The problem is that most underwriters are neither accountants nor financial experts. To assist in their endeavors, the following highlights the top ten warning signs of accounting deterioration.

I. Overstated Revenue

Revenue can be falsely inflated in three major ways:

1. Recording Revenue Too Early
Revenue can be recognized early by shipping goods before a sale is final; recording revenue in spite of material uncertainties; and recording revenue even though future services are owed.

2. Recording False Revenues
Revenue that is not really revenue can be recorded by recognizing income on a mere exchange of similar assets, by recording refunds received from suppliers as revenue, and by giving false estimates on interim financial reports.

3. Inflating Income with One-Time Gains
Recognition of non-recurring, one-time gains can falsely inflate income. This can be accomplished by selling undervalued assets, which increases profits; by retiring debt; by failing to set aside nonrecurring activities

from recurring activities, and by burying losses under noncontinuing operations.

II. Under-Reported Expenses

Expenses can be understated by:

4. Moving Current Expenses to a Later Period

Recognition of expenses can be put off to later periods by improperly capitalizing costs, depreciating or amortizing costs too slowly, and failing to write off worthless assets.

5. Failure to Disclose Liabilities

Nondisclosure of liabilities can be accomplished by reporting revenue upon receipt of cash before rendering services; failing to accrue expected or contingent liabilities; failing to disclose commitment and contingencies; and doing things to keep debt off the books.

III. Shifting

Moving expenses and revenue can improperly increase the bottom line:

6. Moving Current Income to a Later Period

A company can create reserves and release them in a later period. For example, analysts may predict that a company will hit $1.00, but the company actually brings in earnings of $1.10. The company can save the extra earnings for a later period when they may need to mask greater losses. They can do this by reporting earnings of only $1.00 and setting up $ .10 in a reserve fund. This not only preserves the money for later, but also protects the sell side analysts who predicted $1.10.

7. Moving Future Expenses to the Current Period

A company can gain expenses from the future by accelerating discretionary expenses into the current period and by writing of future depreciation and amortization in the current year.

IV. Other Red Flags

Also watch out for:

8. Erosion of gross margins, a sign of things to come;
9. Sequential revenue growth; and
10. Net income gains from non-core operations.

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[1] From Dr. Howard M. Schilit, *Financial Shenanigans: How to Detect Accounting Gimmicks and Fraud in Financial Reports*, (McGraw Hill, 1993).

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[3] Bajaj, Mazumdar, Sarin, *Securities Class Action Settlements: An Empirical Analysis*; available at http://securities.stanford.edu.

[4] Tillinghast-Towers Perrin, *2000 Directors' and Officers' Liability Survey*; PriceWaterhouseCoopers, *2000 Securities Litigation Study.*