Tricking Investors With Merger-Related Accounting Shenanigans

By Howard Schilit

Article Highlights

- Though accounting rules require the write-off of investments when their value becomes impaired, companies can trick investors by shifting write-offs into the future.
- Since buyers and sellers have great flexibility in structuring a deal, investors should be wary if revenue (or a gain) is recorded when assets are purchased—especially if the seller pays anything to the buyer.
- Reserves created during the closing process of an acquisition can be used to artificially boost net income later, including when the acquired company performs worse than expected.

Japanese camera maker Olympus Corp. was aggressively diversifying its business in the 1980s and early 1990s.

Since they confidently believed these new investments would add much value to the company, the investments were properly listed as assets on the balance sheet. Unfortunately, that optimism was misplaced and most of these investments proved to be worthless.

What to do? Accounting rules require the immediate write-off of assets as soon as their value becomes impaired. Olympus either chose to ignore this rule or had tremendous optimism that the value of its investment would soon recover. Regardless of the reason for failing to write off the investments and instead keeping them on the balance sheet, Olympus was improperly inflating profits by using an earnings manipulation (EM) shenanigan, shifting current expenses to a later period.

The EM Shenanigans box to the right lists the seven categories of earnings manipulation shenanigans. The first five EM shenanigans inflate current-period profits: numbers 1, 2 and 3 do so by inflating revenues or gains; numbers 4 and 5 inflate current-period profits by deflating costs, expenses or losses. In contrast, the last two EM shenanigans (numbers 6 and 7) have the opposite goal—they deflate current-period profits, but the purpose is to inflate future-period profits.

Earnings Manipulation (EM) Shenanigans

Some dishonest corporate executives hurt investors by misrepresenting their company's actual performance using the following manipulation tricks.

EM Number 1: Recording Revenue Too Soon
EM Number 2: Recording Bogus Revenue
EM Number 3: Boosting Income Using One-Time or Unsustainable Activities
EM Number 4: Shifting Current Expenses to a Later Period
EM Number 5: Employing Other Techniques to Hide Expenses or Losses
EM Number 6: Shifting Current Income to a Later Period
EM Number 7: Shifting Future Expenses to the Current Period

The first five *inflate current-period profits*. The last two deflate current-period profits with the purpose of *inflating future-period profits*.

Source: "Financial Shenanigans," 4th Edition, McGraw-Hill Education, 2018.

Covering Up the Trick With Acquisition Accounting Shenanigans

Olympus tricked investors into believing their investments were still sound, using EM number 4, which inflates profits by shifting any possible write-off to tomorrow. As the bad investments grew to an uncomfortably large amount (and it became easier for investors to notice the problem), Olympus knew it had to find another trick to make the balance in its investment account disappear.

What to do? Management must have known that they would soon get caught, so they found a clever way to hide the problem (and cover up the first accounting trick, EM number 4). They used an acquisition accounting (AA) shenanigan. Olympus made a series of strange acquisitions, recording a new asset called goodwill and reducing the bloated investment account balance, all under the hard-to-spot cover of acquisition accounting.

Olympus' Massive Fraud Cover-Up

In October 2011, when Olympus fired its newly appointed CEO, Michael Woodford, it was revealed that the company had been operating a *tobashi* scheme (a scheme that makes problems "fly away," in Japanese) in which $2 billion was said to have been siphoned off to cover bad investments made up to 20 years earlier.

Around 2008, Olympus bought three companies and paid far more than they were worth, according to Woodford. The inflated price (totaling a whopping 30% of the deal value) was labeled "fees to a middleman." Woodford pointed out that the cut for investment bankers typically would be 1% to 2%, so the $674 million paid on the $2 billion deals likely was a payment to cover losses and move the investments from the balance sheet to an unconsolidated, related-party entity.

In summary, Olympus fraudulently was inflating profits by hiding losses at the time of closing acquisitions. (See EM number 3.)

Acquisition Accounting (AA) Techniques to Artificially Boost Revenue and Earnings

Serial acquirers have mastered the art of convincing investors of an optimistic future after a merger close. A handy way of doing this is through the following techniques.

AA Number 1: Inflating profits through tricks at the target company before the deal closes
AA Number 2: Inflating profits by hiding losses at deal closing
AA Number 3: Creating dubious new revenue streams after closing deal
AA Number 4: Inflating profits by releasing suspicious reserves either before or just after closing

Source: "Financial Shenanigans," 4th Edition, McGraw-Hill Education, 2018.

The AA Techniques box above lists four techniques that companies sometimes use (under the cover of an acquisition) to artificially boost revenue and earnings.

While the combination of earnings manipulation shenanigans followed by acquisition accounting shenanigans covered up a massive fraud that doomed Olympus, the following examples provide techniques showing how easy it is to use these tricks, even when no major fraud exists. They describe acquisition accounting tricks to inflate revenue and profits.

Inflating Profits at the Target Company Before the Deal Closes

Investors at Valeant Pharmaceuticals (VRX) would have found a very puzzling pattern had they paid close attention to the revenues of the company's acquisition targets just prior to consolidation. In several cases, reported revenue at the target company slowed down dramatically compared to prior periods, just before the deal closed. No example, however, was more extreme than at Salix, a company Valeant acquired April 1, 2015. Table 1 shows Salix's quarterly sales from 2013, 2014 and 2015. Notice a few interesting patterns in the numbers: (1) during the last three quarters of 2013, sales were virtually unchanged; (2) during the first quarters of 2014 (when Salix management began actively shopping the company), sales grew rapidly compared to the same prior-year periods; (3) during the last quarter of 2014 and first one of 2015 (when Valeant was in the process of closing the Salix acquisition), sales completely dried up; and (4) in the last three quarters of 2015 (after Valeant acquired Salix), sales grew dramatically.

Let's dig a bit deeper to make sense of these strange numbers and trends. Starting in 2014, Salix made a strong push to report terrific sales growth to maximize the share price an acquirer would pay for the company. Trying to spruce up the financial statements before a deal might be fairly common, but stuffing inventory to distributors that have no customers to buy those products (an example of EM shenanigan number 1) goes a bit too far. Indeed, this aggressive channel stuffing caught the attention of regulators at the U.S. Securities and Exchange Commission (SEC) and eventually cost the company's CEO and CFO their jobs.

The accounting games were far from over. In the fourth quarter of 2014, for example, Salix reported almost no sales at all—a mere $13 million. So, compared to the same quarter in 2013, sales declined an unbelievable 95%. How is that even possible? We can think of only two possible explanations: (1) the numbers reported are correct and Salix's business

Table 1. Quarterly Revenues for Salix

The revenues for Salix grew rapidly during the first three quarters of 2014 when Salix's executives were actively shopping the company to potential acquirers. Revenues then fell dramatically in the fourth quarter of 2014 and in the first quarter of 2015 as Salix was in the process of being acquired by Valeant. After the acquisition was completed on April 1, 2015, sales grew over the remainder of the year.

	Quarter-Ending Revenue ($ Mil)			
Year	March	June	September	December
2013	203	235	239	238
2014	403	376	342	13
2015	0	313	461	497

Source: "Financial Shenanigans," 4th Edition, McGraw-Hill Education, 2018.

must have completely imploded—a very unlikely scenario as Valeant chose not to abort the deal, or (2) the numbers reported by Salix must have been rigged and they had intentionally refrained from booking any business during the fourth quarter of 2014 to allow Valeant to include that revenue in the periods after the deal closed on April 1. This trick is called "spring-loading" revenue to a later period.

After the deal closed, Valeant booked a whopping $1.3 billion (averaging $424 million per quarter) in Salix product sales over the remaining three quarters of 2015. While we claim no "smoking-gun" evidence to prove inflated revenue at Valeant from spring-loading sales, the numbers in Table 1 look quite convincing.

Creating Dubious New Revenue Streams After an Acquisition

Both buyers and sellers of businesses have great flexibility in structuring a deal to create dubious future revenue streams. One trick we have seen is to cleverly create a bogus recurring revenue stream by bundling a seemingly unrelated agreement into the acquisition accounting. Indeed, FPA Medical Management (FPAM) appears to have done just that.

In 1996, FPAM paid $197 million to nursing home operator Foundation Health to purchase a group of medical facilities. As part of the acquisition, however, FPAM guaranteed that Foundation Health's patients would receive continued and uninterrupted access for the next 30 years. In exchange, Foundation Health (the seller) agreed to pay FPAM $55 million in rebates over the next two years. As FPAM received the $27.5 million payment each year, it recorded these amounts as sales revenue. As we thought through the essence of this transaction, we considered it quite aggressive by FPAM to record any sales revenue for the transaction. In real economic terms, FPAM paid $197 million for the medical facilities and received a $55 million rebate over two years, resulting in a net acquisition cost of $142 million and zero revenue on this deal. Investors should be wary if revenue (or a gain) is recorded when assets are purchased. It is far more logical to expect revenue (or gains) to be recorded when assets are sold.

The key lesson for investors is to first spot such an unorthodox new revenue stream and conclude that if the "seller" of a property pays anything to the "buyer," the amount received should be viewed as an adjustment to the purchase price, not as a new revenue stream.

A different trick to watch for after a deal closes is when the acquirer changes accounting practices of the target company, resulting in inflated profits of the acquirer.

Indeed, one of Valeant's many tricks involved using acquisition accounting as a "cover" to make a variety of accounting policy changes at the target company—just after the deal closes. Indeed, the aggressive increases in the pricing to the new drugs acquired (in some cases over 500%) led to an outcry from Congress and others to curtail this horrible practice. But in the less noticed financial statements, Valeant found ways to immediately boost sales (as the Salix story also revealed).

Just after closing an acquisition of Medicis Pharmaceutical at the end of 2012, Valeant changed the revenue recognition policies, resulting in sales being recorded at an earlier point—making Valeant's sales appear to be growing faster. Specifically, Medicis sold through its distributor, McKesson Corp., which then sold to its customer, the physicians. Medicis historically used the more conservative "sell-through" approach, that is, booking no sales until the distributor sold to the physicians. To goose sales at the Medicis unit after the deal closed, Valeant had Medicis immediately switch to the more aggressive "sell-in" approach and started recognizing sales much earlier—when product was sent to the distributor. Not surprisingly, this brazen change caught the attention of the SEC, which notified the company in a formal letter and asked it to explain any reason for this change.

Inflating Profits by Releasing Suspicious Reserves

During the closing process of a deal, a variety of new opportunities are created for management to provide an artificial boost to net income at a later point. For example, management can take a charge for layoffs or projected legal payments and later release part of these reserves back into income, as management deems such payments will be much less than first anticipated. This trick was widely used at two of the biggest frauds over the last quarter century (WorldCom and Cendant). The creation of bogus reserves at the time of acquisition and subsequent release of such reserves whenever needed created billions in fictitious profits.

While far less troubling than these colossal frauds, games with deal-related contingency reserves can also create myths of stupendous jumps in operating profits. Here's how it works.

Let's assume you buy a business paying $60 million cash and later might have to pay an "earn-out" for as much as another $40 million if the acquired

Approaching Financial Statements With a Forensic Mindset

Howard Schilit and his "Financial Shenanigans" co-authors Jeremy Perler and Yoni Engelhart believe a key to spotting accounting manipulation stems from having a different mindset than most analysts. Listed below are some of the key elements needed to detect accounting gimmicks and fraud in financial statements.

Skepticism Is a Competitive Advantage

Corporate issuers of stocks and bonds are incentivized to announce good news. Investors who can remain objective and skeptical have a better chance of profiting from the more blatant disconnects from reality.

Pay Close Attention to Changes

Always ask "Why?" and "Why now?" Many of the insights highlighted in "Financial Shenanigans" came from noticing changes in accounting practices, policy disclosures, balance sheet trends, key metrics, customer payment terms, leadership and auditors. Management often gives flattering and rational explanations to convince investors not to be concerned. Ask what prompted the change and why the change is being made now.

Look at Past Accounting Problems to See If Business Practices Are Being Covered Up

When questions arise about inappropriate accounting practices, investors should seek to identify how these accounting practices have served to hide problems in the underlying business.

Pay Attention to Corporate Culture and Watch for Breeding Grounds of Bad Behavior

Weak checks and balances, an autocratic CEO and a culture of meeting targets at all costs are among the elements that increase the risk of shenanigans.

Never Blindly Accept the Company's Profitability Framework

Non-GAAP metrics such as earnings before interest, taxes, depreciation and amortization (EBITDA), underlying business profit and adjusted earnings can provide a valuable supplement to GAAP (generally accepted accounting principles) figures. In many cases, however, they leave out important aspects of a company's cost structure. Consider how well those alternative metrics actually reflect the full economics of the company.

Pay Close Attention to How the CEO Is Compensated

The performance targets that executives' compensation is tied to will inevitably shape their strategy for the company.

Even in Financial Disclosures: Location, Location, Location

Sections of filings containing information that is too technical or boring for most readers can contain information that is relevant to the health of the business. These back sections can be used to hide disclosures from investors.

As in Golf, Every Shot Counts

Companies that regularly encourage investors to ignore certain expenses or outflows are asking for a "mulligan" (a free shot). Those should only be accepted in very rare cases.

Patterns of Behavior Provide a Reliable Signal

Executives who use aggressive accounting methods at one company are apt to do the same at a subsequent company. If a metric signals a questionable accounting practice, look to see if a revenue or earnings shortfall followed similar behavior in the past.

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business achieves certain agreed-upon targets. That $40 million would be recorded as a "contingent consideration liability" on the balance sheet.

Say, one year later, the business performs below expectations and the expected payout drops from $40 million to $30 million. You must make an accounting entry reducing (debiting) the contingent consideration reserve and reducing (crediting) operating expenses, which results in a $10 million increase to earnings. On the face of it, the outcome seems illogical. You increase your profits when the business you bought underperforms. From an accounting perspective, however, the reduction of the future earn-out is considered a gain.

If a company wants to play games with contingent consideration reserves, it is quite easy to do so. Both inflating the initial fair market value of the total estimated payment to be made and later asserting that the acquired business is performing poorly (and little or no future payments will be made), management, like a master magician, can take out its wand and create profits out of thin air.

And, speaking of magic, no better tool exists than acquisition accounting to give the reported operating cash flows a nice shot in the arm.

Concluding Thoughts

Corporate financial scandals have

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Vanguard Mid-Cap Value ETF (VOE)

This ETF tracks the CRSP U.S. Mid Cap Value Index, which targets stocks representing the value and lower-growing half of the mid-cap market and weights the stocks by market capitalization.

CRSP classifies value securities using book to price, forward earnings to price, historic earnings to price, dividend-to-price ratio and sales-to-price ratio. To measure growth, CRSP looks at future long-term growth and short-term growth in earnings per share, historical growth in sales and earnings, current investment-to-assets ratio and return on assets.

Historically, mid-cap value has had higher returns than large stocks or mid-cap growth stocks. The ETF is weighted at 30% of the portfolio.

Vanguard Real Estate ETF (VNQ)

The Vanguard REIT ETF is transitioning to a new tracking index. As of February 1, 2018, the fund is temporarily tracking a transition benchmark, MSCI U.S. Investable Market Real Estate 25/50 Transition Index. This change is intended to minimize impact to the fund as it moves to its destination index, MSCI U.S. Investable Market Real Estate 25/50 Index, sometime in the third quarter of 2018. Prior to this, the Vanguard REIT ETF tracked the MSCI U.S. REIT Index, which includes domestic-equity REITs, or firms that manage properties. The index doesn't include mortgage REITs or specialty REITs.

Under the new index, investors in the ETF will still have exposure to equity REITs and will also gain exposure to certain specialized REITs as well as real estate management and development companies. The fund's name also changed from Vanguard REIT Index to Vanguard Real Estate to reflect is broader reach.

Historically, the returns of real estate investment trusts (REITs) have exceeded the returns of the S&P 500 over the long run and provide diversification as well.

The ETF is weighted at 10% of the portfolio.

Portfolio Management Notes

For the Level3 Passive Portfolio, the initial weightings are as previously indicated and shown in Table 2. The approach to rebalancing is to keep it to a minimum.

While momentum is less of a factor with funds than it might be a factor with stocks, and transaction costs for funds are much less than they are for stocks, rebalancing frequently is a distraction and can make taxes a significant consideration.

You should be able to achieve almost all the rebalancing necessary when you add and withdraw funds or when changes are made in the holdings.

Rebalancing decisions will have to be made by the individual since every investor will add or have added assets at a different time, so everyone's weights will be different. But the following are some general guidelines:

- Don't rebalance any holding unless you have held it for over a year.
- If a holding is 25% below where it should be in relation to the planned weight, bring it back to the appropriate level by selling some overweighted holdings to provide funds.
- If a holding is 33% above where it should be in relation to the planned weight, bring it back to the appropriate level by selling the excess and using the funds to buy underweighted holdings.

The next review of the Level3 Passive Portfolio will be in the November 2018 *AAII Journal*. ▲

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been around for as long as corporations and investors themselves have been. Dishonest management has preyed on unsuspecting investors, and it is time for investors to redouble their efforts to be alert for such shenanigans, so they can protect themselves.

Since shenanigans, at their most basic level, represent management's attempt to put a positive spin on a company's financial performance and economic health, our universal message is that investors should assume that the urge to exaggerate the positive and hide the negative will never disappear. And where temptation exists, shenanigans often follow. ▲

Howard Schilit is the founder and CEO of Schilit Forensics LLC. He is also co-author with Jeremy Perler and Yoni Engelhart of "Financial Shenanigans: How to Detect Accounting Gimmicks and Fraud in Financial Reports" (McGraw-Hill Education; Fourth Edition, 2018). Find out more about Schilit at www.aaii.com/authors/howard-schilit.