

September 27, 2002

## **Financial Chicanery – Part 5 of a 12 Part Series - Moving Current Expenses to a Later or Earlier Period**

### **Previous Parts**

May Report	<b>Part 1</b> Financial Chicanery Techniques
June Report	<b>Part 2</b> Identifying “Red Flags”
July Report	<b>Part 3</b> Recording Bogus Revenue
August Report	<b>Part 4</b> Recording One-Time Gains

### **Moving Current Expenses to Different Periods**

The objective behind moving current expenses to a different period is to boost profits by excluding expenses. Techniques commonly used in reducing current expenses include the following:

1. Understating reserves against assets
2. Capitalizing normal operating costs
3. Changing accounting policies and moving current expenses to an earlier period
4. Failing to write down impaired assets

### **Understating reserves against assets**

Certain asset accounts are routinely adjusted to properly reflect their value on a company’s financial statements. These include receivables, inventory, capital assets, intangible assets and taxes. Taking reserves against assets, however, is not restricted to these kinds of asset categories. Any asset may qualify. Reflecting the right amounts of reserves can be more of an art than a science. When doing so, a practitioner must use his good judgment. While adhering to professional norms, he should also not be afraid to adopt a different path if that would produce better (fairer) financial statements.

Professionalism is about making good judgments in the circumstances. In this respect, a great amount of leeway exists to manipulate these reserves. A client looking to enhance earnings or reduce losses has many available avenues. Based on recent cases, typical red flags to look out for are as follows:

#### **“Red Flags”**

- A decrease in reserves as the related assets increase
- An absence of asset reserves where they should exist
- A change in the calculation or inputs governing their recording
- A reversal of questionable reserves from prior periods
- A change in the reflection of credits within the reserve account

#### **Capitalizing normal operating costs**

The capitalization of normal operating costs inflates a company's assets and understates its expenses. A prime example of this is WorldCom. Today the company's CFO and president are facing criminal charges related to their capitalization of almost \$7 billion in expenses. Based on a number of recent cases, the following appear to be the most prevalent use of this tool:

#### **“Red Flags”**

- Capitalizing of marketing and solicitation costs
- Capitalizing of software and research and development costs
- Capitalizing of a disproportionately large amounts of software
- Beginning to capitalize software costs after expensing them for years
- Capitalizing store pre-opening costs
- Capitalizing of repair and maintenance costs

#### **Changing accounting policies and moving current expenses to an earlier period**

This is difficult to accomplish without detection, but may become relevant for new clients and engagements. The rationale is that they were audit adjustments that were not previously booked. Obviously practitioners have to be careful with these kinds of changes.

#### **Failing to write down impaired assets**

With the advent of the goodwill and intangible asset and long-term asset standards, much more investigation will need to be directed at these areas. What used to be a fairly safe area to examine, can now be a land mine. The principals inherent in FAS 140 and 141

represent good guidelines for following to evaluate impairments. When an asset is permanently impaired, management must write down that asset to reflect its current value. (The asset's book value exceeds the amount that is expected to be realized through its use or sale.)

### **“Red Flags”**

- Be on the lookout for indicators of asset impairment. The existence of appraisals does not relieve the auditor of his duty to evaluate the assumptions and calculations inherent in appraisals. The best approach is to use and document one's good judgment.
- Be on the lookout for worthless investments that have not been properly written off (non-temporary declines).

The goal in moving expenses to different periods is simply to make the current periods look good. This may be done for a variety of reasons: to meet analyst expectations, impress bankers or investors, personal financial gain (financial performance is tied to compensation), to avoid violating a loan covenant, etc. In order to be able to detect such manipulation, the auditor needs to consider each of the items above.