A Guide To Earnings Abuses: Investors Have To Sort Through Myriad Reporting Methods To Come Up With A Company's True Results. It's A Challenge Worthy Of The Greatest Sleuths.

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When stocks caught fire in the late 1990s and companies went looking for a way to keep them hot, aggressive accountants became the Dr. Feelgoods of the capital markets.

When earnings multiples shot unsustainably high, financial wizards just increased earnings by ignoring costs. When executives promised the market double-digit revenue growth, the bookkeepers were enlisted to cram everything into revenue and bury the details in footnotes.

Most analysts believe many of today's most common earnings abuses got their start in the technology industries, where businesses are loaded with intangible assets and investors often must take a leap of faith paying a huge premium for an ownership stake in little more than a novel idea. Aggressive accounting now spills far beyond the tech sector.

Accounting gymnastics cross almost every sector line, from Assante Corp.'s EBITDA excluding "special" charges to Krispy Kreme Doughnuts Inc.'s "synthetic" leases employed to create the appearance of lower debt and depreciation costs.

For investors, there are numerous swamps into which conventional accounting rules can sink:

REVENUE ABUSE

Revenue recognition became a common funhouse mirror when techs took flight.

Generally accepted accounting principles (GAAP) rules say that when a company is paid for a service or product to be delivered over time, that revenue must be recorded in financial statements over the life of the contract, even if the customer pays up front.

Certicom Corp., for example, used to charge its clients a one-time licensing fee for access to its software. In its pro forma earnings statements it would book all that revenue as it was collected despite the fact that it was obligated under GAAP to amortize it over time. When the company switched to a subscription based service last year, bringing its collection practices in line with GAAP accounting, its stock plunged and analysts cut their ratings.

360networks Inc., the bankrupt Vancouver fibre-optic network company, also released pro forma earnings reports claiming up-front revenue from long-term contracts. But when the market collapsed quickly, investors were surprised to know that much of the revenue on its books was for services never rendered.

COOKIE JAR ABUSE

In the cookie-jar approach, companies take excessive acquisition-related charges in good times, creating a pool of money that can be drawn upon to boost earnings and meet analysts' expectations when business turns cold. Xerox Corp. is now under investigation by the U.S. Securities and Exchange Commission after a former finance employee alleged the company set

up this type of contingency reserve, and improperly booked revenue for years. Xerox maintains the irregularities were confined to its Mexican operations, and have since been fixed.

GROSS V. NET

But few companies played the revenue game better than the now-infamous dot-coms. Analysts promised the Internet would break all the conventions of how the world communicates, and along the way it broke a few accounting conventions too.

Take Priceline.com, for example. The online travel agency's revenue figure represents the total value of all the airline tickets sold and other products sold through the site, despite the fact that most of those revenues actually belong to the airlines. Several others, including Canada's Bid.com, were criticized for doing the same thing.

In Priceline's case, the difference between gross revenue and the company's sales commission was huge. In 1999, the site had gross revenue of US$482.4-million, but Priceline's take of that was just US$72.8-million. Canadian auction site Bid.com and others used the same approach in their financial reports, often making their shares look less expensive than they actually were.

Priceline's finance officials dismissed the discrepancy, because it makes no difference to the company's bottom line. But at the height of the Internet craze, few companies (including Priceline) were profitable, so almost all analysts and investors were valuing the stocks on the basis of revenue growth.

Then there's Amazon.com. The granddaddy of online retailers sold advertising space on its Web site to other dot-coms, sometimes accepting stock as payment. That stock was booked as revenue, despite the fact that the value of those payments was highly volatile. The practice is legal, but some accounting experts have said it's a dangerous approach for shareholders because the value of that dollar this quarter may be very different next.

COUPON ABUSE

Then there's the case of CDNow, an online music store that attracted the ire of accountants thanks to its coupon promotions.

Most companies exclude the value of giveaways when booking revenue, but CDNow found a more flattering approach.

For example, let's say someone buys CDs for $30, and uses a $10 coupon to make the purchase. Normal accounting practices dictate that just $20 of revenue is booked. But CDNow booked $30 in revenue and incurred $10 in costs under marketing expenses. The result? Higher sales, better coverage from financial analysts, and an inflated share price.

GOODWILL OR ILL WILL?

Those inflated stock prices were the catalyst for a flurry of huge acquisitions in the late 1990s, and that gave rise to a massive increase in so-called "goodwill" on balance sheets. That, in turn, soon became a notorious breeding ground for slick accounting.

Goodwill is simply the difference between the appraised fair value of acquired assets and the price paid to acquire them. Because the amount isn't a cash expense on the balance sheet, it used to receive little attention from analysts and investors, and accountants felt justified in using a little sleight of hand.

Intrawest Corp. caused a stir in 1999 by changing the amount of goodwill it claimed in its acquisition of the Whistler ski resort in Alberta. After the acquisition, the company decided that a

portion of the purchase price, originally declared goodwill, was actually the value of long-term provincial government leases. By reducing the amount of goodwill on its books after the fact, it reduced its amortization costs and lifted its bottom line, according to analysts.

INTANGIBLES AND OPTIONS

Goodwill and other so-called "intangibles," such as patents and brand names, have developed into a serious accounting minefield, and now the U.S. Federal Accounting Standards Board has decided to start cleaning things up. The FASB is developing standards to deal with intangibles, and is considering a similar move to clear up problems related to revenue recognition.

The contentious debate over accounting for stock options, on the other hand, has spilled beyond the FASB and is now being played out in the halls of Congress.

A group of congressmen, led by Senators John McCain and Carl Levin, are sponsoring a bill dubbed "The Ending Double Standards in Stock Options Act," which seeks to crack down on one of the most common earnings tricks in the technology sector.

As tech firms in the 1990s showered executives and employees with lucrative stock options in the 1990s, they did not record the value of the options as compensation in the financial statements, reasoning that they had no cash cost to the company.

They would, however, claim the options expenses when filing their taxes, and the resulting tax break provided companies with a huge cash benefit each year. If the bill becomes law, firms will be forced to treat options the same way for both earnings and tax purposes. That means reporting drastically lower earnings, and likely depressing share prices, or giving up their rich tax break.

For several of the biggest and best known tech companies in North America, including Nortel Networks Corp., Qualcomm Inc., Ciena Corp. and Amazon.com, those tax breaks have represented their only positive cash flow in recent years. If not for options-induced tax returns, Lucent Technologies Inc., would have been bleeding cash for the past three years.

WHEN COMPANIES BUY STOCKS

Among the various other lucrative earnings boosts, the treatment of investment portfolios has come under the microscope in recent years, and there's no better example than Microsoft Corp. The world's biggest software company invested in dozens of smaller firms during the 1990s, and when the technology market was surging the value of those investments helped boost Microsoft's bottom line.

Looking back at the first three months of 2000, Microsoft's investment income of US$2.1-billion represented 86% of its total profit during the period. The company focused analysts and investors on its net income, including those market gains, explaining that investing in small start-ups was an essential part of the technology business and a key part of Microsoft's growth strategy.

That strategy apparently changed over the past year as the tech market fell off a cliff, and Microsoft racked up steep losses in the investment portfolio. Through the first six months of 2001, Microsoft's investments lost US$427-million, and now the company focuses on "operating income" excluding investments.

EARNINGS MANAGEMENT

All this and such high-profile corporate failures as Enron Corp., Global Crossing Ltd. and Kmart Corp.

have created a great deal of cynicism in the market. It has also prompted many companies to rush out more information and clearer financial statements to reassure edgy investors.

"Embarrassment and humiliation have already begun to change behaviour," former SEC chairman Arthur Levitt said recently.

But will the newfound vigilance against exaggerated profits and fancy accounting tricks survive when the next wave of exuberance sweeps the stock market, or are we doomed to repeat our mistakes? Many market veterans aren't optimistic.

"Many good business managers became good earnings managers by increasingly resorting to bad accounting," Ed Yardeni, of Prudential Securities Inc., said in a recent report. "Investors mostly knew that the quality of earnings was deteriorating. But, they chose to ignore the problem. They were too busy getting rich in the bull market."