When his publisher wanted to call his upcoming book “Cooked Books,” Howard Schilit objected. The accounting professor felt “cooked” was too strong a word.

His book, though, does identify common financial “shenanigans,” as he calls the “tricks” that companies use in quarterly and annual reports. They often go unnoticed.

“Companies use a variety of techniques, many of them permissible and legal, that intentionally distort performance,” said Schilit.

The book instead is called “Financial Shenanigans: How to Detect Accounting Gimmicks & Fraud in Financial Reports.” Its 1992 publication, which features seven shenanigans, veered Schilit’s career from academia to the world of Wall Street.

Over the years, Schilit has drawn investors’ ire and praise. He has parlayed his nose for fishy financials into a profitable business.

He is president of the Rockville, Md.-based Center for Financial Research & Analysis Inc. Some 400 institutional investors, including Fidelity Investments, Putnam Investments and Janus Group, subscribe.

Schilit says some well-known tech firms use “creative” accounting to camouflage deteriorating business.

His next book is due out around February. Schilit recently spoke with Investor’s Business Daily about how to spot trouble.

**IBD:** What’s an example of shenanigans by a tech company?

**Schilit:** I remember a quote from a senior executive at AOL (AOL) about three years ago, when he was talking about their change in accounting. He used a phrase like they were the “trailblazer” in that area. In an accounting context, trailblazing is the worst thing to be doing.

AOL had a sale of a business division. Rather than pick it up as a one-time gain in that period, which everyone could see is a one-time gain, they called it a sale-leaseback. They then chopped up that gain into five-year pieces and picked up each portion of that as if it were normal operating income each year.

**IBD:** What about shenanigan No. 6, shifting current revenue to a later period?
**Schilit:** If you look at Microsoft (MSFT) and you look at the amount they had put into deferred revenue in 1997 and 1998, until the middle of 1999, you would see a company that had created a very substantial amount of reserve. That means they did not pick up as much revenue (immediately) as they probably should have. So they were shifting that revenue to a later period.

That apparently was what they were doing to save some of the revenue they didn’t need until business started getting a little bit tougher.

Was it a good idea? To the extent they were able to have that revenue to release at a later period, it was a good idea for them. But it was a way for them to cover up from investors that the business was starting to slow down in 1999 (when) they began to release that reserve.

We have evidence that they did that. Investors were late in picking up that the business was slowing.

**IBD:** How could an investor have spotted that?

**Schilit:** If you look at their deferred revenue account on the balance sheet, you see it build up each quarter, where it ballooned to over $4 billion. Then you see in the June quarter of 1999 there was a very modest increase. They usually increased it by about $400 million. I think they increased it by only $40 million (in the June 1999 quarter) and dropped it by $100 million in the September quarter.

I think that was the first sign that things were slowing down. Particularly for a software company, the best place to see early signs of business starting to slow down is seeing a decrease in their deferred revenue accounts.

**IBD:** Is there another example?

**Schilit:** Cisco (CSCO) this year took a $2.5 billion write-off of inventory. If they sell any of that inventory, you will see an artificial boost to their gross profit, because if you sell something that has a zero cost basis the gross profit on that is 100%.

**IBD:** What are key tip-offs to a company in serious trouble?

**Schilit:** Normally a company’s cash flow from operations and its reported net income track pretty closely. When you see a change in pattern, and the cash flow from operations starts to materially lag behind reported net income, that is a good tip-off that something bad is going to happen.

**IBD:** What about Computer Associates (CA)? Didn’t they just have a big accounting change?

**Schilit:** It was in the December quarter of last year. Their situation was a little more peculiar. It’s not evident what the motive was. They went from an accounting system that was considered to be very aggressive. They would sign somebody up, say for a five-year license for their product, and get paid over the five-year period. But rather than taking that revenue (evenly) over the five-year period, they would take the lion’s share of it immediately. They had the revenue booked very early and they had huge - about $3 billion - long-term receivables. We criticized them. A lot of people criticized them. So they said, “We’re now going to have much shorter contracts and basically let people come and go as they feel like.”
As a result, the amount of revenue they are now booking is probably half of what they were booking a year ago. We won’t have our first apples-to-apples comparison until the December quarter. It’s difficult to know how good or how bad their business has been.

**IBD**: Any examples of shenanigan No. 7, shifting future expenses to the current period?

**Schilit**: Look at JDS Uniphase (JDSU). They made a number of acquisitions over the years, and they had a lot of goodwill recorded on their balance sheet as a result of that. They decided that the acquisitions would not be profitable, and they decided to write off an enormous amount of cost associated with (the acquisitions), but mainly the goodwill. The amount was approximately $45 billion.

If you look at the results in the June quarter, you would have expected to see a loss of epic proportions. They have a $45 billion one-time charge, but their loss was only $7.9 billion. I said: It looks like there’s a digit missing.

They went back to the March quarter and threw most of those charges in that period, which I thought was very creative. The March quarter already closed, and people already made their investment decisions based upon that.

How can you go back four months later and say, “Oh, by the way, the profit we recorded really wasn’t a profit. It was a loss of $40 billion.”

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