Financial Shenanigans

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What are Shenanigans?

- Shenanigans are actions or omissions designed to hide or distort the real financial performance or financial condition of a company.
Why do Shenanigans Exist?

- It pays to do it (greed factor)
- It may boost performance-related bonuses
- It may prevent negative outcomes (fear factor)
- It may help company obtain financing
- It may dispel negative market perceptions
- It may help company financing covenants
- It is easy to do it
- It is unlikely you will get caught
What Types of Companies are Most Likely to Use Shenanigans?

- Companies with a weak control environment
  - No independent members
  - Lack of competent/independent auditor
  - Inadequate internal audit function
- Management facing extreme competitive pressure or known or suspected of having questionable character
- Small fast-growth
- Newly-public companies
- Privately held companies
- “Basket-case” companies
The Seven Shenanigans
Schilit’s Seven Shenanigans

1. Recording revenue too soon
2. Recording bogus revenue
3. Boosting income with one-time gains
4. Shifting current expenses to a later or earlier period
5. Failing to disclose all liabilities
6. Shifting current income to a later period
7. Shifting future expenses into the current period
Shenanigan No:1

Recording revenue too soon

- Shipping goods before sale is finalized
- Recording revenue when important uncertainties exist
- Recording revenue when future services are still due
Shenanigan No. 2: Recording bogus revenue

- Recording income in exchange for similar assets
- Recording refunds from suppliers as revenue
- Using bogus estimates on interim financial reports
Shenanigan No. 3: Boosting Income with One-time gains

- Boosting profits by selling undervalued assets
- Boosting profits by retiring debt
- Failing to segregate non-recurring activities
Shenanigan No. 4: Shifting Current Expenses to Later Period

- Improperly capitalizing costs
- Depreciating or amortizing costs too slowly
- Failing to write off worthless assets
Shenanigan No. 5: Failing to disclose all liabilities

- Reporting revenue when cash is received in advance of providing services
- Failing to accrue expected or contingent liabilities
- Failing to disclose all material commitments and contingencies
- Engaging in transactions to keep debt off books
Shenanigan No. 6: Shifting Current Income to Later Period

- Creating reserves and releasing them into income in a later period
Shenanigan No. 7: Shifting Future Expenses to Current Period

- Accelerating discretionary into the current period
- Writing off future years’ depreciation and amortization during the current year
Shenanigans at Internet Companies

- Sales to related parties
- Vendor financing
- Barter transactions
- Extended payment terms
- Creative use of company’s own stock
Ten Clues to Detect Shenanigans

1. Dishonest Management
2. Inadequate control environment
3. Changes in auditors, outside legal counsel, or CFO
4. Changing in accounting principles or estimates
5. Large deficit of CFFO relative to net income
6. Substantial disparity between sales and receivable growth
7. Substantial disparity between sales and inventory growth
8. Large increase or decrease in gross margins (GP/sales)
9. Recording revenue when risks remain with seller
10. Presence of commitments and contingencies