Schilit, Howard - Financial Shenanigans

McGraw-Hill, 2002 2nd ed, [Surrounding Knowledge] Grade ★★★★

Greed is as old as mankind. Unscrupulous people will try to trick others out of their money. One arena for this is the business sector and especially after the IT-crash there was a number of high profile accounting scandals. *Financial Shenanigans* has become the de-facto standard work on detecting "*accounting gimmicks and fraud in financial reports*." Howard Schilit is a former accounting professor who left academia and founded two consultancy firms specializing in so-called forensic accounting. Having sold the prior Centre for Financial Research and Analytics, the author is today the CEO of Schilit Forensics, helping clients research companies of interest. Schilit is, as Barron's puts it, a financial sleuth and this book will provide the reader plenty of advice on how not to be taken advantage of.

The second edition of this book contains five parts. After an introduction the meatiest part of the book is the second where The Seven Shenanigans are presented, i.e. the most common ways to intentionally distort a company's financials to make the current profits and the financial strength look stronger (or weaker) than is warranted by actual performance. In order the shenanigans are 1) Recording revenue too soon or of questionable quality, such as recording revenue before a service has been provided, before a shipment has been made or before the customer's full acceptance or recording sales to an affiliated party and much more; 2) Recording bogus revenues, as when recording cash from lending transactions as revenue or any recording of sales without economic substance; 3) Boosting income with one-time gain, which includes increasing profits by selling undervalued assets or creating income by reclassification of balance sheet items; 4) Shifting current expenses to a later or earlier period, for example capitalizing normal operating costs, amortizing costs too slowly, unduly reducing asset reserves etc.; 5) Failing to record or improperly reducing liabilities, such as failure to record expenses and related liabilities when future obligations remain or recording revenue when cash is received even though future obligations remain; 6) Shifting current revenue to a later period by for example creating reserves and releasing them into income in a later period or improperly holding back revenue before an acquisition closes and; 7) Shifting future expenses to the current period as a special charge - that could include improperly inflating the amount of a special charge or accelerating expenses into the current period.

The first five of those shenanigans aim to inflate the current period and to make it look better than it is. The last two instead deflate the current period to be able to look better than merited in the future. The creative accounting that tweaks the revenues is in a way worse than that which misrepresents costs as the revenues form the basis for the entire profit and loss-statement. The topics discussed are all relevant but to some extent I feel that the book is too profit and loss-centric. The balance sheet get's very little attention. The chapters include a number of guiding accounting principles and there is an appendix tutorial describing the basics of financial reporting. Despite this, it is a clear benefit for the reader to have some basic understanding of accounting principles and concepts.

The much shorter parts three through five handle areas such as how to search for signs of improper accounting by using databases and analysing company reports, trickier areas such as acquisition accounting and financial reporting in companies that due to their business model don't fit into standard accounting models, and finally there is a short historical review of financial tricksters with special attention given to Enron. Especially the history part is so short that it becomes close to unnecessary. However, the part on analysing financial reports does its job. To sum up, this book should be mandatory complementary reading in every accounting class. Apart from learning how accounting ought to work, everybody should know how some people come to misuse accounting.

Mats Larsson, January 25, 2014

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