Magic Workbooks

Business Survival Manual

BALANCE SHEET MANIPULATION

OR

Welcome to the Twilight Zone

Enron, Tyco, WorldCom in the US; Adecco in Switzerland, Parmalat in Italy … the list of global players engaged and caught in the act of manipulating their books has grown amazingly in the last few years.

Time to start asking a few pertinent questions about that heinous crime and its perpetrators:

1. Why do they do it?
2. How do they do it?
3. Why do they always get caught? Or are there any out there who don't get caught?

The first question, namely why we see an increase in balance sheet manipulation, is fairly easy to answer:

The globalisation of our economies and the speeding-up of all commercial transactions in the wake of electronic communications have made even the biggest companies vulnerable to sudden and drastic changes in business development and profit.

The basic need to satisfy shareholders should never be underestimated. It often leads into the dilemma that with business slack and investments high (a classical downgrading situation) it is necessary to keep the company rating high and stocks from plummeting in order to be able procure fresh loans and stay afloat.

Obviously, one way out of this dilemma seems to be Alfred Hitchcock's notorious advice:

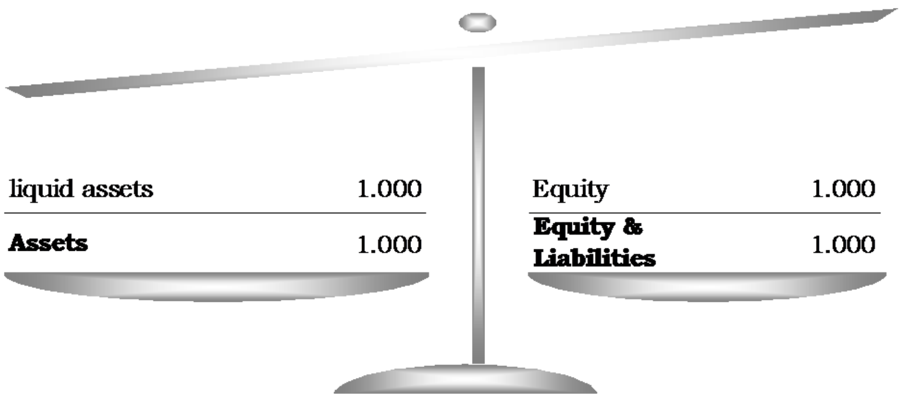
"If you can't do it, fake it."

This brings us to the second question, the one that is not usually taught in Accounting 101: how do you manipulate a balance sheet or, to put it very bluntly, how do you fake a profit when there is a substantial loss?

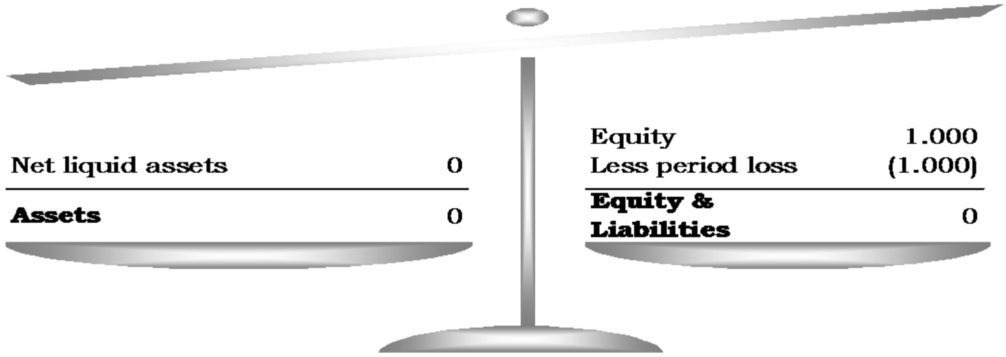
To answer this interesting question we have to take a close look at the balance sheet and its relation(s) to the income statement. Let's keep it nice and very simple for starters:

Suppose you start up a new company and as your first business transaction you have just transferred the capital to the company's brand-new bank account.

This is your opening balance sheet:



At the end of your first year in business, you prepare your income statement and find that reality fell far short of your expectations: You have incurred a loss of 1.000. Let's keep it simple again and say that there are no outstanding payments and no investments. Then your closing balance sheet would look like this:



The corresponding income statement would look something like this:

INCOME STATEMENT

Revenue	200
Expenses	(1.200)
Loss	(1.000)

Congratulations, you're bankrupt! Your liquid assets are used up, your bank is about to freeze your account. This is the situation that invites manipulation.

Balance Manipulation – the real story

Due to the interrelation between balance sheet and income statement, a manipulation always involves both. When we look at types of manipulation on the basis of the income statement structure, it is evident that there are two major ways of manipulating the ledgers:

Faking an increase in revenue, or faking a decrease in expenses.

Example 1: Manipulating Revenue

The typical example for fake revenue is the Imaginary Customer who has placed an order but has not yet paid for it. (Phenomedia, the Moorhuhn company from Germany, is a good example for this kind of manipulation.)

In our example, let's say we fake orders to the tune of 1.050.

This is what our income statement and balance sheet would look like after this manipulation:

INCOME STATEMENT

Revenue	200
Fake Revenue	1.050
Expenses	(1.200)
Profit	50

Accounts Receivable	1.050	Equity	1.000
Net liquid assets	0	Profit	50
Assets	1.050	**Equity & Liabilities**	1.050

Isn't that great?! All your problems gone … NO, wait a second! And give it another close, REAL close look. You have changed a loss into a profit, you have a half-way decent-looking balance sheet, so what is wrong?

Check your liquid assets! They have not changed and you are still bankrupt. O.K., this one did not work. Let's go on and try tackling our expenses.

Example 2: Manipulating Expenses

Messing with the expenses in your income statement takes a little more work and imagination. And we have to give some thought to another interesting facet of the balance sheet, namely fixed and current assets.

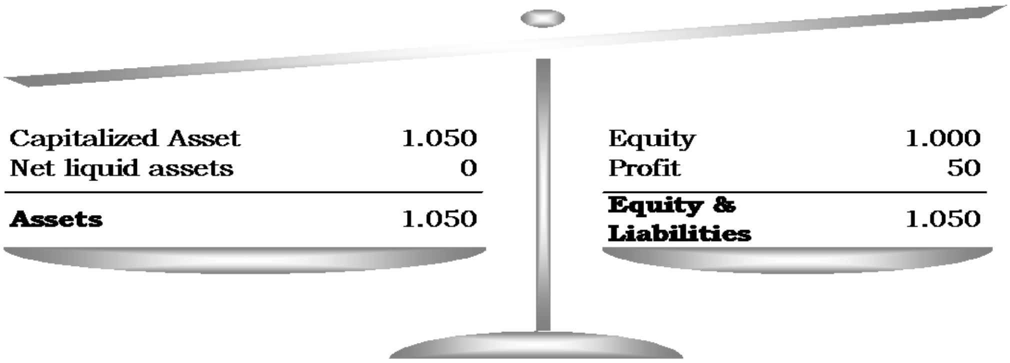
It may seem strange at first, but **assets** and **expenses** have a lot in common. Both refer to goods/services you buy for your business and use in your business. But there is also an important difference: **assets** represent value that is not yet used up, while **expenses** represent value that is gone. (If you need an easy-to-remember image for this relationship think of a big white roll of toilet-paper: all that is torn off and used is **expenses**, all that stays on the roll is **assets**.)

So, in terms of manipulation, assets are good news, expenses are bad news, and being able to turn expenses into assets might just solve all your problems. (Of course, the toilet-paper analogy gets a little smelly at this point.) The usual way to go about this is to define some of your incurred expenses as "investments into the future". This is the way WorldCom went about their manipulations.

And if you do likewise and "re-define" expenses of, say, 1.050 as assets, this is what your income statement and balance sheet would look like:

INCOME STATEMENT

Revenue	200
Changes in Assets	1.050
Expenses	(1.200)
Profit	50



Oops! After all this thought and work, you are still faced with depleted liquid assets. This one does not seem to work either.

What conclusions can we draw from these attempts at hiding a loss?

One thing should be perfectly clear by now: whatever you do with your ledgers, the one thing you cannot change is your bank account balance. No amount of manipulation can up your liquid assets by a single penny!

And that simple fact should ring a bell:
if you recall press and TV coverage of
all major manipulation scandals, did it not always seem as if
the CEO woke up one morning to find his company bankrupt
i.e. with no liquid assets to speak of?

Our little attempts at balance sheet manipulation show you why: the manipulations only provide a kind of wadding that fills up the balance sheet nicely while the real losses behind the manipulations continue to eat up the company capital until there is none left.

Now, a manipulator might counter by saying he knows that and all his efforts were directed at making the balance sheet look great to be able to get fresh money from investors and banks.

Nice try. How does one get money from a bank? By presenting assets which can be financed. A *truck* is an asset, *last month's electricity bill* is not (as WorldCom found out after manipulating expenses to the tune of seven odd billion dollars).

And how does one keep on getting money from investors who have been known to bleed freely at "Great Expectations"? By presenting a sound and, if possible, continuously rising profit margin. So what happens if new money has to be used to stuff old holes, instead of acquiring new business? Right: you enter a vicious circle where the holes in the profit fabric keep getting bigger until it simply tears apart.

If there is one difference in balance sheet manipulation between private and public companies it is quite possibly the bigger leverage effect of tons of public money: it might take a little longer till it blows but when it does, it does so with a vengeance.

So, the lesson behind all this and the answer to question three, why balance sheet manipulators always get caught, is this:

It is not really difficult to manipulate a balance sheet but
IT IS COMPLETELY USELESS.

Actually, this might be turned into a kind of ultimate management test. Ask a CEO / CFO candidate if he believes balance sheet manipulation can be successful. If he opts for yes, throw him out, he's a stupid git.

In contrast to the Income Statement which opens with a clean slate every year, the Balance Sheet is somewhat like an aggregated **mug shot** of the company – taken at one specific moment, at midnight on December 31, but showing every wrinkle that has developed over the years.

This aspect of **continuity** is generally overlooked by manipulators who seem to be obsessed with this year's income statement and this year's balance-sheet ratios. The balance sheet case is never closed – unless the company itself closes down.

What once goes into the balance sheet stays in to haunt you in future years. And even if a manipulation is small enough to stay below the survival level of the company, future profit will be drastically reduced just by setting the books right. And you may rest assured of one thing: the manipulation will not simply go away in a few years, drop from sight into the realm of things long over and forgotten, quite the reverse: the reality of capital drain on the business ends by forcing its acknowledgement in the ledgers. The sad truth is that a manipulation of the ledgers invariably leads to warped figures in the company controlling department which invariably lead to wrong management decisions which in turn accelerate the downward spiral of profitability.

There is another baffling aspect about balance sheet manipulation that we would like to share in passing: **traceability**, or the simple fact that manipulation is not an anonymous crime.

Imagine a bankrobber, armed, masked and all that. He has just finished scaring the hell out of a number of bank employees and hostages and has two bulging money bags on the counter in front of him and a shivering bank employee looking at him from the other side of the counter. He says, "You think I'm stupid enough to walk out of here with those bags? Here's my card, transfer the money to my account, right now!"

Yes, this falls under the category "Jokes that Balance Sheet Manipulators don't Find Funny".

The time and effort spent in cooking the books could be more profitably spent on reengineering the company. Who knows, in the years to come shareholders and financing banks might even welcome a commitment to truth and honest endeavour – at the very least, they will deem it preferable to running for cover under Chapter 11.

No discussion of balance-sheet manipulation is quite complete without mentioning **Enron** and the never-ending story of **off-balance-sheet items**. Though these do not technically belong in the same range with the manipulation of ledgers that we have demonstrated above, their effects can be as disastrous to company survival. The problem here is rather one of omittance or less than full disclosure of obligations and risks and, occasionally, the problem of ego may enter to compound matters further.

("OK, so we have given a guarantee to carry the loss if our telecom subsidiary falls below $10 a share. Why bother putting that in our balance-sheet and getting asked a lot of questions by some stupid analysts? Listen, the telecom biz is expanding like crazy. There is no risk! Those shares will list at $200 in a year …")

A Parting Shot from the Ethics Department

As you will have noticed, we have abstained from drawing the moral gun throughout this discussion. This does not mean that we are unaware of the moral and criminal implications of balance sheet manipulations. But we do believe that no amount of preaching or restrictive laws has quite the same discouraging effect as proving the utter uselessness and stupidity of such manipulations.

If you need further proof or need to convince someone else that it can be done with impunity but not with success:

The following MagicWorkbook® has been designed to accommodate a real and much more complex balance sheet and income statement and will chart the gory outcome for up to five years, showing exactly at what point the manipulation will affect company survival and result in bankruptcy:

Balance Manipulator in both IAS and US-GAAP format

Visit us for more information and a lot of interesting tools for your business survival:

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