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Massaging figures is more widespread than you think

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The revelation last month that the Securities and Exchange Commission was reviewing the financial reporting at Dell was not a surprise to me. Almost five years ago I uncovered a story – thanks to two well-placed and highly credible sources inside the company – about how Dell deliberately presented an artificial picture of its financial health.

The assertion was not that Dell broke any rules, but that it engaged in a number of "unnatural acts" to make its inventory, accounts receivable and accounts payable appear, at each quarter's end, substantially better than they were under normal business conditions.

How much better? My sources at the time estimated that without the "unnatural acts", inventory would have been twice as high and operating cash flow would have been hundreds of millions of dollars lower.

Let me say upfront that I have no knowledge of the SEC investigation and that I own Dell shares. At its current price, I believe the market has overreacted to concerns over Dell's business model, competitive position and its accounting.

What did my sources tell me Dell was doing? To minimise quarter-end inventory levels, once the company determined what it would produce and ship in the last five days of each quarter, it would tell suppliers to deliver no inventory other than what would be needed for that production. It also required most suppliers to hold two weeks of inventory at "hubs" close to Dell's factories. To temporarily lower accounts receivable, it stepped up collection efforts at the end of every quarter. To increase accounts payable, said a former procurement executive: "Dell routinely withholds three weeks or so of payments from vendors at the end of every quarter. In my opinion, it's hurting our long-term relationships with many of our suppliers."

A Dell spokesman denied this at the time. "We have and continue to maintain good relationships with suppliers, evidenced by our ability to serve customers and continue growing at multiples of the industry."

Dell reiterated that it used "standard accounting practices", "thoroughly audited by independent, outside accountants". When I returned to Dell recently with the points my sources had made to me, the company said it had “no further comment to make” beyond its earlier statement.

The first lesson is that companies have tremendous leeway in reporting their financials and can make their performance appear stronger than it actually is, even within the bounds of Generally Accepted Accounting Principles. This is what Dell was doing, according to my sources.

The second lesson is that this behaviour, while perhaps less common than five years ago, is not unusual. Warren Buffett wrote about the pervasiveness of such activities in his 1998 letter to Berkshire Hathaway shareholders: “Many chief executives think this kind of manipulation [of earnings] is not only OK, but actually their duty.”

What is an investor to do? For one, invest in companies that have long-standing reputations for conservatism and do not pander to Wall Street.

A great indicator that a company is managing its earnings is it consistently meets or beats analysts’ estimates by a penny.

Instead, investors are better served by companies that, by word and deed, focus entirely on increasing long-term business value. Among my largest holdings today, three examples are Berkshire Hathaway, McDonald’s and Microsoft. The latter two were not always so admirable. McDonald’s caused serious damage to its business (and stock price) in the late 1990s and early this decade by pandering to Wall Street and focusing on monthly same-store sales, while Microsoft used to abuse options like most of the rest of the technology sector.

Reliable financial statements are part of the bedrock of our capital markets. If widespread violations of this trust are occurring, it is a serious matter indeed. While it may be hard to detect in many cases, how investors reward or punish certain corporate reporting behaviour will play a key role in whether things going forward get better…or worse.

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