PacificCPE

COURSE

21804A

Expense Recognition, EBITDA, and Audit Reliability

How expenses are recognized can be just as important as how revenue is reported. This course explores expense recognition principles, then takes a practical look at EBITDA—what it tells you, what it hides, and when it's being misused. The course wraps up with a candid discussion of disclosures and audits, including their limitations. A great fit for CPAs who want to sharpen their analytical instincts and better evaluate the reliability of the financial information they encounter.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

Start Course ↓

Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the types of accounting scandals associated with Diamond Foods, Nortel Networks, and General Motors.
- Identify the items included in William Beaver's definition of cash flow.
- Recognize the criticisms associated with the Wirecard audit.

Copyright Notice

© 2026 Pacific CPE, LP. All rights reserved.

The materials in this course — including the text, illustrations, exhibits, examples, exam questions, and review questions — are the copyrighted property of Pacific CPE, LP. No portion of this course may be reproduced, stored in a retrieval system, distributed, or transmitted in any form or by any means (electronic, mechanical, photocopying, recording, or otherwise) without the prior written permission of Pacific CPE, LP, except for the personal, non-commercial use of the registered learner.

Pacific CPE, LP grants the registered learner a single-seat, non-transferable license to access this course for the purpose of completing the associated continuing professional education credit. Account credentials may not be shared. Group access requires a separate enterprise license.

This course is provided "as is" for educational purposes. While Pacific CPE, LP makes a reasonable effort to ensure the content is current and accurate, the materials should not be relied upon as a substitute for professional advice. Pacific CPE, LP disclaims all liability for any error, omission, or loss arising from the use of, or reliance on, the course content.

Questions about reproduction, licensing, or use of these materials should be directed to support@pacificcpe.com.

Publication Date: May 2026

TABLE OF CONTENTS

CHAPTER 01

Expense Recognition 5

1.01 Diamond Foods'S Movable Expenses 5

1.02 Nortel'S Deferred Profit Plan 8

1.03 Grasping For Earnings At General Motors 12

1.04 Time-Shifting At Freddie Mac 14

Test Your Knowledge 18

CHAPTER 02

The Applications And Limitations Of Ebitda 22

2.01 Ebit, Ebitda, And Total Enterprise Value 22

2.02 The Role Of Ebitda In Credit Analysis 27

2.03 Abusing Ebitda 30

2.04 A More Comprehensive Cash Flow Measure 32

2.05 Working Capital Adds Punch To Cash Flow Analysis 35

Test Your Knowledge 38

CHAPTER 03

The Reliability Of Disclosure And Audits 40

3.01 Where Was The Cash? 41

3.02 Sloppiness Can Be A Red Flag 45

3.03 How Manipulation Evades Detection 48

3.04 Systematic Problems In Auditing 49

Test Your Knowledge 55

Final Exam Copy 74
Glossary 60
Index .....

Chapter 1: EXPENSE RECOGNITION

Chapter Objective

After completing this chapter, you should be able to:

- Recall the types of accounting scandals associated with Diamond Foods, Nortel Networks, and General Motors.

As Chapter 2 of course 21803B illustrated, companies can grossly distort their earnings through aggressive revenue recognition. Analysts who arm themselves with appropriate skepticism about financial statements are bound to wonder whether companies also pump up the bottom line by taking liberties in booking expenses. The answer is resoundingly affirmative. Corporate managers are just as creative in minimizing and slowing down the recognition of expenses as they are in maximizing and speeding up the recognition of revenues.

DIAMOND FOODS'S MOVABLE EXPENSES

On February 8, 2012, Diamond Foods announced that it would restate its earnings for the previous two years. The snack food producer also found material weaknesses in its financial reporting controls. Chief executive officer Michael J. Mendes and chief financial officer Steven M. Neill were placed on administrative leave and fired the following day.

Diamond's shares fell as much as 44 percent in after-hours trading. Jefferies stock analyst Thilo Wrede wrote in a research bulletin that the company would probably violate its debt covenants as a result of the coming reduction of reported earnings. In addition, Standard & Poor's reduced its outlook for the company's credit rating from Stable to Slightly Negative.

The company's planned earnings restatement involved payments to walnut growers of $20 million in August 2010 and $60 million in September 2011 that were booked in the wrong periods. Shareholders who were suing the company alleged that the payments were used to shift costs one fiscal year forward. That gambit likely would have overstated earlier profits, goosing reported earnings and, by extension, Diamond's share price.

An inflated share value would have advantaged the company in its pending acquisition of the Pringles potato chip business. With that planned deal, originally valued at $2.35 billion, Diamond was poised to become the second largest snack company behind Pepsico, the parent of Frito-Lay. The potato chip maker's owner, Procter & Gamble, was to be paid mostly in Diamond Foods stock.

In the wake of Diamond's announcement, a P&G spokesperson indicated that Pringles had attracted "considerable interest" from other possible buyers. The consumer goods giant, he said, would keep

its options open. A week later, P&G pulled the plug on its deal with Diamond, selling Pringles instead to Kellogg, which thereby snatched the number-two spot in snack foods.

Early Signs of Trouble

Five months before the restatement announcement that torpedoed Diamond's share price, the Wall Street Journal's John Jannarone warned that "investors should take a closer look at its historical business: walnuts[1]." Jannarone's article followed by two days an Off Wall Street Consulting report by Mark Roberts that raised questions about Diamond's accounting. Roberts estimated that if Diamond had booked its costs properly, fiscal 2011 earnings per share would have been as little as $1.14 a share rather than the $2.16 that the company reported. Had the company reported the lower figure, the stock with which it planned to pay for Pringles probably would have represented much less valuable acquisition currency.

The story began with Diamond Foods's 1912 origin as a walnut growers' cooperative. Michael J. Mendes, the CEO who was fired following the restatement announcement, persuaded the cooperative's members to take the operation public in 2005. He soon began creating a snack food empire through acquisitions. Barron's contributor Jannarone noted that friction had developed with growers over multi-year contracts that allowed Diamond to set walnut prices unilaterally.

When walnut prices surged for the 2010 crop, Diamond paid growers considerably less than most buyers, according to the Wall Street Journal's sources. On September 2, 2011, however, Diamond made a "momentum payment" to growers. A similar "continuity" payment had been made in August 2010 and growers said they could not tell whether the payments were for the years in which they were paid or for the preceding years.

Had the September 2011 payment been made by July 31, 2011, the end of Diamond's fiscal year, it would have taken a big bite out of fiscal 2011 earnings. Jannarone estimated just how big a hit that might be by conservatively assuming that Diamond bought 20 percent of the 2010 California walnut crop. (The company had disclosed that in 2005 it bought about 40 percent of the California production.) The Department of Agriculture reported the size of the 2010 crop as one billion pounds. At an average of $0.25 a pound, as growers reported to Jannarone, the momentum payment would have totaled $50 million, more than half of Diamond's $93 million in operating income. That estimate proved close to the approximately $60 million that the company later admitted was recorded in the wrong period.

Even including the 2011 momentum payment, it appeared that walnut growers had received a bit less than $1.00 a pound from Diamond. The Department of Agriculture reported an average price of $1.06 a pound for the 2010 California crop, with some varieties fetching far more. Growers had the ability to obtain better prices, once their contracts with Diamond expired, by selling into burgeoning export markets in China and Turkey. That would spell trouble for Diamond, which derived nearly 30 percent of its sales from walnuts. Its stock priced had risen 31 percent since the

tentative deal to buy Pringles from P&G was announced, so shareholders faced substantial downside if Diamond's nut business began to crack.

Indeed, Diamond's share price fell by as much as 8.5 percent during the September 27, 2011, trading session that coincided with the Barron's revelations. (The S&P 500 Index rose by 1.0 percent that day.) On November 1, 2011, Diamond and Procter & Gamble agreed to delay the Pringles closing while Diamond's audit committee probed the company's accounting for walnut-crop payments. Four days later Bill Alpert presciently wrote in *Barron's Online*, "After Diamond's walnut accounting gets scrutiny, the stock could get crushed again$_2$." In short, the stock plunge that was triggered by the restatement announcement three months later was by no means a bolt from the blue.

When Diamond officially restated its earnings on November 15, 2012, its shares closed at $15.36, down 21 percent on the day. Equity analyst Ashkay Jagdale of KeyBanc Capital Markets said the size of the restatements was in line with expectations. Diamond, however, also reported a $53.4 million loss for the first three quarters of 2012, partly due to a weakening of its walnut business. Back when the company was still a Wall Street darling based on its plan to acquire Pringles, its stock closed at $92.47 on September 20, 2011.

Notably, Diamond Foods's earnings manipulation commenced after the passage of the Sarbanes-Oxley Act that is appropriately credited with substantially reducing the incidence of financial reporting fraud in the United States. Diamond did not even go public until three years after Sarbox became the law of the land in 2002. The company's shifting of expenses, at a time when it was desperate to shore up its share price and keep a transformative acquisition on track, showed that analysts could not afford to let their guard down just because CEOs now faced greater risk of going to prison for falsifying financial statements.

The Aftermath

Nine months after Diamond's restatement announcement, the company filed restated consolidated financial statements for fiscal 2010 and 2011 and interim periods ending January 2010 to July 2011. The revised statements reduced pretax income by $17 million in fiscal 2010 and by $39.5 million in fiscal 2011. Two company directors stepped down from the board at that time.

In 2013 Diamond Foods reached a settlement with investors who acquired its stock between October 10, 2010, and February 8, 2012. The company paid $11 million in cash and issued 4.45 million common shares to resolve all outstanding claims, while denying all claims of wrongdoing or liability. Insurance funded a substantial portion of the cash payment.

The following year Diamond Foods paid $5 million to settle Securities and Exchange Commission charges that it concocted an accounting scheme to falsify its costs. The alleged motive was to increase its earnings and thereby meet *equity* analysts' estimates. Diamond neither admitted nor denied the charges. Its former chief financial officer Steven M. Neill likewise settled in 2015 without admitting or denying the charge against him. He paid $125,000 and forfeited his claim for

approximately $1 million in stock options awarded partly during the time that the alleged fraud occurred.

Deposed chief executive officer Michael J. Mendes followed a similar route, paying $125,000 and returning more than $4 million in bonuses and other benefits. That was on top of missing out on his scheduled November 2011 headline spot at an investor bash at New York's Metropolitan Opera House that featured Sting and James Taylor. Mendes landed on his feet, however, eventually becoming CEO of Just Desserts, producer of such delicacies as Chocolate Dipped Vegan Vanilla Bundt Cake. He made a clean break from his earlier affiliation; Just Desserts proudly stated that its artisan baking processes were nut-free.

NORTEL'S DEFERRED PROFIT PLAN

Nortel Networks illustrated the distorting power of accruals, one of the most abused features of financial reporting. Founded in 1882 as the Bell Telephone Company of Canada's department for manufacturing telephones and telephone equipment, the unit was spun off as the Northern Electric and Manufacturing Company Limited in 1895. It went through various ownership and name changes, eventually becoming known as Nortel Networks to signify the company's quest to dominate the global market for public and private telecommunications networks.

Nortel grew into North America's largest telecommunications equipment manufacturer and rode the late-1990s boom in fiber optics equipment. From the mid-1990s until mid-2000, its *market capitalization* soared more than tenfold, and the company shelled out $30 billion for acquisitions. Nortel's showy advertisements featured celebrities such as Elton John.

The Tech Wreck brought those heady days to an end in 2000. It became apparent that like many of its high-tech peers, the showpiece of Canadian industry had paid exorbitant prices for ill-considered acquisitions, extended credit to customers on unsound terms, and made overly optimistic earnings forecasts. Between September 2000 and August 2002, Nortel's market capitalization sank by 99 percent, devastating Canadian pension plans that were heavily invested in its shares.

First Indications of Accounting Discrepancies

New CEO Frank Dunn moved aggressively to stabilize the company, slashing the workforce from 95,000 to 35,000 and exiting several major businesses. The turnaround ran into a snag on October 23, 2003, however. Nortel announced that it had made accounting "mistakes" that required a reduction of previously stated losses totaling $740 million for 2000, 2001, 2002, and the first half of 2003. A review found that the company's balance sheet overstated liabilities by $900 million for the period in question, with the associated losses partly offset by $160 million in corresponding tax benefits. In addition, the company's second look at its books revealed that $92 million in revenues from the three-and-a-half-year span should have been deferred to later periods.

Dunn, who had been chief financial officer in 2000 and much of 2001, explained that the errors were made during a volatile period for the high-tech industry. "I want to assure Nortel Networks stakeholders that we are committed to working to identify the causes of the mistakes," said Dunn, "and to implement the appropriate measures to ensure that the problems will not recur in the future[3]." Shareholders were not entirely reassured, as Nortel's shares fell by 6 percent in after-hours trading. On the whole, though, investors concluded that because the planned restatements were modest and would reduce previous losses, the news was not all that bad.

Three months later, Nortel and its CEO appeared to have regained any lost ground with investors as the company announced its first annual profit in six years. "Great execution," exulted one Wall Street analyst. "The numbers look really good."

Unfortunately, the numbers proved not to be as good as they looked. On March 10, 2004, Nortel disclosed that an investigation by its audit committee was likely to necessitate another revision of past earnings. As a result, the company had to wave a classic red flag with respect to the credibility of its financial statements by delaying the filing of its 2003 financial reports. The following week, Nortel placed Chief Financial Officer Douglas C. Beatty and Controller Michael J. Gollogly on indefinite paid leaves of absence. Based on the unusual procedure of putting the executives on leave, rather than firing them, accounting experts suspected the company's problems were acute and might involve a disagreement with auditor Deloitte & Touche.

Some brokerage house analysts, however, continued to express confidence in the company's outlook. "In my opinion Nortel has made mistakes in the past, but I'd like to believe that they learned their lesson," commented one analyst who maintained his buy recommendation[5]. An analyst at an independent equities research firm acknowledged there was an issue of trust in management but expressed hope that the accounting changes would be minor and have little impact on Nortel's share price. "When you're adjusting prior year numbers, who cares, I'm buying the stock today," the analyst said[6].

That remark would prove misguided by a long shot. More skeptical observers were apt to wonder whether the latest accounting inaccuracies were truly inadvertent errors. In 2003, Nortel had introduced a special bonus scheme. Senior executives' bonuses were tied to profits, and according to Toronto's *Globe and Mail*, 16 executives had collected a total of $43.6 million under the plan. Dunn and Beatty had reportedly received $2.15 million and $831,000, respectively[7].

From Bad to Worse

Nortel was the most heavily traded stock on the New York Stock Exchange on March 5, 2004, falling by 3.7 percent, as the U.S. Securities and Exchange Commission (SEC) announced that it had upgraded its inquiry into the company's accounting to a formal investigation. John Gavin, president of the regulatory research firm SEC Insight Inc., commented that the SEC's upgrading of its probe, which empowered the commission to issue subpoenas, might indicate that Nortel was "not

cooperating as much as they say they are[8]." The Ontario Securities Commission was also looking into Nortel's financial reporting, and an inquiry by the Royal Canadian Mounted Police later evolved into a criminal investigation.

Analysts who had downplayed the significance of the accounting revelations were dealt a blow on April 28, 2004. Nortel dropped a bombshell in the form of a 50 percent cut in its previously announced 2003 earnings of $732 million. The company said some of those profits would be shifted to earlier years, for which it reported *losses.* Nortel also delayed the reporting of its results for the first quarter of 2003, further damaging its credibility.

In addition to dashing hopes that the new round of accounting statements would be minor, Nortel rattled the market by firing CEO Dunn, CFO Beatty, and controller Gollogly. They were terminated for cause, but under Canadian law that phrase included incompetence, so the dismissal did not necessarily imply any criminal acts. Nortel also placed the finance chiefs of its four operating divisions on paid leave. The company's stock price dropped by 28 percent, and Standard & Poor's downgraded its corporate credit rating from B to B–.

Some observers suggested that the senior executives were scapegoats for the board's failure to police the company's accounting practices. Dunn continued to receive high marks for his response to the 2001 business downturn. Furthermore, industry experts considered the company well positioned from a technological standpoint.

Notwithstanding these purported operational strengths, the credibility of Nortel's financial reporting continued to deteriorate. On June 2, 2004, the company indicated that the 50 percent cut in its 2003 earnings would not necessarily be the last revision. The possibility of further restatements arose as Nortel turned its attention to its reporting for the second half of 2003.

Management's credibility continued to shrink as the company kept pushing back its target date for producing definitive earnings restatements. Nortel had 650 employees devoted to the task, augmented by a host of outside auditors and consultants. By August 2004, their efforts had produced only "estimated limited preliminary unaudited" numbers[9].

Three months later, the company still had not reported any results for 2004, and it once again delayed the release of its financials. On August 11, 2004, a new chapter opened. Nortel's investigation, which previously had focused on accruals and provisions, had turned to revenue recognition. The company said that $250 million of the $2.5 billion in 2000 revenue that had been slated for shifting to later years would be eliminated altogether. Incorrect recognition of that amount resulted from a combination of nontransfer of legal title to customers, failure to meet criteria for recognizing revenue prior to shipment, collectability questions, and other incorrect steps. Duncan Stewart, a fund manager with Terra Capital in Toronto, said Nortel's senior managers were "looking like clowns" for failing to meet self-imposed deadlines for filing financial statements and for announcing major new financial reporting problems after many months of investigating[10].