

THE MICHEL/SHAKED GROUP

RESEARCH FROM OUR EXPERTS

Revenue Reporting and Accounting Fraud "The Emperor's New Clothes"

In recent years, the reporting of revenue or sales for many companies has resembled the emperor's non-existent new clothes of Hans Christian Andersen's fairy tale. Unfortunately, problem revenue reporting is rarely so charmingly transparent or harmless. Just a small sample of the companies that have allegedly engaged in aggressive or fraudulent revenue reporting includes Lucent Technologies, Boston Scientific, Raytheon, ConAgra Foods, Sunbeam, Cendant, MicroStrategy, Cumulus Media, and Livent. The companies range from the familiar to the less familiar, large to small, and high tech to old economy. In short, any company can potentially engage in accounting fraud. The value of its securities frequently plummet by as much as 90 percent or more during the period over which the shenanigans and resulting earnings restatements are announced. Both investors and those who represent them, including financial advisers and attorneys, need to know how to detect the problem revenues.

Our highly competitive business environment, the financial markets' fixation on smooth, year-over-year earnings growth, and executive incentive compensation contracts based ultimately on earnings, have encouraged managers to *stretch the inherent flexibility* in U.S. GAAP revenue reporting in order to improve earnings. Recall that:

Earnings = Revenues - Expenses

Thus, every dollar of reported earnings begins with the dollars of sales. If earnings are not

Dr. Rebecca Todd is a former professor at Boston University's School of Management. She is now an independent consultant and has frequently consulted on accounting and financial issues related to revenue recognition. In addition she has been retained as an expert witness on complex matters associated with the recognition of revenue.

The opinions expressed in this article are those of the author and do not necessarily reflect those of The Michel/Shaked Group.

growing as rapidly or as smoothly as desired, managers may decide to tinker with either the amount or timing of reported revenues in order to solve the problem. Revenue misstatement is the most common approach to earnings enhancement because relatively small changes in revenues have a large effect on earnings. The reason is that the average U.S. company reports earnings in the range of \$.05 to \$.10 per dollar of revenues. Thus, an “optimistic” increase in revenues of 5% could double the company’s reported earnings.

At the present time, some well-known former corporate executives are under federal indictment for fraud. Unfortunately, the biggest losers are the investors who trusted companies and their auditors to tell it like it is.

Thankfully, a number of telltale indicators are available for detecting aggressively reported revenues, or identifying situations where pressures for such optimistic reporting greatly increase the probability of problems. We will consider some of the more common situations and the methods that should be applied to detect them. However, first, we need to consider the ultimate source of the problems, the flexibility allowed in revenue reporting under U.S. GAAP.

The Flexibility in U.S. GAAP Revenue Reporting

U.S. GAAP has provided two general criteria for revenue reporting:

1. Substantial completion of the earnings process.
2. A reasonably determined price.

The first criterion requires the company to *have already done* essentially all that it must do to be *entitled* to receive the money for the sale of goods or delivery of services. The second says that there must be *no major remaining uncertainties* about the money to be received for the goods or services. This means that the price, any warranties or other guarantees or rights of return, any remaining continuing services to be performed (for example, com-

A Letter From Our Managing Directors

Dear Friend:

The issue of revenue recognition has recently been receiving a significant amount of attention by the SEC and attorneys nationwide, as well as by the accounting profession. Countless hours have been spent by regulators, assessing the appropriateness of accounting procedures. Many companies have been accused of fraudulent reporting

We are pleased to present Dr. Rebecca Todd's insightful analysis of revenue recognition and its corollary, accounting fraud. Dr. Todd has taught financial statement analysis at Boston University. She has also served as an expert witness and has consulted on financial/accounting matters for firms around the world.

Dr. Todd's cogent and easy-to-read analysis will make the key issues associated with revenue recognition very clear. It also provides a clear road map for the litigation involved in such potentially complex matters.

We hope that you will find Dr. Todd's opinion insightful and useful in your practice.

Best regards,



Allen Michel



Israel Shaked

puter software “help” desk services or promised upgrades), and probability of collection must either be known or reasonably estimable.

To illustrate a very simple and direct type of revenue recognition, consider a fast food company. Once a customer has paid in cash and received the food, and the cashier has updated the computer system for the transaction, the sales transaction is complete. The price is known, there are no remaining services to be done, and, since the cash has been exchanged, there are no uncertainties about the collection.

Unfortunately, such simple revenue transactions are largely restricted to retail businesses that accept either cash or credit cards. Application of the two criteria in many, if not most, sales transactions involves substantial judgement or estimation. For example, what is “substantial completion of the earnings process”? When has that point been reached? What is the significant uncertainty? Managers may decide to interpret the

criteria very broadly in order to enhance the earnings bottom line.

Notice that the two criteria do not require that cash be exchanged, that is, that the goods or services be paid for, in order for the sale to be reported. In fact it is standard practice in some industries to recognize the sales well before any cash has been received. Also, if companies wish, they may delay recognition of sales, even though the criteria would appear to have been met, by arguing that they believe significant uncertainties related to fulfillment or warranty conditions remain.

Consequently, companies may recognize revenues for earnings purposes before cash is received, at the same time cash is exchanged, or at some time after the cash is received. *Cash and revenue recognition are not necessarily linked under U.S. GAAP.* Moreover, managers may apply substantial judgement and estimation of the process in determining both the amounts of revenues and the time to report them.

The tendency for managers who desire to window-dress earnings is to accelerate revenue recognition, that is, to recognize the revenues as early as possible. Most of the cases cited above involved both early recognition and overly aggressive, or positive, estimation. Thus, both of the two revenue recognition criteria were violated. Revenues and earnings were reported before the earnings process was substantially completed, causing earnings to be reported earlier than they should have been. In addition, because the estimated revenues were materially too high, both were inflated, resulting in overly optimistic market valuations for the securities.

The good news is that in many cases, problem revenues, or the conditions leading to them are detectable. We will examine two of the more common problems connected with revenue recognition: rapid receivables growth and merger-related revenue accounting fraud. Other cases are common, including lease accounting, construction accounting, and software revenue recognition.

Rapid Receivables Growth

When a company completes a sale to a customer of either goods or services, it becomes entitled to receive cash immediately, as in the case of the fast food restaurant, or to receive cash in the future, a sale on credit. In a credit sale, since cash is not received immediately, the company records an asset, an *account receivable*. The account receivable represents a claim against the customer. When the customer pays the account, the claim is

cancelled and the cash is recorded. Accounts receivable are widely used in business to ease and speed the exchange of goods and services. Normally, the business ships the goods or delivers the services, records the receivable, bills the customer, and records the cash when received. The most common collection period for receivables is in the range of zero to sixty days with an average of about thirty days.

Assuming that the collection periods are reasonably stable and that the company is not changing its credit policy over time, the relation between sales and receivables recorded should remain relatively stable. For example, if sales are growing on average at a compound rate of ten percent per year, then we would normally expect receivables to grow at a similar rate. If we should find that sales are growing at ten percent per year for two years, but that receivables are growing at forty percent for each year, then we would immediately suspect revenue recognition problems. At the very least, the revenues being recorded are not being collected in cash in a timely

"Cash and revenue recognition are not necessarily linked under U.S. GAAP."

fashion. At a minimum, the company could have cash flow difficulties. However, we would have to consider the possibility that the company is reporting the revenues well before it is entitled to. In other words, it is aggressively recognizing revenues. An even more ominous possibility is that the company has re-

corded non-existent sales. Since no cash has been or will be received, the company must offset the revenues with an asset other than cash and the usual choice is receivables.

Thus, nearly all of the usual mechanisms for aggressive reporting of revenues, including wholesale fraud, involve the recording of receivables. Tracking the growth of the two will tell the tale.

This simple check, comparing the relative growth rates over time of revenues and receivables, has proven to be a reliable indicator of revenue and cash flow problems in a large number of problem companies. The test can serve both as an early warning signal and as evidence after the fact of earnings manipulation.

Merger-Related Revenue Accounting Fraud

A relatively new form of revenue recognition problem has emerged in the last few years that amounts to accounting fraud, pure and simple. Several of the companies in the sample above have chosen to resort to this gambit, to their shareholders' eventual grief. The problem comes about because of the flexibility in accounting for mergers and acquisitions as well as for spinoffs. Spinoffs are companies that are born when a parent company decides to divest one or more divisions by issuing a new class of stock and jettisoning the divisions to the company's own shareholders by issuing the new stock to them.

At the time of merger or spin-off, some companies typically took large "restructuring" write-offs to earnings. They counterbalanced these earnings write-offs by setting up huge reserves in the balance sheet. Some legitimate reserves might be set up for expected layoffs of employees and the related severance charges. However, some of these companies realized that little scrutiny was being given to the nature of the reserves and thus they took enormous write-offs, vastly overstating the actual costs of the merger or spin-off. In effect, they over-reserved by, in many cases, billions of dollars.

Later, when a little "help" was needed to boost the earnings to meet market expectations, the companies simply reclassified the vastly overstated reserves, transferring portions of the reserve balances to revenues. If questioned, they justified the practice by saying it turned out that their estimates of the restructuring costs had been too pessimistic. Thus, they were effectively "revising their estimates" by recognizing the bloated reserves as revenues.

The SEC has taken a dim view of this line of reasoning and has instituted a number of enforcement actions against the companies. The restatements of revenues and earnings have produced a number of "fallen angels", former market darlings that approached collapse, accompanied by the loss of nearly all of their investors' capital.

Summary

The root cause of all revenue recognition problems, including fraud, is the flexibility allowed in revenue reporting, especially with regard to estimation. The SEC has instituted dozens of enforcement actions in the revenue recognition area and the Justice Department has

brought fraud indictments in some of the cases.

Very recently, the FASB has undertaken a new project on revenue recognition. Presumably, the goal is to tighten the standards for revenue reporting and, as a result, to improve the quality of earnings reported. This effort is likely to take years, however, because the wide spectrum of business contracting practices will challenge any attempts to simplify and clarify revenue recognition and reporting. In the meantime, companies are likely to continue to take advantage of the corporate friendly Emperor's New Clothes Revenue Accounting.

For reprints of previous articles in this series, please contact The Michel/Shaked Group.

- **"Fraudulent Conveyance: The Financial Issues"** by *Allen Michel and Israel Shaked*
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