Association of Corporate Counsel

Monday, April 30
4:30–6:00 pm

502 Revenue Recognition from the Lawyers Perspective
Legal Manager Track

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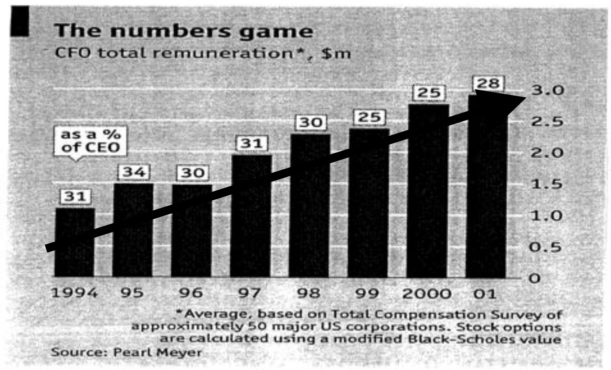

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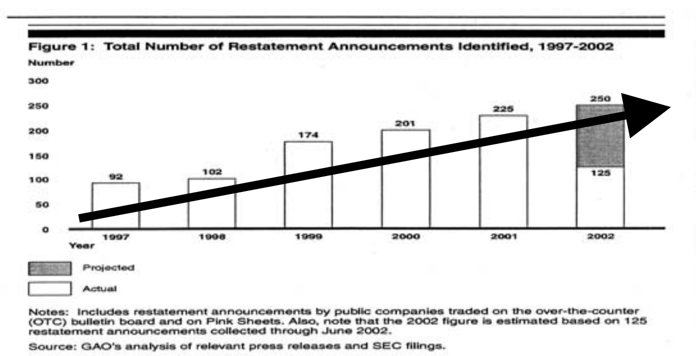

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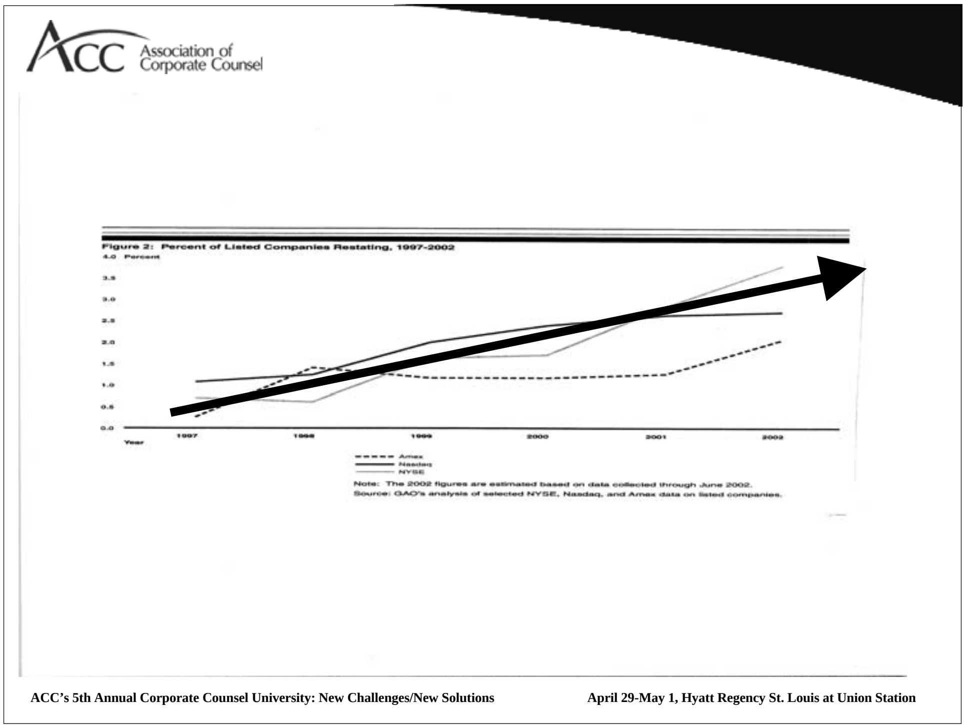
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Figure 2: Percent of Listed Companies Restating, 1997-2002
Percent
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
Year
1997
1998
1999
2000
2001
2002
Amex
Nasdaq
NYSE
Note: The 2002 figures are estimated based on data collected through June 2002.
Source: GAO's analysis of selected NYSE, Nasdaq, and Amex data on listed companies.
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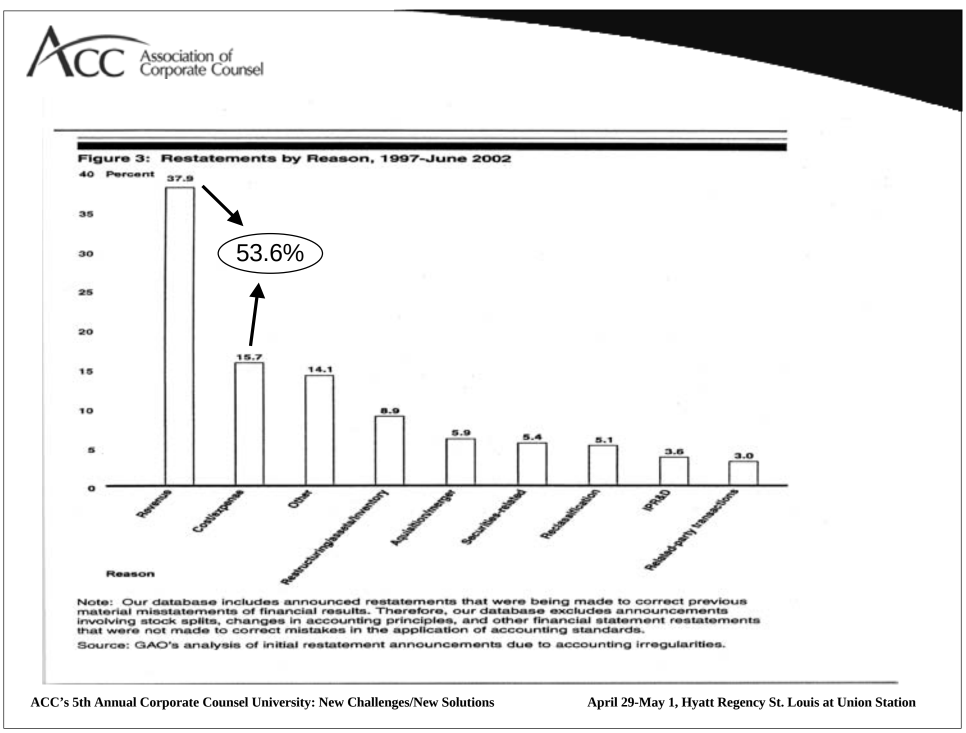
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Figure 3: Restatements by Reason, 1997-June 2002
Percent
40
35
30
25
20
15
10
5
0
37.9
53.6%
15.7
14.1
8.9
5.9
5.4
5.1
3.6
3.0
Revenue
Cost/expense
Other
Restructuring/assets/inventory
Acquisition/merger
Securities-related
Reclassification
IPR&D
Related-party transactions
Reason
Note: Our database includes announced restatements that were being made to correct previous material misstatements of financial results. Therefore, our database excludes announcements involving stock splits, changes in accounting principles, and other financial statement restatements that were not made to correct mistakes in the application of accounting standards.
Source: GAO's analysis of initial restatement announcements due to accounting irregularities.
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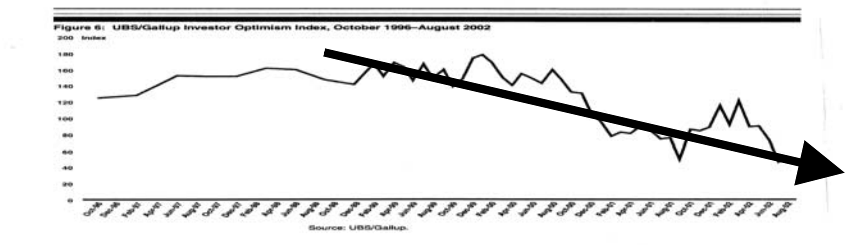

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The Two Epiphanies

- **Accounting presentations are <u>NOT</u> objective . . .**
  - GAAP is flexible, not rigid
  - Audits only relate to GAAP
- **. . . Nor are they Neutrally Portrayed**
  - management prepared
  - inherent bias to:
    - minimize the cost of capital
    - maximize reported earnings

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Underlying Accounting Approach

- Accrual v. Cash Accounting
- The Matching Principle

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Basics of Revenue Recognition

- Revenue is the inflow of:
  - cash,
  - receivables or
  - other consideration
  - in the course of the ordinary activities of an enterprise
- GAAP governs timing of recognition, <u>NOT</u> measurement

Basics of Revenue Recognition

- Revenue is booked net of:
  - trade discounts
  - volume discounts
  - returns & allowances
  - claims for damaged goods
  - certain excise & sales taxes

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When is a Sale a Sale?

- transfer of significant risks & rewards of ownership
- all significant acts complete
- no continuing managerial involvement in goods transferred
- no effective control of goods transferred
- reasonable assurance regarding:
  - measurement
  - extent to which goods may be returned
  - ultimate collection

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Some Key Recognition Issues

- When shipped?
- When customer accepts delivery?
- After return period expires?
- What if price protection is offered?
- Tied Services Offered
  - extended warranties
  - frequent flyer miles
- Licensing Fees
- Franchise Fees

Services and Long Term Contracts

- completed contract method
  - rendering of services completed or substantially completed
- percentage of completion method
  - revenue proportionate to degree of completion
  - total costs need to be estimated (unbilled A/R; Deferred Revenue)
- reasonable assurance regarding:
  - measurement
  - ultimate collection

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Recognition Games

- Massaging the Estimates
- Channel Stuffing
- Revenue Swapping
- Bill and Hold
- Paying Myself
- Lumping In non-operational revenue

Massaging the Estimates

- Discount, return and allowance estimates abnormally reduced
- Percentage of completion cost estimates reassessed
- Terms of sale completion re-characterized
  - side letters
  - abnormal purchase order or invoice terms

Channel Stuffing

- Convince customers to over order
- Deliberately over ship ordered goods
- Ship goods not ordered

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Revenue Swapping

- Two companies selling same type of goods to each other
- Net cash outflow is zero
- Total assets don't change
- Each books revenue amount

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Bill and Hold

- Goods are ordered, made, and invoiced but not shipped until some later date

Staff Accounting Bulletin No. 101

- The risks of ownership have passed to the buyer
- The customer must have made a fixed commitment to purchase the goods, preferably in written documentation
- The buyer, not the seller, must request that the transaction be on bill-and-hold basis. The buyer must have a substantial business purpose for ordering the goods on a bill-and-hold basis
- There must be a fixed schedule for delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer's business purpose
- The seller must not have retained any specific performance obligations such that the earning process is not complete
- The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders
- the goods must be complete and ready for shipment

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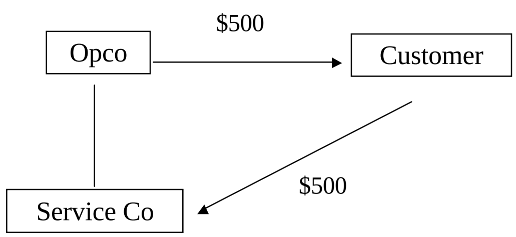
Paying Myself



		Dr	Cr
Opco Accounts }	Capitalized Cost	500	
	~~Cash~~		~~500~~
Service Co Accounts }	~~Cash~~	~~500~~	
	Revenue		500

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Lumping In Non-Operational Revenue

- interest income
- investment income
- gains on asset sales
- foreign exchange gains

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Earnings Management

Revenues
- Cost of Goods Sold (COGS)
- Selling, General and Administrative Expenses (SG&A)
- Other Operating Expenses (e.g. Research and Development)
= EBITDA
- Depreciation
- Amortization
= EBIT
- Interest Expense
= EBT
- Income Taxes
= Net Income

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Earnings Management

- EBITDA
- Capitalized Costs
  - Exploration costs
  - Pre-production costs
  - Pre-operating costs
  - Development costs
  - Prepaid marketing costs
  - Deferred leasing costs
  - Deferred financing costs
  - Licensing & Program Costs
  - Practice Management Costs
  - Pension Costs

NBV (starting)
Less: Amortization
Plus: Cash Spent on Item
NBV (ending)

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Earnings Management

- "Cookie Jar" Accounting
  - restructuring charges
  - provisions and reserves
    - One time hit to earnings in quarter/year taken
    - Creates a liability on the balance sheet
    - In future, spend money and reduce liability, not earnings

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Earnings Management

- Discontinued operations
- Unusual and Extraordinary Items
  - not expected to occur frequently over several years
  - don't typify the normal business activities of the company
  - don't depend primarily on decisions or determinations by management or owners

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Some Trigger Conditions

- Earnings are somewhat short of forecast
- Company is preparing for an IPO
- Earnings are just below the minimum required to earn incentive compensation
- Earnings are above or close to exceeding the maximum beyond which no additional incentive compensation is earned
- Company is close to violating earnings-related financial covenants in existing agreements
- Earnings above or below a long-term trend believed by management to be sustainable
- Earnings volatility is induced by a series of non-recurring items
- A change in top management has taken place
- Large losses associated with restructuring and related charges have been accrued in the past

Source: Charles W. Mulford and Eugene E. Comiskey, *The Financial Numbers Game: Detecting Creative Accounting Practices*, 2002: John Wiley & Sons Inc.

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