Association of Corporate Counsel

Monday, May 22
2:30–4:00 pm

401 Revenue Recognition from the Lawyers Perspective
New to In-House Track

Timothy M. Donovan
Former General Counsel
NEC USA, Inc.

Wendy Shapss
Managing Director - Forensic & Litigation Practice
FTI Consulting

Association of Corporate Counsel

An Introduction to Revenue Recognition for Lawyers

ACC Corporate Counsel University

ACC's 4th Annual Corporate Counsel University:
New Challenges/New Solutions

May 21-23, Baltimore Marriott Waterfront

The in-house bar association.℠

ACC Association of Corporate Counsel

THE WALL STREET JOURNAL.

APRIL 20, 2006

"EBay Profit Declines 3% Despite Revenue Jump"

"IBM Profit Rises 22% but Revenue Shows a Drop"

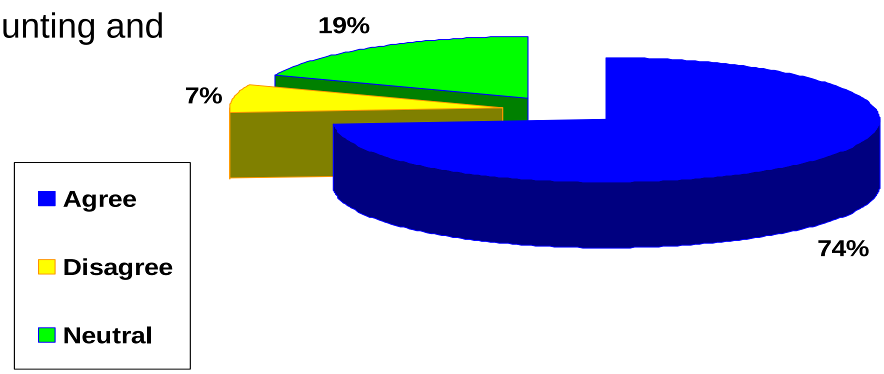
"Yahoo's Net Declines 22% After Accounting Change"

ACC's 4th Annual Corporate Counsel University: New Challenges/New Solutions May 21-23, Baltimore Marriott Waterfront

Survey of CEO's

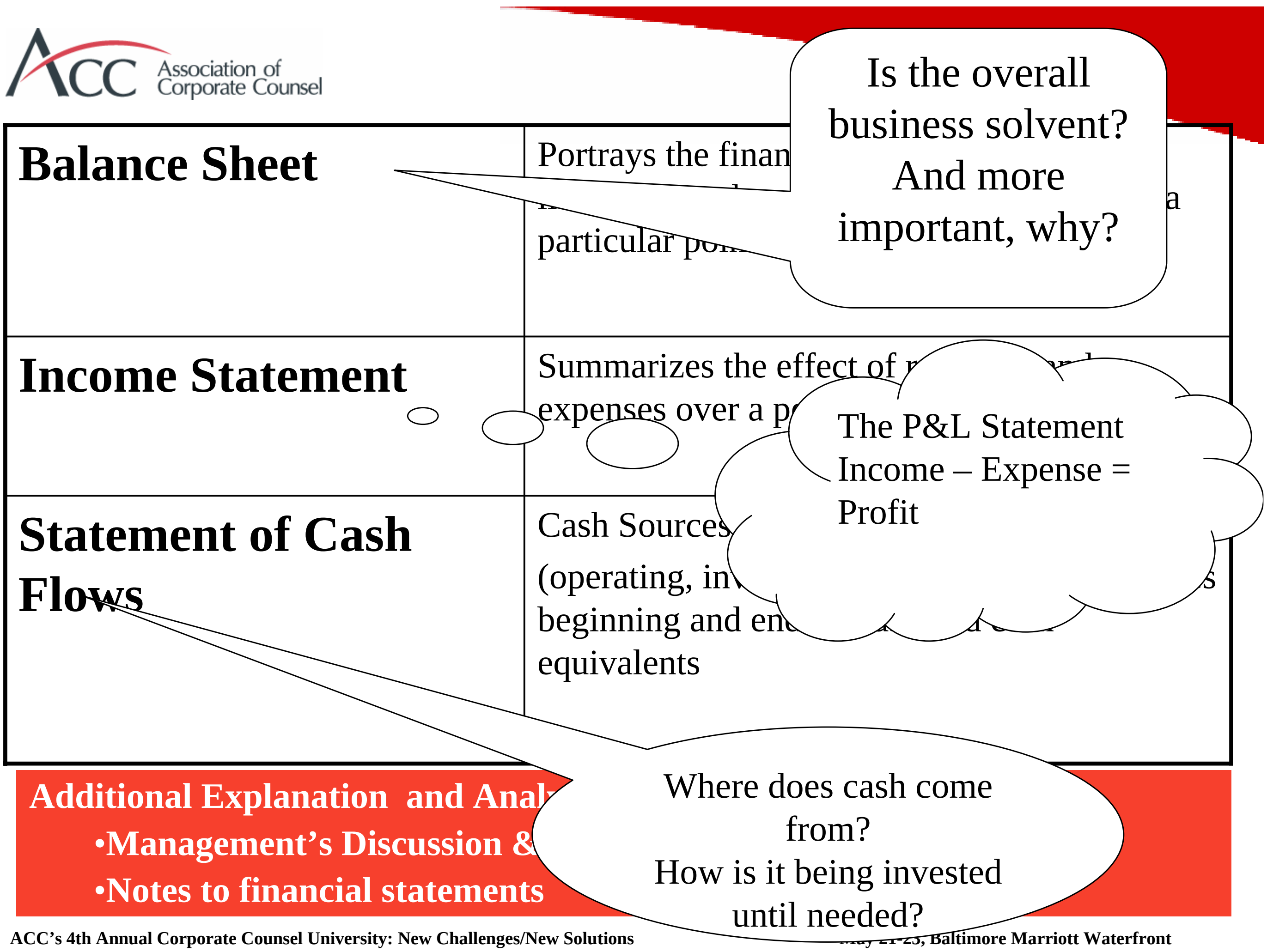
2005

"We asked CEOs if they thought it was important their GCs understood accounting and financial issues"



Source: Inside Counsel and Dickstein, Shapiro, Morin, Oshinsky

ACC's 4th Annual Corporate Counsel University: New Challenges/New Solutions May 21-23, Baltimore Marriott Waterfront


Association of Corporate Counsel
Balance Sheet
Portrays the finan
particular po
Is the overall business solvent? And more important, why?
Income Statement
Summarizes the effect of
expenses over a p
The P&L Statement
Income – Expense = Profit
Statement of Cash Flows
Cash Sources
(operating, in
beginning and en
equivalents
Where does cash come from?
How is it being invested until needed?
Additional Explanation and Anal
•Management's Discussion &
•Notes to financial statements
ACC's 4th Annual Corporate Counsel University: New Challenges/New Solutions
Baltimore Marriott Waterfront

The Basics of Revenue Recognition

- **Cash Basis of Accounting**
  - Revenue is recognized when cash is received.
  - Expense is recognized when cash is paid.
- **Accrual Basis of Accounting**
  - Revenue is recognized when following conditions are met:
    - Revenue is earned (products are delivered or services are provided)
    - Revenue is realized (cash is received) or realizable (when it's reasonable to expect cash will be received in future)
  - Expense is recognized in the period in which related revenue is recognized (Matching Principle).

All financial statements have revenue recognition policy footnotes that should specifically outline how that company records its revenue.

ACC's 4th Annual Corporate Counsel University: New Challenges/New Solutions May 21-23, Baltimore Marriott Waterfront

The Basics of Revenue Recognition (cont'd)

- **SAB 101: Four Criteria Required for Revenue Recognition**

1. Persuasive evidence of an arrangement exists
2. Delivery has occurred or services have been rendered
3. The seller's price to the buyer is fixed or determinable
4. Collectibility is reasonably assured (creditworthiness)

Accruals and Deferrals

- Revenues earned in excess of related billings are ***accrued***, whereas billings in excess of revenues earned are ***deferred*** until the related services are provided.
- Accrual - The recognition of revenue when earned or expenses when incurred regardless of when cash is received or disbursed.
- Deferral – Postpone recognition. Recording a cash payment as revenue or expense at a later date than when received; common example is the receipt of an advance payment for services not yet performed.

ACC's 4th Annual Corporate Counsel University: New Challenges/New Solutions May 21-23, Baltimore Marriott Waterfront

ACC Association of Corporate Counsel

Revenue Rec

“Where an implementation or development project is contracted with a client, and we will also provide services or operate the system over a period of time, EITF 00-21 provides the methodology for separating the contract elements”

- Revenues for business pr
  recognized as services ar
- Revenues from annual m
  and recognized ratably ov
  Where will you find deferred r)
- Production-Type Contracts en extend over long periods, and our right to e future payment depends on our future perform in accordance with the agreement and reve e is recognized using
- Percentage-of-c mpletion methodology (recognizing revenue using the percentage of services completed)
- Separability

Four Contracts from the Accounting Perspective

- Sales Agreement
- Software License
- Equipment Lease
- Settlement Agreement

Sales Agreement

- Common Legal Terms
  - Shipping and Delivery
  - Payment
    - Credit (net 45 days)
    - Installments or Progress Payments
  - Warranty
  - Most Favored Pricing
  - Return Option
  - Indemnification
- Accounting Issues
  - Historical basis for Warranty Reserve
  - Reserve for Doubtful Accounts
  - When does title pass in installment sale?
  - Post sale price reductions
  - Is indemnification a likely event? Notes disclosure?

ACC's 4th Annual Corporate Counsel University: New Challenges/New Solutions May 21-23, Baltimore Marriott Waterfront

Software Transaction

- Common Legal Terms
  - License Fee
  - Maintenance Fee
  - Customization
    Progress Payments
  - Training
  - Acceptance Required for final Payment
- Accounting Issues
  - License fee = Royalty
  - Intangible assets
  - Separability of Maintenance and License Revenue

Equipment Lease

- Common Legal Terms
  - Security Deposit
  - Rent
    - Payable in advance
    - Payable in arrears
  - Late Fees
  - Purchase Option
    - FMV
    - Low or No Cost
- Accounting Issues
  - Lease or Installment Sale? Operating lease or Capital Lease
  - If true lease, equipment is inventory of Lessor?
    - Depreciation vs. Amortization
    - Obsolescence
  - If Installment Sale?

Settlement Agreements

- Common Legal Terms
  - Payments over time
  - Payment of royalties for a license to use
  - Payment of Opposing Counsel Fees
  - In class actions – offer coupons for new product purchases or rebates for past purchases
  - Set up a trust for future medical conditions
- Accounting Issues
  - Cost of Goods Sold
  - Deferral of Expense
  - Amortize
  - 1099 Issues (employment settlements and attorneys fees)
  - Pre- Settlement Disclosure in Notes or Reserve for Future Cost
  - Impact on prior periods? Future Periods?

ACC's 4th Annual Corporate Counsel University: New Challenges/New Solutions May 21-23, Baltimore Marriott Waterfront

Settlement Agreement Accounting Pop Quiz

- On February 23, 2006, Gateway and Hewlett-Packard ("H-P") signed a Binding Term Sheet in which both parties agreed to cross-license each other's patent portfolios for a period of seven years and also agreed to dismiss all claims in litigation against the other company. Gateway paid HP $47,000,000
- Question: Did Gateway incur a $47M expense in 2006?

Correct Answer?
No!

	2005	2006	2007	2008	2009	2010	2011	2012
Cost of Goods Sold (past infringement)	(16,700)							
Cost of Goods Sold (future license payments)		(4,329)	(4,329)	(4,329)	(4,329)	(4,329)	(4,329)	(4,328.57)

Gateway attributed $16.7 million to resolving past patent infringement, recognizing such this cost as a component of in *2005*. The remaining $30.3 million will be attributed to the value of the new seven year cross-licensing agreement. Gateway will begin recognizing the cost associated with the future cross-licensing agreement in Cost Of Goods Sold, beginning in *2006*.

ACC's 4th Annual Corporate Counsel University: New Challenges/New Solutions May 21-23, Baltimore Marriott Waterfront

Income Statement

When does the sale become recognizable?

Where does it show up?

(In millions, except per share amounts)	
Year Ended June 30	2005
Revenue	$39,788
Operating expenses:	
Cost of revenue	6,200
Research and development	6,184
Sales and marketing	8,677
General and administrative	4,166
Total operating expenses	25,227
Operating income	14,561
Investment income and other	2,067
Income before income taxes	16,628
Provision for income taxes	4,374
Net income	$12,254
Earnings per share:	
Basic	$ 1.13
Diluted	$ 1.12
Weighted average shares outstanding:	
Basic	10,839
Diluted	10,906
Cash dividends declared per share	$ 3.40

NET SALES

Cost of Goods Sold

Balance Sheet

(In millions)

June 30	2005
Assets	
Current assets:	
Cash and equivalents	$ 4,851
Short-term investments	32,900
Total cash and short-term investments	37,751
Accounts receivable, net	7,180
Inventories	491
Deferred income taxes	1,701
Other	1,614
Total current assets	48,737
Property and equipment, net	2,346
Equity and other investments	11,004
Goodwill	3,309
Intangible assets, net	499
Deferred income taxes	3,621
Other long-term assets	1,299
Total assets	$ 70,815

When product ships, what happens to inventory?

ACC's 4th Annual Corporate Counsel University: New Challenges/New Solutions May 21-23, Baltimore Marriott Waterfront

ACC Association of Corporate Counsel

Balance Sheet (cont'd)

(In millions)

June 30	2005
Liabilities and stockholders' equity	
Current liabilities:	
Accounts payable	$ 2,086
Accrued compensation	1,662
Income taxes	2,020
Short-term unearned revenue	7,502
Other	3,607
Total current liabilities	16,877
Long-term unearned revenue	1,665
Other long-term liabilities	4,158
Commitments and contingencies	
Stockholders' equity:	
Common stock and paid-in capital – shares authorized 24,000; outstanding 10,862 and 10,710	60,413
Retained earnings (deficit), including accumulated other comprehensive income of $1,119 and $1,426	(12,298)
Total stockholders' equity	48,115
Total liabilities and stockholders' equity	$ 70,815

Deferred revenue: shows up as liabilities

ACC Association of Corporate Counsel

Statement of Cash Flows

How do credit terms affect the financials – cash flow?

Cash from Operations

(In millions)	
Year Ended June 30	2005
Operations	
Net income	$ 12,254
Depreciation, amortization, and other noncash items	855
Stock-based compensation	2,448
Net recognized (gains)/losses on investments	(527)
Stock option income tax benefits	668
Deferred income taxes	(179)
Unearned revenue	13,831
Recognition of unearned revenue	(12,919)
Accounts receivable	(1,243)
Other current assets	(245)
Other long-term assets	21
Other current liabilities	396
Other long-term liabilities	1,245
Net cash from operations	16,605

Statement of Cash Flows (cont'd)

Cash used for Financing

(In millions)

Year Ended June 30	2005
Financing	
Common stock issued	**3,109**
Common stock repurchased	**(8,057)**
Common stock cash dividends	**(36,112)**
Other	**(18)**
Net cash used for financing	**(41,078)**

Statement of Cash Flows (cont'd)

Cash from Investing

(In millions)

Year Ended June 30	**2005**
Investing	
Additions to property and equipment	**(812)**
Acquisition of companies, net of cash acquired	**(207)**
Purchases of investments	**(68,045)**
Maturities of investments	**29,153**
Sales of investments	**54,938**
Net cash from investing	**15,027**

Revenue Recognition - Earnings Management Examples

Company has met sales goal for the period and management wants to "save for a rainy day"

- Stop shipping until next quarter
- Changes company's standard shipping terms from FOB shipping to FOB destination
- Ships under normal FOB, but adds acceptance condition – and asks the customer not to "accept"
- Adds a customer right of return
- "Post-dates" the shipping documents
- Tailors the transaction so it is part of a multiple delivery commitment with a pending element that cannot be estimated

Red Flags

- Extended Warranty
- Backdating contracts to another fiscal period
- Channel Stuffing (sale with right to cancel)
- Out of Policy upgrades, services, Discounts
- Side letters that alter business terms or obligations
- Penalties for non delivery or non performance
- Conditional Payment Terms
  - Extended due dates
  - Rebates
  - Payment subject to extraordinary events or conditions
  - Payment in advance for work remaining to be completed

Relevant Accounting Literature

- SAB 101: Revenue Recognition in Financial Statements
- FASB Statement No. 86: Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed
- FASB Statement No. 48: Revenue Recognition When Right of Return Exists
- FASB Con 5: Recognition and Measurement in Financial Statements of Business Enterprises
- SOP 97-2: Software Revenue Recognition

ACC Association of Corporate Counsel

More information . . .

- SEC
  - www.sec.gov/investor/pubs/beginstmtguide.htm
  - www.sec.gov/divisions/corpfin/fortune500rep.htm
- AICPA www.aicpa.org
- FASB www.fasb.org
- ACFE www.acfe.net
- Terminology
  - WSJ Business Terms
    - http://online.wsj.com/documents/glossary.htm
  - Financial Terms
    - http://www.financeglobe.com/Finance/glossary.php?src=gl

Beginners' Guide to Financial Statements

Report on Fortune 500

More . . . .

- The Revenue Recognition Information Website
  - http://www.revenuerecognition.com/
- What is Forensic Accounting?
  - http://www.forensicaccounting.com

Exhibit A
Financial Statements

MICROSOFT BALANCE SHEET

(In millions)

June 30	**2005**
Assets	
Current assets:	
Cash and equivalents	**$ 4,851**
Short-term investments	**32,900**
Total cash and short-term investments	**37,751**
Accounts receivable, net	**7,180**
Inventories	**491**
Deferred income taxes	**1,701**
Other	**1,614**
Total current assets	**48,737**
Property and equipment, net	**2,346**
Equity and other investments	**11,004**
Goodwill	**3,309**
Intangible assets, net	**499**
Deferred income taxes	**3,621**
Other long-term assets	**1,299**
Total assets	**$ 70,815**
Liabilities and stockholders' equity	
Current liabilities:	
Accounts payable	**$ 2,086**
Accrued compensation	**1,662**
Income taxes	**2,020**
Short-term unearned revenue	**7,502**
Other	**3,607**
Total current liabilities	**16,877**
Long-term unearned revenue	**1,665**
Other long-term liabilities	**4,158**
Commitments and contingencies	
Stockholders' equity:	
Common stock and paid-in capital – shares authorized 24,000; outstanding 10,862 and 10,710	**60,413**
Retained earnings (deficit), including accumulated other comprehensive income of $1,119 and $1,426	**(12,298)**
Total stockholders' equity	**48,115**
Total liabilities and stockholders' equity	**$ 70,815**

MICROSOFT INCOME STATEMENT

(In millions, except per share amounts)

Year Ended June 30	**2005**
Revenue	**$39,788**
Operating expenses:	
Cost of revenue	**6,200**
Research and development	**6,184**
Sales and marketing	**8,677**
General and administrative	**4,166**
Total operating expenses	**25,227**
Operating income	**14,561**
Investment income and other	**2,067**
Income before income taxes	**16,628**
Provision for income taxes	**4,374**
Net income	**$12,254**
Earnings per share:	
Basic	**$ 1.13**
Diluted	**$ 1.12**
Weighted average shares outstanding:	
Basic	**10,839**
Diluted	**10,906**
Cash dividends declared per share	**$ 3.40**

MICROSOFT STATEMENT OF CASH FLOWS

(In millions)	
Year Ended June 30	**2005**
Operations	
Net income	$ 12,254
Depreciation, amortization, and other noncash items	855
Stock-based compensation	2,448
Net recognized (gains)/losses on investments	(527)
Stock option income tax benefits	668
Deferred income taxes	(179)
Unearned revenue	13,831
Recognition of unearned revenue	(12,919)
Accounts receivable	(1,243)
Other current assets	(245)
Other long-term assets	21
Other current liabilities	396
Other long-term liabilities	1,245
Net cash from operations	16,605
Financing	
Common stock issued	3,109
Common stock repurchased	(8,057)
Common stock cash dividends	(36,112)
Other	(18)
Net cash used for financing	(41,078)
Investing	
Additions to property and equipment	(812)
Acquisition of companies, net of cash acquired	(207)
Purchases of investments	(68,045)
Maturities of investments	29,153
Sales of investments	54,938
Net cash from investing	15,027
Net change in cash and equivalents	(9,446)
Effect of exchange rates on cash and equivalents	(7)
Cash and equivalents, beginning of period	14,304
Cash and equivalents, end of period	$ 4,851

Exhibit B
Presenter Information

Timothy Donovan

Timothy Donovan is an intellectual property and corporate attorney and former senior vice president and general counsel of a global technology corporation. Mr. Donovan has over 20 years of experience as in house counsel handling corporate financial transactions, mergers and acquisitions of private companies, planning and start-up of new ventures and managing legal teams and projects.

Mr. Donovan is a frequent speaker on topics related to the business and practice of law and current issues facing general counsel. His innovative use of technology to support compliance and legal processes was identified as a best practice by the General Counsel Roundtable of the Corporate Executive Board.

His current practice centers on technology and software legal issues, electronic financial controls and compliance, and knowledge management and process improvement in the law department.

Wendy Shapss, CPA, CFE, MBA

Managing Director - Forensic and Litigation Consulting

wendy.shapss@fticonsulting.com

Three Times Square
11th Floor
New York, NY 10036
Tel: (212) 247-1010
Fax: (212) 841-9350

Certifications

Certified Public Accountant

Certified Fraud Examiner

Professional Affiliations

American Institute of Certified Public Accountants

Association of Certified Fraud Examiners

American Bankruptcy Institute

New York State Society of Certified Public Accountants

International Women's Insolvency and Restructuring Confederation

Education

B.S., Accounting and Marketing, Lehigh University

M.B.A., Lehigh University

Wendy Shapss is a managing director in the FTI Forensic and Litigation Consulting practice and is based in New York City. Ms. Shapss has over 14 years experience in accounting, auditing, fraud and financial-based matters and specializes in litigation consulting, forensic accounting, fraud and financial investigations, and bankruptcy consulting.

Ms. Shapss has provided factual testimony in cases involving preference actions, as well as advice and factual testimony through written and oral presentations at arbitrations, depositions and settlement conferences. Ms. Shapss has advised on cases involving lost profits, breach of contract claims, and accountants' malpractice. These cases include a multi-billion dollar lawsuit filed by a lender against an accounting firm serving as auditors prior to a debtor filing Chapter 11. Ms. Shapss has additional expertise with matters involving fraudulent financial reporting, SEC investigations, asset diversion, damage quantification, purchase price disputes, acquisitions and divestitures, antitrust, price fixing, claims management, expert testimony, forensic investigations, accounting irregularities, liquidation, product liability, solvency and insolvency, trustee and examiner issues, and valuation.

Ms. Shapss has worked on various out-of-court troubled company engagements, and has also been responsible for overseeing and monitoring the day-to-day activities of various bankrupt estates. She managed a bankruptcy case that involved more than 20 debtor companies and substantial allegations of fraud. Some of Ms. Shapss' bankruptcy engagements include Raymark Corporation, Leon Wright, National Restaurants, Food Management and Venture Holdings Company. Her experience includes identifying and pursuing preference actions and fraudulent conveyances, monitoring pension plans, sale of estate assets, financial reporting to the Court and parties-in-interest, and negotiating plans of reorganization and liquidation. Her work assisting troubled companies has included financial model forecasting and long-term strategic business plan development.

Her assignments have given her a broad range of industry experience. These industries include hospitality, automotive, waste management, insurance, publishing, manufacturing, financial services, apparel and textiles, not-for-profit, restaurants, and retail. She has also worked on matters involving a broad range of environmental and asbestos issues.

Prior to its acquisition by FTI, Ms. Shapss worked for Kahn Consulting. Prior to Kahn Consulting, Ms. Shapss worked as a senior auditor with Price Waterhouse where she planned and supervised audits for multinational and middle-market clients in industries such as book and magazine publishing, apparel manufacturing, financial and professional services and non-profit organizations.