Defending Managed Earnings Cases by Understanding Revenue Recognition

Protecting clients means that defense counsel must be prepared to traverse a jungle of accounting rules and standards in order to avoid catastrophe

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IN RESPONSE to the infamous Enron debacle, securities law reform legislation was enacted in the United States in 2002 by way of the Public Company Accounting Reform and Investor Protection Act, better known as the Sarbanes-Oxley Act of 2002.[1] In addition, the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) stepped up the enforcement of existing securities laws. It now seems that hardly a week goes by without another publicly traded corporation announcing plans to restate its earnings.

The typical scenario is, first, a publicly held company is forced to restate its earnings because of past aggressive revenue recognition practices. Next, class action securities fraud and shareholder derivative suits are filed. At the same time, the DOJ and the SEC launch investigations. Thus, the stakes are remarkably high. Miscalculations in the revenue recognition context may lead to financial ruin and jail.

IT'S SIMPLE—OR IS IT?

The recent onslaught of DOJ and SEC investigations probing corporate accounting practices reflects a sea change in the government's approach to enforcement in "managed earnings" cases. One consequence is that many defense counsel have been or soon will be retained to defend these cases. The underlying concepts are simple. Revenue is to be recognized in the period in which it is actually earned. Publicly held corporations are not permitted to implement creative revenue recognition practices designed solely to boost quarterly earnings.

Yet, those seeking to avoid the government's wrath, as well as that of disgruntled investors, must navigate the perilous straits between the Scylla and Charybdis of the revenue recognition provisions of the Generally Accepted Accounting Principles (GAAP), on the one hand, and the SEC staff's accounting bulletins, on the other. Distinguishing what is permitted from what is not permitted can be difficult. It is challenging simply to figure out where to look for answers.

GAAP are the official standards adopted by the American Institute of Certified Public Accountants (AICPA) through its three successor organizations: the Committee on

1. For an informative website on the legislation, *see* <http://www.sarbanes-oxley.com>, which also provides the text of the act. *See also* <http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf> and <http://www.aicpa.org/info/sarbanes_oxley_ summary.htm>.

Accounting Procedure, the Accounting Principles Board (APB), and the Financial Accounting Standards Board (FASB). In *In re K-tel International Inc. Securities Litigation*,[2] the Eighth Circuit held that a publicly-traded company's financial statements must comply with GAAP. In reality, however, GAAP are far from being a precise, canonical set of rules that ensure identical accounting treatment of identical transactions. Indeed, there are 19 different GAAP sources.

The AICPA Auditing Standards Board Statement of Auditing Standards (SAS), SAS 69, identifies the following as the sources of GAAP:

> A. Accounting principles promulgated by a body designated by the AICPA Council to establish such principles, pursuant to Rule 203 of the AICPA Code of Professional Conduct.
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> B. Pronouncements of bodies, composed of expert accountants, that deliberate accounting issues in public forums for the purpose of establishing accounting principles or describing existing accounting practices that are generally accepted, provided those pronouncements have been exposed for public comment and have been cleared by a body referred to in Category A.
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> C. Pronouncements of bodies, organized by a body referred to in Category A and composed of expert accountants, that deliberate accounting issues in public forums for the purpose of interpreting or establishing accounting principles or describing existing accounting practices that are generally accepted, or pronouncements referred to in Category B that have been cleared by a body referred to in Category A but have not been exposed for public comment.
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> D. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry, or the knowledgeable application to specific circumstances or pronouncements that are generally accepted.

According to SAS 69, the determination of which accounting principle is applicable under a particular set of conditions is a function of the hierarchy of GAAP categories.

Compliance with accounting pronouncements included in Category A is mandatory. If an accounting treatment is not specified by a pronouncement covered by Category A, one proceeds next to Category B, C or D, using the treatment specified by the source in the highest category. If an accounting pronouncement in Category B, C or D is relevant to the circumstances, that pronouncement must be followed or the alternative justified as generally accepted treatment.

Category A consists of officially established accounting principles, which include FASB Statements of Financial Accounting Standards and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins.

Category B consists of FASB Technical Bulletins and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.

Category C consists of AICPA Accounting Standards Executive Committee Practice Bulletins that have been cleared by the FASB and consensus positions of the FASB Emerging Issues Task Force.

Category D includes AICPA accounting interpretations and implementation guides (questions and answers) published by the FASB staff and practices that are widely recognized and prevalent either generally or in the industry.

If the answer cannot be found in one of the above sources of established accounting principles, other accounting literature may be considered. This includes FASB statements of financial accounting concepts; AICPA issues papers; the international financial reporting standards of the International Accounting Standards Board and of its predecessor; GASB statements; interpretations and technical bulletins of the FASAB; and statements, interpretations, technical bulletins and pronouncements of other professional associations or regulatory agencies, just to name a few, as well as accounting textbooks, handbooks and articles. The use of other sources depends on their relevance to particular cir-

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2. 300 F.3d 881, 889 (8th Cir. 2002), *aff'g* 107 F.Supp.2d 994 (D. Minn. 2000).

cumstances, the specificity of the guidance and the general recognition of the author or issuing organization as an authority.

To complicate matters even further, the SEC staff issues staff accounting bulletins (SAB), which introduce an additional practical regulatory overlay to GAAP. But the statements in the staff accounting bulletins are not law or even rules or interpretations of the SEC; nor are they published as bearing the SEC's official approval. The statements, however, do represent interpretations and practices followed by the SEC's Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of federal securities laws. For instance, SAB 101 addresses the staff's views in applying generally accepted accounting principles to revenue recognition in financial statements. Thus, prudence dictates that financial statements should comply with both GAAP and SAB 101.

RECOGNIZE WHEN?

Under GAAP, revenue should not be recognized until it is realized or realizable and earned.[3] SFAC No. 5, ¶ 83(b) provides that:

> an entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

SAB 101 is substantially more specific and arguably more restrictive. The SEC staff's views on revenue recognition as provided in SAB 101 are that revenue generally is realized or realizable and earned when: (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, and (4) collectibility is reasonably assured.

Traditional consignment sales provide an important example of an instance where revenue may not properly be recognized. Products delivered to a consignee pursuant to a consignment arrangement do not qualify for revenue recognition until the ultimate sale occurs. Under GAAP, the consignor has not "substantially accomplished what it must do to be entitled to the benefits represented by the revenues," to quote SFAC No. 5, ¶ 83(b). The SEC staff reasons in SAB 101 that revenue recognition in such cases is inappropriate because the seller retains the risks and rewards of ownership of the product and title usually does not pass to the consignee.

Moreover, under SAB 101, even where the transaction is not characterized as a "consignment sale" and title of the products passes to the buyer, the SEC staff nonetheless may find that the substance of the transaction is that of a consignment or a financing. This determination requires a careful analysis of the facts and circumstances of the transaction, as well as an understanding of the rights and obligations of the parties, and the seller's customary business practices in such arrangements.

Under SAB 101, one or more of the following characteristics in a transaction precludes revenue recognition, even if title to the product has passed to the buyer:

- Revenue may not be recognized when the buyer has the right to return the product, the buyer does not pay the seller at the time of sale, and the buyer is not obligated to pay the seller at a specified date or dates.
- Revenue may not be recognized when the buyer has the right to return the product, the buyer does not pay the seller at the time of sale, and is obligated to pay at a specified date or dates, but the buyer's obligation to pay is contractually or implicitly excused until the buyer resells the product or subsequently consumes or uses the product.
- Revenue may not be recognized where the buyer does not pay the seller at the time of sale and the seller has significant obligations for future performance to directly bring about resale of the product by the buyer.

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3. SFAC No. 5, ¶¶ 83-84; ARB No. 43, Ch. 1A, ¶ 1; APB Op. No. 10, ¶ 12.

- Revenue may not be recognized in instances where the seller is required to repurchase the product at specified prices that are not subject to change except for fluctuation due to finance and holding costs, and the amounts to be paid by the seller will be adjusted, as necessary, to cover substantially all fluctuations in costs incurred by the buyer in purchasing and holding the product.

DEFENSE COUNSEL PROBLEMS

A. Recognition of Revenue

In an SEC administrative proceeding, *In re Sunbeam Corp.*,[4] it was found that Sunbeam improperly recognized revenue on a "sale" to a wholesaler. Sunbeam booked $1.5 million dollars in revenue and $400,000 in income from a purported sale of barbecue grills to a wholesaler. But the wholesaler held the Sunbeam merchandise over a quarter without accepting any of the risks of ownership. The agreement provided that the wholesaler could return all of the merchandise it did not sell and that Sunbeam would pay all the costs of shipment and storage. The administrative law judge found that this transaction lacked economic substance and violated GAAP, citing FAS 5 and SFAC No. 5, ¶ 83).

The substance of a transaction must be examined to determine whether it is a consignment, a financing or other arrangement for which revenue recognition is not appropriate. If title to the goods has passed, but the substance of the arrangement is not a sale, the inventory should be reported separately from other inventory in the seller's financial statements as "inventory consigned to other" or another appropriate designation.

Shipping products early to meet earnings expectations may but may not fail as a proper means of recognizing revenue under GAAP. Early shipments to distributors may constitute improper "channel stuffing," a term that generally is described as "the oversupply of distributors in one quarter to artificially inflate sales, which will then drop in the next quarter as distributors no longer make orders while depleting their excess supply."[5]

This practice allows a company to escape an immediate revenue shortfall by, in effect, borrowing revenue from future quarters.[6] As one commentator has noted: "In a world where a failure to meet quarterly profit forecasts can be punished brutally by Wall Street, stuffing can seem like a wise, if risky tactic."[7] Distributors' willingness to play a role that has been described as "half warehouse and half bank" can be explained by the willingness of sellers to bribe them with discounts and other financial incentives.[8]

Yet, revenue management through channel stuffing does not necessarily constitute financial statement fraud.[9] To the extent that late-in-the period sales spurts are real events—for instance, precipitated by sales contests—the revenues are properly recognized since they reflect the underlying economic events and are not mere accounting artifacts. At the opposite extreme, sales made after period end but recorded as having taken place earlier—for instance, because the books had been "held open"—are clearly improper. In between these extremes, however, might be sales made prior to the period end cutoff but that were stimulated by "side agreements," such as the promise of extended return privileges. Such provisions probably make the sales conditional and hence not appropriate for revenue recognition under GAAP.[10]

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4. Release No. 7976, Release No. 44305, Release No. 33-7976, Release No. 34-44305, Release No. AE-1393, 2001 WL 616627 (SEC Release No. May 15, 2001).
5. Steckman v. Hart Brewing Inc., 143 F.3d 1293, 1298 (9th Cir. 1998).
6. *See* Andy Pasztor, *Mattel Methods of Accounting Are Scrutinized*, WALL ST. J., April 11, 1996, at C1.
7. Floyd Norris, *At Coke, Less Fizz Than Met the Eye*, N.Y. TIMES, October 27, 1996, at 3-1.
8. Mark Maremont, *Bausch & Lomb and Former Executives Settle SEC Accounting-Fraud Charges*, WALL ST. J., Nov. 18, 1997, at A6.
9. Rubin v. Trimble, 1997 WL 227956, 18 (N.D. Cal. 1997).
10. Bausch & Lomb Inc., Accounting and Auditing Enforcement Release No. 987, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,502, at 63,657-63,661 (November 17, 1997).

Not all revenue recognition errors and irregularities involve questions of when or if revenue should be recognized. In some instances, the mode of presentation in the financial statements is of greater concern. Even where early shipping does not result in improper revenue recognition, it may raise significant disclosure obligations.

A company that accelerates sales revenue at the expense of future quarters may be required to disclose this as a business practice, and discuss its financial implications for future periods.[11] Failure to comply with these disclosure obligations may constitute actionable fraud.[12]

B. Management Discussion and Analysis

The SEC's requirements for the management's discussion and analysis (MD&A) mandate a discussion of liquidity, capital resources, results of operations and other information necessary to an understanding of a registrant's financial condition, changes in financial condition and results of operations.[13] This includes, under SAB 101, unusual or infrequent transactions, known trends or uncertainties that have had, or might reasonably be expected to have, a favorable or unfavorable material effect on revenue operating income or net income and the relationship between revenue and the costs of the revenue.

Changes in revenue should not be evaluated solely in terms of volume and price changes, but should also include an analysis of the reasons and factors contributing to the increase or decrease. The SEC's Financial Reporting Release 36 provides that MD&A also should give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations, with a particular emphasis on the registrant's prospects for the future.

Relevant examples of such revenue transactions or events that are to be disclosed and discussed in accordance with FRR 36 include:

- shipments of product at the end of a reporting period that significantly reduce customer backlog and that reasonably might be expected to result in lower shipments and revenue in the next period;
- granting of extended payment terms that will result in a longer collection period for accounts receivable (regardless of whether revenue has been recognized) and slower cash inflows from operations; and
- changing trends in shipments into and sales from a sales channel or separate class of customer that could be expected to have a significant effect on future sales or sales returns.

For instance, in the *Sunbeam Corp.* proceeding, Sunbeam offered its customers discounts and other incentives to place their purchase orders before the period when they would otherwise have done so. The administrative law judge found that Sunbeam was required to disclose its practice of accelerating expected sales from later periods into the present period in its quarterly filing on Form 10-Q, citing 17 C.F.R. § 229.101-103.

CONCLUSION

In sum, the consequences of improper revenue recognition in corporate financial statements can be catastrophic. Courts have found that corporate financial statements that improperly recognize revenue and fail to conform to GAAP constitute presumptively false and misleading statements and violate Rule 10b-5.[14] But distinguishing what is permitted from what is not permitted can be difficult. It is challenging simply to figure out where to look for the answer.

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11. SEC Regulations S-K, Items 101(c)(1)(i) ("Description of Business") and 303 ("Management Discussion and Analysis"). See 17 C.F.R. § 229.101(c)(1)(i).

12. Harvey M. Jasper Ret. Trust v. Ivax Corp., 920 F.Supp. 1260, 1266 (S.D. Fla. 1995).

13. *See* 17 C.F.R. § 229.303. *See also* Financial Reporting Release (FRR) No. 36.

14. Sec. Exch. Comm'n v. Sys. Software Assoc. Inc., 145 F.Supp.2d 954, 958 (N.D. Ill. 2001).