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Can You Spot the Distortion?

Corporate financial scandals and Sarbanes-Oxley have complicated the role of in-house counsel. That's why lawyers should understand the schemes that executives might use to manipulate reported earnings.

By Tad Howard

The financial scandals at Enron, WorldCom, and other companies led to the passage of the Sarbanes-Oxley Act and to the demand for greater integrity in financial reporting. At the same time, the office of the general counsel took on the primary responsibility for corporate governance. Since Andrew Fastow, Scott Sullivan, and other chief financial officers had been at the center of most of the devious reporting schemes, prudence dictated that the governance activity be completely separate from the finance department.

IN-HOUSE COUNSEL

Of course, any general counsel who wants to maintain a strong corporate governance function has to understand the revenue distortions that some clever executives have used to inflate reported earnings. In the most recent scandals, devious executives have used various schemes for manipulating reported earnings. There are at least seven forms of revenue distortions that in-house counsel should understand.

Channel Stuffing

Most of us would assume that the results of operations shown on an income statement represent activities for a 12-month period that can reasonably be expected to continue into the future. One-time, nonrecurring items are treated as extraordinary items and shown "below the line" of operating profit. But some companies move sales associated with future periods into the current period in a tactic known as "channel stuffing." Coca-Cola settled accusations by the Securities and Exchange Commission that it had shipped excess beverage concentrate to Japanese bottlers in the 1997-1999 period as a way of inflating reported revenues.

In June 2005, Bristol-Myers Squibb paid $300 million to settle Justice Department charges that it inflated sales in the 1999-2001 period by $2.5 billion by pre-shipping goods to distributors. In an extreme example of channel stuffing in 1993, Bausch & Lomb invited its independent distributors of contact lenses to a meeting at its Rochester, N.Y., headquarters and provided strong inducements for them to order up to a two-year supply of lenses. Profit results for the year exceeded most Wall Street estimates, but, not surprisingly, performance for the subsequent year was below expectations.

Bundled Services

When Electronic Data Systems (Ross Perot's former firm) entered into a contract to supply hardware, software, maintenance, and software updates for a five-year period for $10 million, how much revenue was recognized in each of the five years? The response of the clever CFO might be, "What would you like it to be?" Is there any difference in the economic reality of a cell-phone provider who offers to sell a $500 phone and provide three years of free basic service and the provider who offers a free phone with a prepayment of $500 to cover three years of basic service? When an airline sells a $400 round-trip ticket to an individual who participates in its frequent-flyer program, how much revenue can it recognize at once, and how much needs to be deferred to cover the revenue from the future flight once frequent-flyer miles are redeemed?

The leeway available to CFOs in each of these sorts of circumstances has allowed them to recognize revenues in periods when earnings need a certain boost. But now, under rules promulgated by the Financial Accounting Standards Board (FASB), a company needs to unbundle the services and specify a fair-market value to each component of the transaction. Obviously, the reliance on fair-value assessments still leaves a lot of room to maneuver.

Quarter-End Blips

While no one expects revenues to flow evenly over 13 weeks, a sudden burst of revenue at the end of a reporting period should raise certain questions. MicroStrategy Inc., headquartered in McLean, Va., was one of the high flyers during the dot-com heyday. It frequently negotiated contracts in the last week of the fiscal quarter and even booked revenue on contracts not finalized until after the close of the reporting period. Computer Associates, based in Islandia, N.Y., admitted that it had fraudulently backdated contracts in order to recognize revenue in prior periods. It's another way to generate revenue in the waning days of a quarter.

Skew Revenues

Wall Street analysts apply a subjective price earnings multiple (PE) to a company's earnings per share to arrive at their target price for a company's stock. The PE multiple is generally considered a direct function of the future growth of the company's earnings. If companies A and B have the same earnings per share, but company A has a PE of 20 and company B has a PE of 10, then company A's stock will trade at twice the price of company B's stock. While different PE multiples are used to value earnings between companies, they can also be used to value different revenue and earnings streams within companies.

Thus, if a company has revenue derived from three sources—nanotechnology, buggy whips, and a favorable settlement of a lawsuit—it can expect the reaction from Wall Street analysts to be excitement over the nanotechnology, a ho-hum reaction to the buggy whips, and, for the lawsuit, the realization that this is a one-time item.

A savvy company knows that it needs to put the most favorable spin on its results in order to maximize the price of its stock. Alliance Data Systems, based in Dallas, participated in three related business segments: private-label credit cards, processing credit-card transactions, and marketing services. It was aware that Wall Street valued credit-card companies at roughly 10 times earnings, while it assigned a multiple of approximately 16 to transaction service providers.

But Alliance Data's transaction group charged the credit-card operation for processing its transactions so that, while intercompany charges were properly eliminated on consolidation, the segment reports suggested that the company was more of a transaction services company and less of a credit-card provider than was really the case. AOL also responded to signals from Wall Street when, prior to its affiliation with Time Warner, analysts conceded AOL's ability to generate Internet service provider fees from its online subscribers, but questioned its ability to garner advertising revenue. With this as a challenge, AOL accounted for two nonrecurring transactions (the settlement of a lawsuit and the sale of warrants in a technology customer) as revenue from advertising.

'Investing' in Customers

Enterasys Systems Inc., based in Andover, Mass., supplied computer networking equipment at the height of the technology bubble. When some of its customers fell on hard times, Enterasys "invested" in the stock of the wounded companies.

In a tacit quid pro quo, the customers then turned around and purchased products from Enterasys. While the round-trip transaction looks very unfavorable to Enterasys (the cash went out of their coffers and came back later, while the company shipped out valuable equipment), it was able to show two positive results: a higher level of assets (the investment) and higher revenues.

Changing Terms of Sale

If a company wants to boost sales, there are at least three terms of sale it can change to spur more customer interest: credit terms, payment terms, and the return policy. While there is nothing wrong with any of these approaches, the first two should be accompanied by a higher provision for doubtful accounts (a reduction in the net reported sales figure), while the change to a more accommodating return policy could ultimately lead to treating the sales not as final sales but as sales on consignment. In this situation, no revenue should be recognized until the ultimate sale occurs, as the consignee can return the goods at any time.

'Gross Up' Revenues

When a real estate firm sells a $500,000 house, it earns a 6 percent commission and shows revenues of $30,000 from its brokerage activity. If, on the other hand, it serves as a principal on both sides of the transaction, it could show gross revenue of $500,000 and a cost of house sold of $470,000. In either case, the pre-tax profit is $30,000, but the reported gross revenue is materially different.

In mid-2001, AOL agreed to serve as an ad broker for eBay. As it turned out, AOL produced $80 million of ad revenue for eBay. However, in accounting for the sales, AOL booked the entire $80 million as advertising revenue for AOL and recorded the net-of-commission amount as a purchase of advertising from eBay. Again, while there was no difference in the pretax profit amount for AOL, there was an enormous difference in the gross advertising revenue reported.

Finally, general counsel need to recognize that merely complying with the letter of FASB directives will no longer justify certain accounting practices. The SEC has commissioned a study to look into the further adoption of the principles-based Generally Accepted Accounting Principles and get away from the rules-based environment that permitted companies to evade the spirit of the law while adhering to the letter of the law. To paraphrase Supreme Court Justice Potter Stewart's frustration with defining pornography in 1964, the SEC and FASB may not be able to define the principles, but they'll know them when they see them.

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