Special Report

Revenue Recognition

Probing Questions, Focus on Culture Seen Aiding Boards in Fighting Fraud

"Public enemy number one in accounting fraud—and a problem that continues to plague us—is improper revenue recognition," an accounting expert told BNA in a recent interview.

Pointing to the massive number of restated financial statements last year, as well as legal cases that "seem to be getting bigger and bigger," Charles R. Drott, a certified public accountant and fraud examiner in San Francisco and a California Board of Accountancy member, said improper revenue recognition is a serious, widespread problem that has not yet been solved.

The key to improving the detection and reporting of improper revenue recognition, Drott said, is a change in the mindset of corporate America by establishing a culture of honesty and integrity.

Audit committees can play a pivotal role in combatting improper revenue recognition by asking key questions about such things as sales percentages, the nature of revenue transactions, changes in policies, and whether independent auditors view any revenue accounting as aggressive, another accounting expert, former SEC Chief Accountant Lynn E. Turner, told BNA.

Another approach is for corporate boards to focus on risk management and engage in appropriate benchmarking, a prominent corporate and securities attorney said.

Revenue Recognition Public Enemy No. 1. "Improper revenue recognition is the accounting fraud of choice that companies use to deceive investors and Wall Street, and is the darkest hole of all, because there are so many different permutations and scams," Drott, speaking on his own behalf and not for the CBA, said March 15.

"Improper revenue recognition is rampant in corporate America and is the most utilized fraud scheme to create fraudulent financial statements," he said. "Nothing even comes close to it. It never ceases to amaze me, and it never stops."

The magnitude of improper revenue recognition, Drott said, can be seen in a recent Huron Consulting Group report (3 CARE 77, 1/28/2005), which reported it was the leading cause of the record 414 financial restatements last year.

Highlighting the magnitude of what these restatements mean to investors, Drott said, "A restatement of a previously issued financial statement by definition is an admission by corporate management that there has been a material or significant error or irregularity (fraud) in those previously issued financial statements, and therefore those financial statements are misleading to any investor that has read and relied on it."

As a certified public accountant and fraud examiner, Drott has testified against the Big Four accounting firms as well as their large public clients in cases of accounting fraud. He said over the last 10 years, 90 percent of his cases involved improper revenue recognition as the top issue. "That is how bad it is," he said, adding, Enron and WorldCom "only scratched the surface" in accounting fraud.

Noting improper revenue recognition schemes alone have caused investors losses in the billions of dollars, Drott said compliance with SOX may be costly, but it "pales in comparison to the cost of massive investor losses without the protections that SOX provides."

What Audit Committees Should Do, Ask. Turner, a former SEC chief accountant who is now managing director of research at the proxy advisory firm Glass Lewis & Co. LLC in Broomfield, Colo., told BNA March 17 in written comments audit committees need to understand some key things in order to detect improper revenue recognition:

- the marketing and distribution channels a company uses;
- how the marketing and distribution channels impact revenue recognition;
- when a company recognizes revenue;
- the key criteria that must be met in order for a company to recognize revenue;
- what has gone on each quarter with orders, shipments, and backlog; and
- whether the information on orders, shipments, and backlog is consistent with what is going on with the revenue line in the income statement.

Turner listed seven particular questions an audit committee should be asking the independent auditor, internal auditor, and chief revenue officer (CRO):

- Were a higher percentage of sales recorded in the last two weeks of the quarter than has been the historical average, and if so, why?
- Were there any nonrecurring revenue transactions, and if so, (a) what is the nature of them, (b) how large were they, and (c) are they fully disclosed as nonrecurring?
- Were there any unusual transactions in terms of payment terms, warranties, return al-

Top 10 Schemes for Cooking the Books.
Charles R. Drott, a certified public accountant and fraud examiner in San Francisco, told BNA in a recent interview he has seen at least 10 recurring schemes of booking fraudulent revenue in his cases as an expert witness against large companies and their auditors:

- secret side agreements—one of the favorite tools;
- circular and triangular schemes—transactions that involve co-conspirators of two or three companies that agree to perpetrate the fraud;
- selling products or services to companies that are not creditworthy or are unable to pay, but the seller books the revenue anyway;
- booking premature revenue by getting to the end of a quarter and holding the period open to book additional revenue;
- booking revenue without an agreement—when a contract has not been executed or finalized, but the seller books it under the guise of having an agreement;
- booking revenue when the product has not been delivered;
- channel-stuffing—when companies are in cahoots and one company sells unneeded products to another company, but allows the purchasing company to return the products at a later date;
- related-party transactions;
- barter transactions—non-monetary transactions where companies swap products; and
- "bill and hold" transactions—where one company bills another company for a product but does not ship it to the company right away.

lowances, or guarantees, for example, outside the typical normal shipments, and if so, how was it determined revenue recognition was proper for these transactions?

- Have there been any changes in the company's revenue recognition policies?
- Have there been any new types of sales transactions in the quarter, and if so, does the independent auditor believe the most appropriate accounting policy for them was chosen?
- Does the independent auditor view any of the company's revenue accounting as aggressive, and if so, why?
- Were there any "top side" entries booking revenue recognition, and if so, why?

Drott said he sees a lot of abuse with barter transactions in particular, which are covered by generally accepted accounting principles (GAAP), and are "really outrageous. Essentially," he said, "you cannot always recognize revenue in a non-monetary transaction." So one of the first questions to ask—and the first red flag—is why two big companies would not pay each other cash and instead resort to bartering products and services, he said.

Drott added companies often will get caught at some point for booking premature revenue, because the cycle of fraud is self-perpetuating and tends to become larger and larger.

Boards Need to Benchmark, Manage Risk. Michael J. Halloran, a corporate and securities attorney with Pillsbury Winthrop LLP in San Francisco who addressed corporate governance and financial fraud issues generally in the wake of the guilty verdict of former WorldCom chief executive officer Bernard J. Ebbers, told BNA in a March 16 interview it appeared WorldCom directors did not engage in adequate management of risks that were evident, such as downward trends in the telecommunications industry.

Citing another hypothetical, Halloran suggested that perhaps if Royal Dutch Shell directors had asked for figures on what numbers other oil companies were using to state reserves in the very same fields in which Shell was overstating its reserves, "maybe there would have been some questions asked."

Boards should look at key ratios for their business, for example, in the case of telecommunications and WorldCom, line costs compared with overall costs, and then do some benchmarking against other companies' ratios, he said. Directors "need to think [not only] about adjustment, but also about risk management," he said.

"Good boards demand benchmarking" as part of their oversight role, he said.

What Auditors Should Do. Drott said it is important to remember "transactions must have a legitimate business purpose." Some of the most effective expert testimony he gives in his legal cases regarding revenue recognition fraud—and what usually costs companies huge damages in this area—is GAAP's requirement that a transaction be accounted for in accordance with its economic substance and not its legal form, he said.

Drott said there are many ways auditors can improve their detection and reporting of revenue recognition fraud, most importantly by being truly independent.

He said in the 60 or more audit failure cases he has been involved in, auditors failed to:

- employ professional skepticism and objectivity;
- corroborate management representations with independent evidence;
- ensure inexperienced auditors are not the only ones doing the work on the audit team, especially in high-risk audit areas like revenue recognition, because all they see is the legal form of transactions and do not have the experience to ask the probing questions or see the fraud for what it is;
- have the audit partners and managers spend enough time on the audits instead of assigning less experienced staff to increase the profit realization of the audit;
- investigate known and documented red flags;
- send and properly evaluate appropriate audit confirmations for revenue transactions;
- have strong audit evidence;
- adequately consider the possibility of improper revenue recognition and other fraud;
- conduct thorough testing and probing in high-risk audit areas; and
- follow professional standards and internal policies.

It's All About Honesty, Integrity. Drott stressed that the answer to the improper revenue recognition problem is honesty and integrity. He commended the Public Company Accounting Oversight Board for their new audit

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standards and said he hopes they will help to create an environment for compliance with professional standards. However, he said, "The Sarbanes-Oxley Act and new audit standards are not the ultimate answer. You can't legislate or regulate honesty and integrity. Unless you have a rebirth and a real awakening of true honesty and integrity and an obligation to serve the public, nothing will ever change. Frauds are and will keep occurring."

He said, "Enron and WorldCom may be behind us, but that does not mean the problems have been cured. In the companies I have seen, there has been a breakdown in financial reporting, honesty, and integrity, as well as a lack of integrity and independence on the part of major accounting firms by refusing to apply an appropriate level of professional skepticism."

"This means," he said, "auditors must stand up to corporate America and must conduct thorough audits."

What also will help to create a culture of honesty and integrity is awareness and attention in university and continuing education programs, he said.

By Alison Carpenter