Where there's revenue-recognition deviation, there could be fraud.

Hocus-Pocus Accounting

BY DOUGLAS R. CARMICHAEL

EXECUTIVE SUMMARY

- **PUBLIC COMPANIES** that fail to report quarterly earnings which meet or exceed analysts' expectations often experience a drop in their stock prices. This can lead to practices that sometimes include fraudulent overstatement of quarterly revenue.

- **ONE OF THE MOST COMMON** schemes is the bill-and-hold sales transaction. While it's not necessarily a GAAP violation, it's often associated with financial frauds and calls for deeper investigation. The SEC says that all of the following conditions must be met for revenue recognition to be appropriate:

  - The risks of ownership must have passed to the buyer.

  - The customer must have a commitment to purchase, preferably in writing.

  - The buyer must request the bill-and-sale transaction and substantiate a business purpose for it.

  - A fixed delivery date must exist.
  - The seller must not retain any significant specific performance obligations.
  - The goods must be complete and ready for shipment and not subject to being used to fill other orders.

- **DEALS CALLED SHAM TRANSACTIONS** refer specifically to sales schemes that appear genuine but actually are rigged for the purpose of letting the seller recognize revenue. Other indicators that fraudulent financial reporting might exist include bogus shipping dates, revenue figures that always meet analysts' expectations and transactions with unusual payment terms.

- **AUDITORS WITH A GOOD UNDERSTANDING** of the client, the business and its products are well prepared to see the warning signs of revenue-recognition fraud.

DOUGLAS R. CARMICHAEL, CPA, CFE, PhD, is the Wollman Distinguished Professor of Accountancy at Baruch College, the City

University of New York. He is the vice-president of the Philadelphia chapter of the Association of Certified Fraud Examiners. His e-mail address is douglas.carmichael@wordnet.att.net.

SEC Chairman Arthur Levitt decried what he termed "accounting hocus-pocus" and called for coordinated efforts to uncover it. He targeted the practice by some companies of improperly boosting reported earnings by manipulating the recognition of revenue. Among the most common methods of doing this are the bill-and-hold transaction and a long list of sham transactions involving shipping, billing and/or related-party involvements. Both the SEC and the AICPA seek to increase independent auditors' awareness of problems associated with these practices.

Public companies feel pressure to report quarterly earnings that meet or exceed analysts' expectations—after all, failure to meet those expectations can hurt companies' stock prices. This pressure can lead to practices that sometimes include fraudulent overstatement of quarterly revenue. Any of the improper and unusual revenue-transaction methods used to misstate quarterly revenue also can be used to change annual results. Auditors need to be alert to the whole gamut of warning signs that revenue-recognition fraud may be present.

BILL-AND-HOLD SCAMS

Although the bill-and-hold method is not in itself a GAAP violation, it's difficult to audit and has long been associated with incidents of financial fraud. Bill-and-hold fits the fraud-risk-factor description in SAS no. 82, Consideration of Fraud in a Financial Statement Audit: unusual and highly complex transactions that pose difficult substance over form questions. In a bill-and-hold deal, the customer agrees to purchase goods, but the seller retains possession until the customer requests shipment. An example: A municipality building a sanitation plant buys equipment for the facility and delays delivery until it's completed. The seller may be able to book revenue even though nothing has been exchanged physically. This is a legitimate business purpose for a bill-and-hold arrangement because two conditions are met: (1) realized or realizable and (2) earned.

FINANCIAL FRAUD

GAAP requires that revenue recognition be based on whether the revenue is realized or realizable and earned. Revenues commonly are recognized at the time of sale, usually meaning delivery. Because revenue recognition on bill-and-hold transactions departs from this general practice, the auditor must know how and why a company maintains that using this method is justified. In recent enforcement actions, the SEC said a transaction must meet all of the following conditions to justify revenue recognition:

The risks of ownership must have passed to the buyer.

- The company must have from the customer a fixed commitment to purchase, preferably in writing.
- The buyer—not the seller—must have requested the transaction and must have a substantial business purpose for a bill-and-hold deal.
- There must be a fixed delivery date that is reasonable and consistent with the buyer's business purpose.
- The seller must not retain any significant specific performance obligations, such as an obligation to assist in resale.
- The goods must be complete and ready for shipment and not subject to being used to fill other orders.
- The exhibit, a confirmation request letter, is an example of how the independent auditor can confirm whether a transaction meets the revenue-recognition conditions.

The SEC has emphasized that the above is not a simple checklist. A transaction might meet all the criteria and still fail the revenue-recognition guidelines. The following factors also must be considered:

- The date the seller expects payment and whether the seller has modified its normal billing and credit terms for the buyer.
- The seller's past experiences with bill-and-hold transactions.
- Whether the buyer has the expected risk of loss in the goods' market value.
- Whether the seller's custodial risks are insurable and insured.
- Whether Accounting Principles Board Opinion no. 21, Interest on Receivables and Payables (on discounting the related receivable), applies.
- Whether the business reasons for the transaction have introduced a contingency to the buyer's commitment.

A WELL-PREPARED AUDITOR

In planning the audit of all revenue transactions, the auditor must understand the client's industry, business and products as well as its procedures for accepting orders, shipping goods, billing and recording sales and removing product from inventory. When a client engages in bill-and-hold transactions, he or she should determine whether the transactions comply with the SEC's criteria.

Auditors need to consider many factors to assess the appropriateness of revenue recognition. For example, in an SEC enforcement case, the seller was a toy maker with a highly seasonal business. Its customers couldn't accept delivery of Christmas toys before the season began. Although there clearly was a business purpose for delayed shipment, the deal failed the SEC test because the risks of ownership hadn't passed to the customers and the toy maker had prepared the sales invoices without the customers' participation in order content.

DIGGING DEEPER

Auditors can use analytical procedures to help detect undisclosed bill-and-hold practices. Comparing current-year monthly sales with those of the preceding year might uncover significant fluctuations. For example, an unusual decrease might result from the reversal of fraudulent bill-and-hold transactions in a subsequent period. Also, inspecting documents supporting sales transactions might disclose bill-and-hold practices. For example, bills of lading might be signed and dated by company employees rather than a shipping company employee; shipments might be to warehouses rather than to the customer's regular address; and shipping information might be missing on invoices. Auditors should review special notations on invoices to see whether they reveal bill-and-hold transactions.

Coordination with audit work in other areas also is important. For example, during an inventory, the auditor might come across goods that were billed to customers but that were not shipped or physically segregated.

Detecting Revenue-Recognition Fraud

Where to find guidance.

SEC documents

Accounting and Auditing Enforcement Release 108 (on bill-and-hold sales transactions), August 1986.

Accounting Series Release 153 (on related-party transactions), February 1974.

Accounting Series Release 292 (on bill-and-hold sales transactions), June 1981.

AICPA documents

Audit Issues in Revenue Recognition, 1995, www.aicpa.org/members/div/auditstd/pubaud.htm.

Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82, by Michael J. Ramos, CPA, 1997.

Practice Alert 98-3, Revenue Recognition Issues, SEC Practice Section Professional Issues Task Force, November 1998.

SAS no. 82, Consideration of Fraud in a Financial Statement Audit, February 1997 (AICPA Professional Standards, AU section 316).

SHAM TRANSACTIONS—MORE RED FLAGS

There is a long history of other types of revenue-recognition manipulations involving related parties that are connected with fraudulent financial reporting such as

- Sales without substance, including funding the buyer, for example, so collection is assured.
- Sales with a commitment from the seller to repurchase that, if known to the auditor or SEC, would preclude revenue recognition.
- Sales with a guarantee by an entity financed by the seller of what would otherwise be viewed as an uncollectible receivable.

These schemes are sometimes referred to as sham transactions: The transaction appears to be a genuine sale, but it isn't. The buyer goes through the motions so the seller can recognize the revenue.

Fraud risk factors. Many related-party transactions are linked to fraud. The auditor should view the risk factors as a warning that fraud may exist, as required by SAS no. 82. If the auditor sees any one—or a combination—of the following risk factors, he or she should react accordingly:

- Significant related-party transactions outside the ordinary course of business or with unaudited entities.
- Significant unusual or highly complex transactions, especially those close to the end of a reporting period.
- Significant bank accounts or operations in tax havens for which there appears to be no clear business justification.
- An organizational structure with a high degree of complexity that is without apparent business purpose.
- Difficulty in determining who controls the entity.

Accounting sense. The assumption that financial statements reflect arm's-length bargaining between independent parties is fundamental to financial reporting. However, when transactions differ materially from their economic substance, immediate profit recognition generally should be deferred. Profit should not be recognized until there is an exchange transaction with an unrelated party. For example, when an entity has created the other party and is effectively both buyer and seller, revenue recognition generally is inappropriate even if the relationship is disclosed.

Auditing alert. The auditor should be on the lookout for the existence of undisclosed related parties and the possibility of fraud. SAS no. 45, Omnibus Statement on Auditing Standards—1983, includes several procedures for identifying undisclosed related-party relationships. The auditor should be watching for them when doing a

Review of conflict-of-interest statements obtained by the company from its management.

Review of the extent and nature of business transacted with major customers, suppliers, borrowers and lenders to look for previously undisclosed relationships.

Review of accounting records for large, unusual or nonrecurring transactions or balances, paying particular attention to transactions recorded at or near the end of the reporting period.

Review of confirmations of loan receivables and payables for indications of guarantees.

When a review reveals a significant transaction involving a guaranty or similar relief of a transaction principal from risk of loss, the auditor should seek information on the nature and extent of the guaranty and the full identity of the guarantor. The auditor can also do the following:

- Ask tax and consulting personnel who provide services to the client about their knowledge of management's involvement in material transactions or with transaction principals.
- If the company is going public, review information obtained by its securities counsel about management relationships for registration statement disclosure.
- Use the Internet and other sources of information (such as newspapers, phone books and industry or trade publications) to search for information about key members of management and the company. For example, an Internet name search will list for 47 states the corporation and limited partnership records in which that name appears.
- Review material cash disbursements, advances and investments to see whether the client provided funds to a related entity.
- Discuss with intermediaries (such as lawyers, predecessor auditors or others providing professional services) what they know about the principal parties to material transactions.

If the auditor's procedures uncover the existence of related-party transactions that were concealed deliberately, the auditor must determine their effects on the audit, especially the implications for management integrity.

DOES IT NEVER END?

Any of the fraudulent schemes used to misstate annual revenue can also be used to manipulate quarterly information; the following were used in recent instances:

- Shipping after a quarter ends, but keeping the books open so revenue is recorded in that quarter.
- Shipping to a warehouse without the customer's instruction.
- Shipping in advance of the scheduled date without the customer's agreement.
- Making sales in which substantial uncertainty exists about either collectibility or the seller's ability to comply with performance guarantees.

For example, a manufacturer of electronic security devices shipped products after the end of a quarter but manipulated the computer dating of internal shipping documents in order to include the sales in the quarter. Because this premature revenue recognition had an offsetting effect on the next quarter in which the sales should have been recorded, management contended that the practice wasn't objectionable due to overall immateriality. The "immateriality" cover story is, in fact, a relatively common feature of fraudulent quarterly revenue overstatements.

Other indicators of fraud include

- Constantly increasing revenues and earnings that always meet or exceed budgeted targets and analysts' expectations.
- A substantial portion of revenue recorded near the quarter's end.

- Individual material revenue transactions with unusual payment terms or other significant variations from normal terms of sale, particularly those recorded near the quarter's end. (For more on what unusual number patterns can reveal, see "I've Got Your Number," JofA, May99, page 79.)

Finally, if auditors detect intentional departures from GAAP, even if immaterial to the annual financial statements, they should weigh the implications and design an appropriate audit response. And if senior management appears to have been involved, the auditor should inform the audit committee.

Revenue-recognition frauds have been at the core of many suits against auditors; similarly, such frauds have been uncovered during SEC and AICPA ethics and quality control inquiry investigations. Thus, it's appropriate that auditors improve their efforts to detect fraudulent financial reporting by focusing on improper revenue recognition.

An auditor who is familiar with the methods that have been used to fraudulently overstate revenue and the audit procedures that have been successful in detecting those frauds is better equipped to provide the scrutiny of revenue recognition now being called for by the SEC and the AICPA.

Confirmation Request for a Bill-and-Hold Transaction

[Client Letterhead]

[Date]

[Name and address of customer
employee with sufficient
authority to commit customer]

Dear [Name]:

Our auditors [CPA firm name and address] are auditing our financial statements at [balance sheet date]. Please compare the following information with your records and report directly to our auditors whether that information is correct:

We sold you [product description] on [date] for [total sales price] under your purchase order [date and number].

[Product description] has been sold to you on our normal payment terms as described in our invoice [number and date] and those terms have not been modified. There are no written or oral amendments to the terms specified in the purchase order.

At your request we are holding [product description] at your risk on our premises, and title has passed to you.

You requested us to hold [product description] for you because [description of business reason for delayed shipment].

There are no written or oral amendments to the terms specified in the purchase order.

You are obligated to pay us [total sales price] by [payment due date].

Please use the enclosed preaddressed, postage-paid reply envelope. Because this response is needed for our auditors to complete their audit, we would appreciate a prompt response.

Very truly yours,

[Signature and title of authorized client representative]

If the above information is correct, please confirm. If your understanding of anything described above differs in any respect, please explain.

____

____

Date: ____________________

Signed: ________________________________

go back