

IFAC

**Financial and
Management
Accounting
Committee**

February 2003

QUALITY OF EARNINGS:

A Case Study Collection

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International
Federation of
Accountants



The mission of the International Federation of Accountants (IFAC) is the worldwide development and enhancement of an accountancy profession with harmonized standards, able to provide services of consistently high quality in the public interest.

The Financial and Management Accounting Committee (FMAC) of IFAC welcomes any comments you may have on this booklet. Comments should be sent to:

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FOREWORD

The Financial and Management Accounting Committee (FMAC) of the International Federation of Accountants (IFAC) explores emerging trends and seeks to represent contemporary best practice in the domain of accounting work concerned with the management of organizations. This is done primarily through a range of publications: annual theme booklets, an annual collection of articles of merit, research studies, International Management Accounting Practice Statements (IMAPS) and guides for practitioners. Periodically, a member body makes available its own work for distribution to a broader audience through FMAC in an effort to share that work. Such is the case with this collection of case studies on earnings quality.

“Earnings Quality” has been a subject of investigations by regulators in many countries, articles in most, if not all, business publications, and significant debate in recent years. It is a matter of importance in the financial reporting and regulatory communities, and it impacts the confidence of investors in global financial markets. For this reason, the American Institute of CPAs in the U.S. engaged authors and experts to assemble this collection of case studies, to put the reader in the seat of executives making decisions that could impact the future of their company, and their own and their employees’ livelihoods.

The concept of Quality Earnings goes back to preparers understanding the economic substance of a transaction, then reflecting it properly in the books and records of the company. However, this is not always easy, as accounting rules are not simply black and white, and the nature of transactions is ever more complex. This understanding can be improved when the chief financial officer (CFO), an expert in the management of process, technology and resources, is part of the decision-making process in a company and can help guide and shape decisions to make better sense within the context of the applicable accounting standards and regulatory reporting requirements.

Managing the business and its operations to achieve a desired outcome or hit a target is entirely appropriate, (the emphasis here is placed on managing the *business*); managing earnings as we all agree, is not an acceptable practice to hit earnings targets. This fact is critical to professional accountants in management throughout the globe, and especially to our brethren in the United States where the profession has been challenged by corporate scandals and government regulation. As practitioners in the global financial reporting community we must report high quality earnings and the necessary disclosures to enable the investing public to make better informed decisions.

One way to do this is through the creation of a robust performance measurement system incorporating both financial and non-financial measures that not only measure current positions but also are predictive of future conditions in the business. Knowing and understanding key metrics in a company can lead to better decision-making and reporting, and thus higher quality earnings. Having an effective early-warning system in place could obviate the need for managing earnings by giving more of an opportunity for managing operations.

We hope you use these cases as an education opportunity for yourself and for your colleagues. You may want to create an interactive discussion session by distributing the cases for discussion, and then introducing the expert commentary for review. If you learn something about earnings quality, and it

Quality of Earnings

sensitizes you to the importance of this topic to your company, and to the integrity of the broader financial markets, then we will have achieved our objective.

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Managers can use their knowledge about the business and its opportunities to select reporting methods and estimates that match the company's business economics, potentially increasing the value of accounting as a form of communication. However management's use of judgment also creates opportunities for earnings management in which managers choose reporting methods and estimates that do not adequately reflect their company's underlying economics (Healy, Wahlen, Working paper, 1998).

The following table contains just a sample of the issues in the case studies that impact quality of earnings and is by no means an exhaustive list.

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DO THE RIGHT THING

By Howard Fowler, MS, CPA, CFM, FHFMA

Union Hospital will not be able to issue the new bonds and that may result in a sale of the hospital to buyers outside of the community. What would you advise?

Abstract

Chief executive Dr. Ronald Weaver is facing shrinking demand for services at Union Hospital. His executives are giving him conflicting opinions about how to solve the hospital's immediate cash flow problems. Examine the facts presented for Union Hospital and determine the course of action you believe Dr. Weaver should follow.

Background

Dr. Rodney Weaver has been the chief executive officer of Union Hospital for the past seven years. He has been affiliated with the hospital for the 25 years, first as a physician, then in various administrative roles and finally as CEO. Dr. Weaver had a small private practice and for many years he was quite content with simply being a family physician. He entered hospital administration because he wanted to make a difference in an area in which he felt that effective leadership was sorely lacking.

Today, Union Hospital and Dr. Weaver face a serious dilemma, one that is not unique to the hospital industry, but one that is in fact timeless. The hospital industry has excess supply and waning demand for inpatient services. Many hospitals are struggling to remain economically viable. Union's survival depends on the quality of the decisions made by its senior leadership. In the face of adversity, how will Dr. Weaver and his management team respond? Dr. Weaver takes great pride in "doing the right thing." In this case, the right choice may not be obvious.

Union Hospital is a not-for-profit hospital located in the heart of the inner city. It has a long and distinguished record of providing care to the citizens in its service area regardless of their ability to pay. The hospital generates about \$125 million annually in revenue and spends nearly all of it on patient care, community outreach and the maintenance of its aging facilities. It employs well over a thousand people in the community and it is renowned for its positive labor relations. Union actively sponsors health awareness and prevention activities and it has gained fame for its community outreach programs.

For the last few years, the number of inpatient admissions at Union has decreased by 3% to 5% percent annually. At the same time, the average payment per inpatient case has stayed flat. This is due to the pressures associated with managed care and with tight Medicare and Medicaid regulations. Managed care is the collection of business practices adopted by insurance companies to reduce health care costs. Medicare is the federal program that provides care to senior citizens. Medicaid is a joint federal and state program that provides care to certain indigent residents. Payment rates from insurance companies, Medicare and Medicaid have been under significant pressure to remain flat or decline. At the same time, the costs of providing care have been increasing,

particularly due to a nationwide shortage of nurses. Union provides free care to many area residents who do not have any health care coverage and yet are not poor enough to qualify for Medicaid. The costs of providing this charity care directly reduce Union's bottom line, but the hospital cannot curtail this service since it is an integral part of its not-for-profit mission.

Dr. Weaver has seen the hospital through many changes, including a major bond issue about 10 years ago. The \$75 million bond offering was used to renovate a significant portion of the facility as well as to purchase the latest technology for the hospital's clinical departments. Principal payments on the bonds are due over a 30-year term. Five million dollars have been paid to date. Unfortunately, health care technology continues to advance and the costs of acquiring the latest diagnostic and surgical equipment pose a serious challenge to Union's finances.

Albert Case, Union's chief financial officer, has proposed a new \$80 million bond offering to refinance the remaining \$70 million of outstanding bonds and to obtain an additional \$10 million to buy the latest clinical equipment. Case feels that although interest rates are at an all-time low they will rise in the next year. The reduced interest costs will more than pay for the debt service on the additional \$10 million of debt. If the hospital does not obtain this financing, it will have difficulty keeping its clinical equipment up-to-date and may have to shut down certain programs.

Union Hospital currently has a bond rating of BBB, just barely maintaining its investment grade status. This is a relatively high rating in comparison to hospitals of a similar size. It enables Union to receive favorable interest rates from the bond market. The BBB rating is based in large measure on the stability of Union's operating results even in difficult circumstances. While many hospitals have made poor investment decisions and suffered financial setbacks, Union has avoided many of these problems. As a result, the management team has gained significant credibility with the rating agencies and others in the bond market.

The Problem

During 20X2, Union's financial situation has deteriorated. The hospital had budgeted net income of approximately \$3 million for 20X2. With eleven months of the year completed, though, it appears that the hospital will actually suffer a net loss of approximately \$3 million. This \$6 million difference is due mainly to a shortfall in revenue associated with reduced admissions and lower payment rates. Budgeted revenue was \$125 million, while actual revenue is trending to roughly \$120 million for the year. The remainder is due to slightly higher-than-anticipated labor costs. The forecasted net loss of \$3 million is just on the threshold of pushing Union into technical default on its outstanding bonds. A technical default would result in the acceleration of the remaining \$70 million liability and would essentially bankrupt the hospital. The bond trustee, the bondholders and the ratings agencies are not aware of the extent of Union's financial difficulties. Quarterly financial statements that Union has provided to these parties have shaded the issue, showing the hospital breaking even during the first two quarters of the year and earning just under \$1 million in the third quarter. Because of Union's historical stability, the rating agencies have not expressed significant concerns about these results. They continue to have faith that Union's management team will navigate through any difficulties.

Albert Case, the CFO, has brought a situation to Dr. Weaver's attention that may have an effect on Union's reported results for 20X2. Sharon Morella, the hospital's director of reimbursement, believes that Union is owed approximately \$5.2 million from the state Medicaid agency for the years 20X0 to 20X2. The basis of the claim is that the hospital incurred certain costs in delivering care to Medicaid patients, but the agency incorrectly applied the existing law and rejected the claims. The Medicaid agency says the state legislature did not appropriate funds for this particular matter during those years and thus it feels that the state does not owe this amount to Union. The hospital had asserted its right to the payments in prior years, but the Medicaid agency had rejected the claims. Union did not record any revenue related to this issue in prior years. Of the total amount, approximately \$1.2 million pertains to services delivered in 20X0, \$1.4 million to 20X1 and \$2.6 million to 20X2.

In November 20X2, the state courts ruled in favor of another hospital in the state in a similar claim filed against the Medicaid agency. Union's counsel feels this decision strengthens the hospital's claim. Since the case is subject to appeal, the ultimate outcome will not be settled for several years. However, Morella believes that this case is ample evidence that Union will eventually be paid and, thus, should record the \$5.2 million as revenue in 20X2.

The Options

Union's financial management team met to discuss the disputed Medicaid payments and came up with a number of differing opinions. The participants include Dr. Weaver, Albert Case, Sharon Morella, the controller and the vice president of strategic planning.

The controller, Christopher Harolds, believes that disputes with third-party payors are not uncommon. Typically, they are considered to be contingent gains until the third-party acknowledges the liability. Then a change in accounting estimate is made to recognize the revenue in the current period. Thus, Harolds believes that Union should not record the \$5.2 million in 20X2, but rather that the revenue should be recorded as soon as the litigation is resolved. Harolds does believe that Union should disclose the existence of the issue and the potential gain in the notes to the financial statements. Sharon Morella, the director of reimbursement, takes a more pragmatic approach. Third-party payments are always subject to retroactive settlement and/or audit. Frequently the hospital will not know the final settlement for a given year until many months or years after the end of that year. In these cases, management simply makes use of all available information to prepare a good-faith estimate of the ultimate settlement. Morella sees nothing different between this approach and the current situation, other than the fact that litigation will be required to realize this particular settlement and collection might take longer than usual. The hospital should record its best estimate of the ultimate settlement regardless of whether that settlement results in a gain or a loss.

Harolds argues that financial statements should be prepared in a conservative manner. The hoped-for settlement from litigation is different from the typical third-party settlement process. Medicaid has indicated specifically that it is not going to pay the amount claimed. While management believes that the claim will be successful, accounting principles do not provide for recording such an uncertain claim as revenue. "The quality of earnings that we report is just as important as the actual amount of earnings that we report," Harolds argues. "Readers of our financial statements will see that we have recorded revenue for which we have no expectation of receiving cash in the near-term. This will erode confidence in our integrity and in our ability as a management team."

Michele Seans is the vice-president of strategic planning. She is the newest member of Union's management team, having joined the hospital from a major consulting firm about six months ago. She is troubled by the discussion. While it is important to account for the Medicaid claim appropriately, it seems to her that there is a lack of focus on the underlying issue. "The financial problem at hand," she says, "has its source in a very serious operating issue. Declining volumes and payment rates have resulted in lower revenue, yet our cost structure remains unchanged. The Medicaid issue is irrelevant to the goal of improving our operations and keeping our doors open. We should focus our attention on right-sizing our operations and reducing costs."

Dr. Weaver is confused by the wide variety of opinions. While he has been involved in administration for many years, his original training was in medicine. He is not interested in the subtleties of accounting gains and losses. His main concern is that the hospital will continue to provide care to patients. Accordingly, he is worried that the forecast shows that Union will suffer a net loss of \$3 million this year. When Dr. Weaver hears Sharon Morella say that the \$3 million net loss could become net income of \$2.2 million, he is both excited by the opportunity and confused by the "fuzziness" of the numbers.

Harold attempts to explain the revenue recognition principle to Dr. Weaver. "Revenue should be recorded in the period earned rather than in the period that cash is received. This principle is widely accepted as the basis upon which financial reports are prepared. Normally, it is easy to determine when revenue is earned. It is simply the period in which the related services are provided to the patients. In this instance, however, we know that services were provided, but we are uncertain about the amount that Medicaid will ultimately pay us for those services." Dr. Weaver finds it confusing that no one can pinpoint the moment that this portion of revenue becomes earned.

Albert Case, in a fit of practicality, tells the assembled group that this is more than just a theoretical discussion. If the hospital does not record the disputed Medicaid payments as revenue, it will be in default on its existing bonds. Union will not be able to issue the new bonds and will be unable to fund needed capital improvements. Case hints that this may result in a sale of the hospital to buyers outside of the community or even to a closure of the facility. "Sure," he says, "accountants are often conservative, but there is no place for that now. This hospital needs to record the \$5.2 million of revenue to survive. We do expect to receive cash for this claim, just not for a few years. These earnings are real and we must record them. After the new bonds are issued, we will deal with our operating problems."

The Decision

Dr. Weaver is confronted with a number of intertwined financial, operational, legal and ethical issues. As the CEO his ultimate responsibility is to ensure that Union can fulfill its mission by continuing to provide care to the residents of its service area. Dr. Weaver believes that Union should do the right thing and record only the revenue that is appropriate. But he is confronted with starkly differing opinions from the key members of his management team. In a situation this unclear, he does not know what course of action to take. How would you advise Dr. Weaver?

Comments on “Do the Right Thing”

Robert M. Tarola, CPA, is Chief Financial Officer and Sr. Vice President of W.R. Grace & Co.

Meet privately with lenders and rating agencies to alert them of the financial issues and management’s plan to improve results.

The most important objective in this case is that the hospital remain in operation to serve the medical needs of its community. The capital structure needed to support continued service is important, but even more important is the ability to generate sustained cash flow to fund operations, capital requirements and debt service. These executives seem to be more concerned about immediate financial measures than about sustainability of services. They should first address operating issues, then couple the communication of improved operating plans with disclosure of less-than-expected historical financial performance. It is unlikely that new capital can be raised before operating issues are effectively resolved.

My recommendation to this executive team is:

1. Develop an operating plan that will restructure services, costs and capital needs to improve profitability for the foreseeable future.
2. Follow the controller’s advice on accounting and disclosure. Defer revenue recognition but disclose the matter in detail.
3. Meet privately with lenders and rating agencies to alert them of the financial issues and management’s plan to improve results.
4. Seek waivers from lenders, if necessary, on the basis that current cash flow issues are being addressed and future cash flows should provide sufficient liquidity to meet debt covenants.
5. Aggressively pursue litigation to recover disputed revenue.
6. Evaluate and pursue debt restructuring alternatives supportable by the new operating plan.

This approach will likely allow the executive team to maintain its credibility with the financial community; mitigate the risk that lenders and agencies will take drastic actions; sustain medical services to a needed market; and leave the hospital better prepared for an increasingly difficult operating environment. In this case, “doing the right” thing should result in a partnering response from capital providers.

Carol A. Purcell, CPA, is the Chief Financial Officer at the Roman Catholic Archdiocese of Newark (NJ).

Carol spent 10 years at Coopers & Lybrand specializing in hospitals and not-for-profit organizations, in addition to having experiences in large commercial organizations. Following her years at Cooper & Lybrand, Carol was a senior financial executive at a major hospital corporation in Northern New Jersey, before taking her current position as CFO at the Roman Catholic Archdiocese of Newark.

Current financial results are out of line with market expectations. Dr Weaver should educate outside stakeholders regarding the current problems and management's proposed solutions.

The situation Union Hospital finds itself in is not unique. Managed care arrangements ended the “cost-shifting” of losses from providing services to indigent patients to insured patients. This impact was felt most acutely at inner-city facilities like Union Hospital, where a greater percentage of the patients served may have been indigent. Cuts in Medicare reimbursement rates as a result of the Balanced Budget Act hit inner-city hospitals most dramatically, although Congress eventually recognized this unintended impact and provided some relief. Depending on the strengths of any specialty services Union provides, such as cardiac or oncology services, managed care companies may or may not be motivated to negotiate more attractive rates with Union.

Given these revenue challenges, the expense management issues are no easier to conquer. Union is attempting to attract and retain nursing staff as the shortage of nurses intensifies. However, the salaries needed to accomplish this are rising while revenues stay basically flat. The costs of pharmaceuticals increase annually at incredible rates and are not always recouped, particularly from the indigent patients served.

Union Hospital is unique in one particular aspect. It appears that it is unaffiliated with any other hospital or hospital/health care system. The revenue challenges brought on by all the changes in health care reimbursement motivated hospitals to merge or affiliate in an effort to reduce overhead costs, particularly in back office functions, and to achieve greater pricing preferences through combined, committed purchasing volume. It appears the acquisition of the facility and its service area is not seen as a strategic “plus” to a competitor or investor. As a result of this unaffiliated status, Dr. Weaver's fears could become reality: the community Union Hospital currently serves will be left without local access to inpatient hospital care if the hospital should cease to exist.

What should Dr. Weaver do? It is true that health care reimbursement is a highly complex and everchanging area. Significant estimates of future receipt of disputed items are common on the balance sheets and income statements of health care institutions. The regulations concerning reimbursement from governmental payors are subject to interpretation and providers at times take stances that are as aggressive as those taken regarding tax regulations in the for-profit arena. It can take years for the cases and their appeals to be resolved.

The management team at Union, specifically those from the financial areas, at this point need to have a discussion with their outside auditors. Accounting firms providing services to hospitals have expertise in the assessment of hospital reimbursement issues. The complexities of the issues and the material impact of the estimates required by hospital management make this area perhaps the most critical in the conduct of a hospital audit. Locally, the accounting firms with the greatest health care client presence stay very close to the progress of appeals and have opinions as to the eventual outcome. Full reserves on receivables may be adjusted as an outcome becomes clearer. The Medicaid issue being discussed is obviously not unique to Union and the hospital's auditors will be taking a position with all their clients on the recognition of a possible gain. Union needs to get involved in the dialogue.

There are risks in choosing not to obtain the outside auditor's concurrence and recording the receivable anyway. Should Union's auditors disagree with the hospital's recognition of the \$5.2 million receivable and adjust the financial statements, eliminating the \$5.2 million from revenue, the management team loses its credibility with the rating agencies, investment community, the board of directors and the auditors.

It would be naïve for the Union management team to believe that the losses would not become apparent in any due diligence process in connection with the bond issue. The losses will soon be felt in the cash balance, negatively affecting days in accounts payable. The statistical analysis used in any required projections of revenues will highlight the declining income versus the more aggressively increasing expenses.

Dr. Weaver and the management team need to discuss the facility's challenges with its board and begin a discussion with the state regarding the potential technical default issues and concerns over the risk of the community becoming "medically underserved" should Union close. This would be the best way to ensure the mission is preserved over the long term.

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Note: Martin's comments are based on a fictitious case, any resemblance to person living or dead is coincidental.

By overstating its financial strength, Union would be acting like a fruit peddler who sells a bag of mostly spoiled cherries by placing a few juicy, ripe specimens on top.

Dr. Weaver's temptation to recognize the disputed Medicaid payments as revenue stems from commendable motives. Indeed, it is in some sense refreshing to see an executive contemplating an accounting misdeed for a reason other than naked financial self-interest. Booking the \$5.2 million item would be unethical, all the same, and unlikely to achieve its purpose, to boot.

The moral objection arises from the harm that would be done to a party not mentioned in the financial management team's discussion. Purchasers of Union Hospital's bonds rely on the obligor's financial statements to estimate the risk and value of their investment. By overstating its financial strength, Union would be acting like a fruit peddler who sells a bag of mostly spoiled cherries by placing a few juicy, ripe specimens on top.

A further objection to the proposed aggressiveness in revenue recognition relates to the dissemination of misleading financial statements. If Union misrepresents its financial condition and investors consequently suffer unexpected losses, the victims will become more risk-averse. Other bond issuers will then be forced to pay higher interest rates than would otherwise be required. This increase in the cost of capital, in turn, will produce some small degree of underinvestment in the economy at large. To be sure, the impact of Dr. Weaver's decision will be infinitesimally small in an economy measured in trillions of dollars. The principle is the same for a small transgression as for a large one, however.

In this case, even the accounting “solution” to the revenue problem is unlikely to save Union Hospital. If Union’s survival were threatened by a truly temporary cash flow problem, it would probably be feasible to obtain interim financing to avert a crisis. The fact is, however, that managed care and tightened Medicare/Medicaid regulations are relentlessly driving down revenues by 3% to 5% a year, while costs are rising. Dr. Weaver cannot reverse these trends by any amount of accounting legerdemain. He can only destroy the fine reputation that he has built up over many years.

No doubt Dr. Weaver feels responsible for the hospital’s thousand-plus employees. He also shows a praiseworthy concern for low-income members of the community who have no other health care providers besides Union. Attempting to cover up the cost-revenue squeeze at Union Hospital will not help those individuals over any extended period, however. Instead of becoming engrossed in “the subtleties of accounting gains and losses,” Dr. Weaver should broaden his thinking about strategies for maintaining services in the face of changing economics in health care.

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After Dr. Weaver and the management team have defined their operational goals, they should determine how the broader economic and social trends will impair or enhance their ability to achieve them.

The first thing that Dr. Weaver should do is ignore Albert Case’s simplistic distinction between “conservative” accounting and what the hospital really needs. Institutions consistently misapprehend the range of options available to them for reaching their goals by ignoring risks inherent in the most obvious alternative. Thus, Mr. Case’s admonition to ignore the “conservative” accountants in order to “do the right thing” misses the point—both because he takes no account of the serious risks inherent in his proposal and because he does not spend the time to consider the nuanced source of his problem and the potential solutions.

In spite of the hospital’s difficult circumstances, Dr. Weaver cannot rush into making a decision. He first should initiate a number of steps designed to get him and the other decision makers the information they need to make a reasoned choice. To accomplish that, Dr. Weaver should establish consensus regarding:

- The hospital’s mission;
- The hospital’s principal users;
- Those users’ chief needs; and
- The resources necessary to satisfy those needs.

Only once Dr. Weaver and the rest of the management team have agreed on those critical elements will they be prepared to decide how best to achieve their operational goals.

After Dr. Weaver and the management team have defined their operational goals, they should determine how the broader economic and social trends will impair or enhance their ability to achieve

them. For example, if the hospital's in-patient admissions and patient revenue were to continue to fall, maintenance of the same physical plant—even assuming few improvements—would take a larger share of revenue, hindering the hospital's ability to continue to maintain up-to-date technology and hire necessary staff. Similarly, management should identify the factors that have led to its past success (e.g., the trust of the financial community). Thus, the management team will need to determine how the institution's long- and short-term missions can best be achieved in its economic and social setting.

Only after all that analysis will Dr. Weaver and the management team be prepared to decide how to deal with potential revenue from historical Medicaid payments and whether to seek refinancing of its bond issue. In reaching their decision, Dr. Weaver and management should probably consult with other stakeholders, such as the nurses' union and representatives of the local and financial communities. A solution that appears to satisfy all of management's goals might very well disappoint other stakeholders, thereby causing unanticipated problems that will overwhelm whatever good was going to come of management's solution.

In the immediate case, it appears that:

1. The hospital needs an infusion of cash to maintain its current standard of care;
2. It is too large for its current needs;
3. Its operating costs are increasing as its revenue is decreasing; and
4. Current financial results are out of line with market expectations.

Further, no matter what benefit can be had from the \$5.2 million in revenue from historical Medicaid payments potentially owed by the state, the long-term trend seems to be toward disappointing financial results, regardless the one-time bump up were the revenue recognized in the current year.

Even assuming that recognizing the \$5.2 million was permissible in the current year, it would merely mask what would likely be poor future financial results. Even worse, were the hospital to use the financial results—including the \$5.2 million—as the basis for filing a new bond registration, without adequate disclosure (which would nullify the utility of applying the \$5.2 million in the current year), the hospital, its directors and managers at least might be liable in the event of a future default and at worst might have committed fraud.

The questions of whether and when to recognize the \$5.2 million in revenue are just the tip of the iceberg. To make a reasonable decision about the \$5.2 million, he and management need to be in a position to assess the characteristics and consequences of their revenue situation. Only then can they approach other stakeholders and determine how to proceed. Using a deliberative process (even if they are under time pressure), management will likely reach a better long-term solution and will minimize the likelihood that they or the hospital will be subject to future liability.

Dr. Weaver would do well to think like both a doctor and a coach. To arrest the hospital's decline, he should ask management to identify how to realign goals so that they are consistent with the circumstances in which it finds itself. He should then educate other stakeholders regarding the current problems and management's proposed solutions.

A CONTROLLER'S CHALLENGE

By Timothy L. Riedinger, CPA

Can Jim Woodruff find another million profit to bolster the sales of the consolidated company?

Abstract

Controller Jim Woodruff is under pressure to accelerate profits at Advanced Parts Manufacturing. Examine the facts presented for this case and determine the course of action you believe Jim Woodruff should follow.

Background

“Would you come over to Mr. Patterson’s office right away?” Jim Woodruff was a bit puzzled about the summons from the president’s office; no meeting was scheduled and Bill Patterson’s style was not an impromptu one. Organizer and calculator in hand, Jim left for the meeting wondering what the subject might be and how he might mentally prepare for whatever discussion was about to take place.

Jim was the recently appointed controller of Advanced Parts Manufacturing Company, a division of a Fortune 500 company. He had started his career as an auditor in public accounting before joining the parent company’s corporate headquarters accounting staff. After a few years in headquarters, he was promoted to Advanced to replace its retiring controller. He came with a strong technical background gained through his experience in auditing and accounting. After about a year, he had become a valued member of the Advanced management team. He had played an important role in the financial decisions associated with a recent capacity expansion and had made major improvements to the management reporting and planning systems. He was working on reducing the division’s investment in inventory through consignment arrangements with suppliers.

The Problem

Bill Patterson greeted Jim as he entered his office. “Jim, we have a challenge that I hope you can help us with. We need another million in profit this year because of low sales by the consolidated company. When you reviewed our division’s 11-month actual results last week, we were a little better than our forecast. Is there any more we can do?” Jim paused for a moment to think.

Advanced Manufacturing was a parts supplier to the automotive sector and was enjoying slow but steady growth under Patterson, who had been aggressive in pursuing increased volume through new business. Its business provided diversification for the parent company, which was concentrated in a lower growth, more mature industry. Profit contribution from Advanced was favorably disproportionate to its sales volume within the parent.

Thinking aloud, Jim answered, “Well, with about a month left in the year, there aren’t many options. Our average sales margin is 20%, so that’s over \$7 million in sales, including the income tax effect. Can we accelerate any shipments, maybe pull some sales ahead into this month?” Patterson said he

thought this was a possibility. He asked Jim to investigate and report back with some other ideas by the end of the week. “OK, Bill, I’ll look into it.”

A number of ideas ran through Jim’s mind, some of them perhaps reasonable, others a bit compromising. He decided to start with the shipment forecast and called the production manager, John Burns. “John, if I told you we needed to book as many sales as possible this month, could you increase shipments?” John’s answer was encouraging. “Yes, Jim, we’re scheduled to start a huge order for Imperial this week, but it won’t be ready to ship until early next month. We could work overtime on the weekends to finish this month, but are you sure we want to do that? The overtime would cost about \$100,000. That’ll kill my budget and it really isn’t necessary.” Jim agreed. “I know—just a question at this point. Thanks for the info; I’ll get back to you.” Calls to production scheduling and sales revealed that the Imperial order was for \$2 million with a gross margin of \$500,000. The promised delivery date was for the fifteenth of January and early shipment would be acceptable to the customer.

Jim’s inner tension increased. “Why would I endorse spending real money to move profits a few weeks ahead?” he wondered. “This seems a little like tax planning, shifting income from one year to another.” Jim realized that other tactics would require some creativity and he began to brainstorm. He made a quick review of the division’s income statement and his financial performance reports for previous months, including his comments on profit and cash flow results. He noted some potential opportunity with accounting issues and that the division was experiencing an increase in inventories for the year. Under the last-in, first-out method, this increase would be added at current cost to the lower, historical value from prior years. He also noted the large expense recorded for some prototype manufacturing equipment, which had not been proven fully viable for production use. He was reminded of the recently installed capacity expansion that had not yet been capitalized but was starting up in the current month.

Jim also reviewed some recommendations he had made to management and was planning to follow up on this month; both related to inventory management. The spare parts inventory included some older parts that hadn’t been used or replenished for several years. Based on this history, he had recommended that they be disposed of and written off the books before the end of the year. Not only would this free up some storage space and simplify the inventory records, it would reduce personal property taxes on the items. He had also recommended expensing an inventory of small parts used for routine maintenance that was immaterial in total value. After several more telephone calls and some analysis of these alternatives, Jim went to see Bill Patterson. He was feeling more unsettled about the project.

Much of Jim’s past success had come from his ability to deliver results and respond to management needs. He was torn between his desire to make good on this assignment and his reservations about compromising accounting discipline, although nothing he was about to propose was inappropriate per se. He was also thinking about the profit-sharing effect, questioning his own objectivity in helping to engineer a profit increase that would result in a benefit for him.

The Choices

The meeting with Patterson began. “Well, Bill, I have some ideas, but I don’t think they represent good business decisions. If the plant works overtime and we ship the big Imperial order by year-end, the sales increase will add about half a million in margin. That’ll cost \$100,000 in overtime premium. That’s a pretty high price tag.”

“What else is there?” Patterson asked.

“As you know, Bill, we use the last in, first out method to value inventories.”

“Yes, that’s LIFO, right?” Patterson said. “But how does that help?”

Jim provided a brief accounting lesson. “We can create a profit effect if we can reduce the inventories to below last year-end levels. The trend is generally toward increasing raw material and labor costs. Under LIFO we record higher costs of sales for these increases and that reduces taxable income and therefore, cash flow—the real purpose of the method. If we can avoid the inventory increase for the year, and instead have a reduction, we can take a credit adjustment to cost of sales and increase our profits.”

“That sounds legitimate,” Patterson said. “We’ll get a reduction if we ship the Imperial order before year-end, but is that enough?”

“Not according to our estimates,” Jim answered, “but our raw materials are in the LIFO pool. If we can delay purchases of raw materials to next month, we can reduce the overall pool and get the reduction we want. I have to warn you, though, that we can only estimate the impact, because final results will be based on total actual inventory mix on December 31. Much can go wrong with the timing of raw material receipts, too, and this could cause problems. You asked if it was legitimate—well, inventories go up and down all the time; this would just be a temporary liquidation. If the method weren’t generally accepted, we wouldn’t be using it in the first place. In my opinion, though, it’s not good business to interrupt the flow of materials into our warehouse and it rather defeats the tax purpose behind the method. Also, under accounting theory, it creates an artificial mismatch of costs with sales. Realistically, we can’t reduce our year-end materials inventory enough to reach the amount you’ve asked for, even with the increased sales.”

“So what other ideas do you have?” Patterson asked. It seemed to Jim that the president was becoming less interested in details and more interested in results.

“You know the System A that is still under development? All costs for that line have been expensed due to the experimental status of the project. We have begun to run assemblies on it, but nothing we can put in the warehouse or ship to customers. We could capitalize the cost and take half a million into profit. I really don’t recommend this, though, because the equipment is still new and unproved technology. Accounting principles require the expensing of such costs as development expense, but if it proves out next year, we’d capitalize it then anyway. The risk is having to write it off next year if it doesn’t pan out.”

Bill challenged Jim's comments. "I don't always get those differences between expense and capital. Is it really that black or white? How do you determine the status of such equipment?"

"There's been no valid production from the system up to now, but it's getting close, according to John Burns and the engineers," Jim answered. "As of this year-end, it's still experimental. In the end, it's really a matter of management judgment. Management has responsibility for the integrity of financial statements and if you're willing to commit to the production viability of the equipment, then... Remember, we may have to justify our position to the auditors."

"I know, Jim, but that's something I expect you to handle," Patterson retorted. "What about the plant expansion? Has our depreciation expense gone up as a result of that?" Jim explained that the plant expansion was scheduled for capitalization this month, as it had just been placed in service; monthly depreciation would be just over \$50,000. "We can delay that a month, can't we Jim? We'll need a cushion in case your inventory adjustments fall short."

By this point, Jim had decided not to raise the inventory issues; the climate was not right. Patterson summarized the discussion. "Running a business means having to balance out the ups and downs on the bottom line. We can get a sizable chunk of it from the Imperial order. The rest is mostly accounting issues. The target is a million—see if you can get it."

The Dilemma

Jim left for his office not too confident about his next steps. He needed some time to think before taking any action. He was wondering, "How could I have handled this differently? Are all of the ideas acceptable? Are any unacceptable? What do I do next?"

Comments on "A Controller's Challenge"

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The use of LIFO allows management to influence the company's income through the acceleration of, or delay in, acquiring inventory, thereby reducing the quality of its earnings.

First, Jim Woodruff, Advanced Parts Manufacturing Company's controller, should analyze the individual suggestions for shifting revenues/net income from the coming year into the current year's income. In making his analysis, Jim, of course, should determine what's acceptable and what's not according to generally accepted accounting principles.

Increase Shipments to Imperial

Advanced Parts Manufacturing can speed up the shipment of the \$2 million order to Imperial and under GAAP revenues would be increased by \$2 million and gross margin would go up by \$500,000.

However, from a business prospective that would be a costly decision, since incremental overtime premium will run about \$100,000 and the \$400,000 increase in income from operations is before tax.

LIFO Inventory Reduction

If Advanced Parts Manufacturing decides to increase its income by delaying purchases to dip into last-in, first-out inventory, Jim should consider a number of consequences. The company's income will be higher (because cost of goods sold will include older and lower costs), but there is no economic substance to the higher income and the company will have to pay additional income taxes (since there will be higher taxable income reported under the LIFO conformity rule). The LIFO liquidation profits will be treated as income under GAAP. However, according to the Securities and Exchange Commission staff, in a case like this, Advanced Parts Manufacturing will have to disclose (effect on the income statement and earnings per share) the amount of LIFO liquidation profit so that its financial statements users may obtain an accurate understanding of the income generated by the company. Although this step is acceptable under GAAP, management should make decisions about inventory levels on the basis of economic and operational factors. The use of LIFO, however, allows management to influence the company's income through the acceleration of, or delay in, acquiring inventory, thereby reducing the quality of its earnings.

Depreciation on Plant Expansion

Unless Advanced has a contrary policy, it should not postpone the recognition of the monthly depreciation of \$50,000 on its plant expansion. Unless otherwise stipulated in a policy or consistent practice, depreciation is normally computed on the basis of the nearest full month.

Other Options

Others items under consideration violate GAAP. For example, if Jim delays the write-down of spare parts inventory until the next year, he has committed a GAAP violation—treating an item as an asset when it is not. Likewise, Jim should not consent to a scheme to treat the experimental system as an asset when GAAP requires that it be expensed (unless the experimental assets—for example, machinery, equipment, facilities, etc.—have alternative future uses in other research and development activities or otherwise).

A Commitment to Accuracy

Advanced Parts Manufacturing has a major problem pertaining to the “tone at the top.” Management should, and must, insist on accuracy in financial reporting. This entails an unrelenting insistence that numbers not be massaged. A proper tone demands a strict commitment to truthfulness as the foremost company objective. Jim must pledge allegiance to truth and transparency in his division's financial reporting. He perhaps needs to be reminded that financial manipulation starts out small and in those hazy areas where people think they are still being somewhat honest. Once the culture is seeded with contrived revenue enhancement and deferred recognition of real expenses, that culture is tainted and fraud blossoms. The costs arising out of the discovery of fraud are extraordinary—an SEC investigation, class action suits and perhaps delisting of the company's securities. In addition, consequences include possible criminal investigation. Jim should not focus on his bonus and other short-run benefits when faced with the dire consequences of manipulated financial statements.

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If the earnings management is undertaken to avoid defaulting on debt covenants or falling short of analyst forecasts it may be in the shareholders' best interests to accelerate the sales.

This case explores issues in earnings management from many different perspectives. It can be used to compare earnings management both within and outside generally accepted accounting principles. The case also highlights the distinction between managing earnings by exercising discretion over operations rather than over accounting measurement. Finally, the case provides a scenario in which to consider whether various forms of earnings management are in the best interests of the companies' owners, and whether the earnings management strategies are observable by the shareholders. It is instructive to enumerate the number and relative magnitude of the changes in management judgments and estimates that would be necessary to generate an additional \$1 million in profits, a fairly trivial amount for a Fortune 500 business, such as the parent company in this case.

Advanced Parts Manufacturing Company's normal average sales margin is 20%. If the Imperial order, with a sales price of \$2 million and a gross margin of \$500,000, is completed in the normal course of business it will lead to recognition of sales margin of 25% in January of the next fiscal year. If it is completed this fiscal year by incurring overtime premium charges of \$100,000, it will lead to recognition of sales margin equal to the average sales margin (\$400,000 in margin relative to \$2 million in sales). Although normally investors would prefer that the company not incur the extra \$100,000 in overtime charges, if the earnings management is undertaken to avoid defaulting on debt covenants or falling short of analyst forecasts it may be in the shareholders' best interests to accelerate the sales.

Other factors Patterson and Woodruff should consider include:

1. Whether there are alternate uses for the capacity that will be freed up in early January.
2. How much disruption in the planned capacity expansion will occur as the result of moving production up by two weeks.
3. The overall tax effects of recognizing the \$2 million in sales this year.
4. The effects on the labor force of requiring overtime work at the end of the year.

The several changes in inventory procedures proposed in the case as ways to accomplish higher reported earnings this year should be evaluated in combination with Woodruff's explicit program to reduce the division's investment in inventory through consignment arrangements with suppliers. Depending on whether raw materials suppliers are part of this initiative, it may not be imprudent to reduce inventories of raw materials at year-end. The recognition of extra profits from inventory holding gains is a one-time-only event and will have to be recognized at some point in the near future if the controller is successful in reducing the division's investment in inventories. If the inventory holding gains will be recognized this year or next, and would be especially helpful in meeting earnings targets this year, it may not be imprudent or contrary to the shareholders' interests

to let the raw materials inventories fall before fiscal year end. Other factors Patterson and Woodruff should consider in addition to the planned reduction in inventory investment include supply and demand conditions in the raw materials market, opportunities for volume discounts to replace the inventory run down, and the likelihood of production interruptions if the materials inventory cannot be brought quickly back to the optimal level after the first of the year.

The case provides a context for exploring several more accounting measurement issues involving management's judgments and estimates, including when:

1. A research and development project has reached technological feasibility (governing whether costs must be expensed or can be capitalized and depreciated slowly over time).
2. Depreciation charges start for self-constructed assets.
3. A charge should be taken to write off obsolete or damaged inventory.

Each of these issues also poses a context in which to consider the materiality of a collection of mutually reinforcing changes in judgments and estimates, each of which is probably immaterial on its own.

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When company management starts to trade long-term economic considerations for near-term revenue it is difficult to reverse the trend.

The controller for Advanced Parts Manufacturing came up with a variety of ideas that have financial and operational implications for the company.

1. **Accelerate the production and shipment of a large order to Imperial.** Apparently Imperial is a valued customer. Accelerating the order would entail overtime that would have an incremental cost of approximately \$100,000 and would require the sales team to negotiate the early shipment with the customer.

The broader question deals with the rhythm of the manufacturing operation. Questions that require deep consideration but were left unasked include:

- What impact would acceleration of production have on overall quality control? Some manufacturing can be negatively affected by sudden logistical changes associated with overtime.
- What would be the impact on production team morale? This overtime likely would come during the holiday season. Many manufacturing companies have a traditional practice of closing during the week prior to the new year.
- If the Imperial order is accelerated, what happens to plant utilization during the period the order was originally scheduled for production?

- What is the potential consequence to future orders from Imperial? Will they now attempt to negotiate deeper discounts or to place orders closer to quarter-end knowing that management may be inclined to sacrifice long-term economics for near-term orders? There is a similar risk in future sales to other customers, and subtle impacts on the way the sales team approaches the market.

Based on the discussion in the case study, it's reasonable to conclude accelerating the shipment of this order would be a very poor alternative. First, it would reduce the contribution margin on this order by 20% and it's likely that the scheduling inefficiencies in the month the order was scheduled for production will further erode the overall realized margin. It's not possible to evaluate the impact on morale and quality, but these issues are also important elements to consider. The only reason the company should consider accelerating this order is if it were facing a production bottleneck in the future, and working overtime now helps to smooth out the production flow. It goes without saying that customers will learn the company's operational objectives. When company management starts to trade long-term economic considerations for near-term revenue it is difficult to reverse the trend.

2. **Reduce inventory to create a LIFO inventory layer adjustment.** The controller has worked actively to reduce inventory levels. This has positive benefits associated with lower risks of obsolescence, working capital relief and reducing physical storage space. If in the ordinary course of business there are ways to further reduce the level of inventory and to continue the move toward "just-in-time" inventory replenishment, this is a good business decision. It may also have positive near-term financial benefits. If on the other hand the inventory reduction is temporary, it will likely have significant future consequences associated with inefficiencies in the manufacturing process and negative implications for vendor relationships.

As for inventory reserves, this is a slippery slope. The inventory either has value or does not. If it is spare parts for service and warranty, then this most likely should either be depreciated over time or charged to expense up-front as part of expected future warranty.

3. **Prototype manufacturing equipment.** The financial considerations are simple: If the equipment is production ready, the costs are capitalized. If the equipment is still in the development phase, the costs are expensed as incurred. While the controller has focused on the definition of "production ready," there is a broader, more relevant theme. Presumably the new equipment will yield economic benefits to the company through a combination of better yields, higher quality and lower production costs. Given these benefits, it's in the company's best interest to get this equipment into production as soon as practical. It is potentially to the company's advantage and therefore a good business decision to accelerate development and deployment of the new production equipment.

ACCOUNTING FOR LOAN LOSSES AT COUNTY NATIONAL BANK

By Larry M. Prober, PhD, CPA

Bellows wants to avoid regulatory intervention. Most analysts are predicting a reduction in the discount rate. Is the current year loan loss provision justified?

Abstract

Jane Bellows, controller at County National Bank, is debating whether the current year's loan loss estimates are justified. Trying to meet her professional obligations and the bank's goals are not easy when accounting and regulatory objectives differ. Examine the facts presented for County National Bank and determine the course of action you believe she should follow.

Background

County National Bank is a large regional bank with 375 branch offices located mainly throughout the southeastern United States. Known for its strong customer service and innovative product offerings, the bank has in recent years taken on new strategic initiatives. These new goals—made possible through acquisitions—have included broader geographic diversification of its customer base and a wider range of products and services, including new types of brokerage accounts, investment fees from asset management and personal/business advisory services. Bank management is concerned that in the current environment banks are racing to acquire or be acquired, so it is careful in its assessment of the financial marketplace and in its considerations of potential product offerings/services, its own capacity to meet these needs and the competition in each banking segment.

To meet corporate goals for growth, County has targeted several groups of potential customers, such as high-earning individuals and small businesses, to provide new services and loans. The economic boom of the nineties made this strategy feasible and, along with merger economies of scale and technological additions that improved service levels and lowered transaction costs, provided a viable means to improve profitability. However, acceleration of the economy in the early part of the year 20X2 combined with Federal Reserve tight money policy and increased competition have made the year more difficult than expected. These events, coupled with a declining stock market, high personal bankruptcies and slowing growth during the last quarter have created profitability concerns among the bank's management. Some of its major concerns are the quality of the bank's loan portfolio and its ability to withstand negative economic circumstances. Although the bank views its lending policies as conservative and more than adequate for the risks involved, several key executives are not happy with loan procedures and related grading of loans. They believe that until recently stock market gains made everyone feel better off than was justified, and that eventually market conditions will change, making it essential for institutions such as theirs to be in strong economic shape. They reason that after an extended period of high economic growth, the bank should be able to weather any type of storm. Consequently, as the bank completes its current year, they wonder how the accounting for loan losses and the provision for the m reflect the underlying nature of these assets.

The Problem

While lending policies at County have changed little in the recent past, these newly raised concerns have created some anxiety for Jane Bellows, County's controller. She is responsible for preparing the financial statements and reports submitted to bank regulators. She knows from her own experiences that profitability and valuation issues have been raised before, but this year she has conflicting thoughts. Ms. Bellows has always sought to comply with generally accepted accounting principles as a first priority, particularly when she felt that loss estimates were high. Accordingly, she has in the past challenged some of the estimates for being on the high side, a position now endorsed by the Securities and Exchange Commission. On the other hand, she realizes that bank regulators look for loan provision adequacy and would rather the bank maintain healthy loan provisions. In accordance with Financial Accounting Standards Board Statements No. 114, Accounting by Creditors for Impairment of a Loan—an amendment of FASB Statements No. 5 and 15, and No. 5, Accounting for Contingencies, she is obligated to measure as well possible loan loss estimates based on circumstances through the balance sheet date. Although some of her previous training in economics tells her that a longer timeframe for economic events in the decision would be preferable, she understands the vital role of consistency in financial reporting and her obligation to the financial reporting model. She also understands that with adequate disclosures, those in the investment community should be able to assess the adequacy and appropriateness of the bank's estimates. Nevertheless, Ms. Bellows is uncomfortable with the apparent conflict between FASB rules and bank regulator objectives. She is also troubled that some at the bank see loan loss estimates as a means to an end when it comes to profit rationalizations.

At year-end Ms. Bellows and her staff are finalizing the estimates needed for the financial statements. She is aware that most analysts are predicting a Federal Reserve reduction in the discount rate. That change should help enhance value of the bank's fixed rate portfolio and lower the bank's cost of capital, which should stimulate demand and reduce delinquency rates for customer loans. Thus, her concerns are not as great as some at the bank who would rather see an increase in the loan loss provision.

This limited discussion describes some key points of County Bank's policies regarding loans and the provisions needed for financial reporting.

1. The allowance for loan losses is developed to absorb probable losses to the portfolio as of the balance sheet date. While a number of tools are employed to measure losses, no group of tools can replace seasoned judgment. Losses for retail products, such as credit cards, residential mortgages and consumer installment loans, are developed based on net losses expected over a 12-month period consistent with bank loss models. Commercial portfolio losses are estimated on the basis of the bank's loss migration model relying on eight quarters of data and historical loss experience for loans of similar quality and with similar ratings.
2. The loss factors resulting from the above procedures are tempered by known changes in economic trends from the time periods used in the analysis. Loss estimates developed from the analysis are applied to each segment of the portfolio and ultimately added to specific reserves established for impaired loans.

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3. A loan is considered impaired when it is not expected that amounts for both principal and interest will be collected in accordance with the terms of the lending agreement. Some smaller-balance consumer loans are collectively evaluated for impairment in a separate assessment.

Financial Information

The following is the condensed income statement for years 20X2, 20X1 and 20X0 based on pre-audited numbers: (\$000,000s)

	20X2	20X1	20X0
Net interest income	1,386	1,293	1,192
Provision for credit losses	212	161	158
Net interest income after provision for credit losses	1,174	1,132	1,034
Noninterest income:			
Service charges on deposits	206	182	165
Fees for trust services	174	109	96
Credit card income	145	94	88
Investment fees	131	33	29
Capital markets income	94	71	27
Electronic banking	48	40	35
Mortgage fees	18	24	13
Other operating income	134	116	103
Total other income	950	669	556
Other expenses:			
Salaries and benefits	561	491	408
Occupancy	83	76	64
Equipment	109	84	76
Merger and restructuring charges	10	57	101
Other	364	310	284
Total other expenses	1127	1018	933
Income before income taxes	997	783	657
Income taxes	299	227	199
Net Income	698	556	458

Quality of Earnings

The following schedule presents certain details pertaining to County's loans and loan loss reserves.

Loans at December 31 are summarized as follows: (\$000,000s)

	20X0	20X1
Commercial	9,752	8,415
Retail	5,613	6,007
Real estate	9,801	9,087
Lease financing	1,428	1,033
Foreign	693	601
Total	27,287	25,143

The following schedule summarizes impaired loans and related allowance information at December 31.

	20X2	20X1
Impaired loans with related allowance	76.4	15.1
<u>Impaired loans with no related allowance</u>	<u>5.2</u>	<u>16.1</u>
Total impaired loans	81.6	31.2
Allowance on impaired loans	23.6	3.9

Changes in the allowance for loan losses for the three years ended December 31 were as follows:

	20X2	20X1	20X0
Balance at beginning of year	301.4	299.6	285.6
Additions from acquisitions	0.2	1.5	16.6
Provision for loan losses	212	161	158
Recoveries on loans previously charged off	32.9	32.6	31.6
<u>Loans charged off</u>	<u>-193.1</u>	<u>-197</u>	<u>-176.9</u>
Balance at end of year	353.4	297.7	314.9

The Dilemma

Jane has examined some of the underlying documentation behind in the above loan loss estimates. Her review included discussions with loan officers and other members of the loan committee. While she believes that substantial data are provided to support the allowances recognized, she is not totally convinced this year's increase is justified. Even though the economy has declined in a general sense she reasons that much of the negatives were already considered during the previous year and that the expected changes in Federal Reserve policy will benefit County's customers in the future. She also believes that the bank's loan policies are conservative and therefore provide a cushion from any economic downturn. Accordingly, she sees no reason to increase the provision from the previous year. Her discussions with members of the finance committee have not convinced her that any change is justified. Thus, she is debating her next course of action. Should she pursue the matter further or just rationalize that the increase will provide an even more favorable rating when the bank regulators examine the data?

How should Jane Bellows handle the current situation? Are any changes from the original estimates necessary? What criteria or considerations should be used in making this determination?

Comments on “Accounting for Loan Losses at County National Bank”

Anwer S. Ahmed, Ph.D., is Associate Professor of Accounting at the School of Management, Syracuse University.

He is the author of “Bank Loan Loss Provisions: A Reexamination of Capital Management, Earnings Management and Signaling Effects,” (with C. Takeda & S. Thomas), *Journal of Accounting & Economics*, August 2000.

There appears to be tension between incentives to increase the provision to ensure a smooth income stream and to lower the provision to more accurately convey the economics of the business.

This case deals with the choice of loan loss provisions by a commercial bank’s managers. The loan loss provision is an important accrual for commercial banks (averaging about 20% of income before taxes and provision). In general, the loan loss provision should adjust the allowance for loan losses to an amount that reflects expected loan losses (or default risk). However, because the size of the provision is a matter of judgment, managers have a potential tool for managing earnings. Furthermore, because the loan loss allowance is considered part of regulatory capital, managers can also use their discretion over loan loss provisions to ensure that they comply with regulatory capital requirements.¹

In this case there appears to be a tension between incentives to increase loan loss provision (to enable managers to ensure a smooth income stream) and to lower loan loss provisions to more accurately convey the changes in the underlying economics of the business. Ms. Bellows believes that the proposed provision is too high, while others think this provision is appropriate to appear strong from a regulatory capital perspective and to save for a rainy day (essentially to ensure a smooth income stream in the future). Therefore, the key issue is: What is the appropriate size of the provision (or the loan loss allowance)?

We can address this question in two steps. First, we can estimate the required loan loss allowance under the assumption that the riskiness of the loan portfolio has not changed. Second, we can adjust this amount for justifiable changes in riskiness.

If the loan portfolio is as risky as last year and last year’s allowance properly reflects default risk, the only adjustment to the loan loss allowance would be a scale adjustment. In this case, the required allowance would be computed as follows:

¹ For a brief discussion of regulatory capital requirements see Ahmed, Takeda and Thomas, 1999, Bank loan loss provisions: a reexamination of capital management, earnings management and signaling effects, *Journal of Accounting & Economics* Vol. 28, No. 1, 1-26.

$$\begin{aligned} & \{ \text{Last year's allowance} \div \text{last year's loans balance} \} \times \text{This year's loans balance} \\ &= 0.0118 \times 27,287 \\ &= \$322\text{m} \end{aligned}$$

Under this scenario, the proposed provision is overstated by \$30m.

Next, we can adjust the required allowance amount for changes in underlying default risks. There are two factors that qualitatively suggest a reduction in default risks:

1. The expected decline in rates is likely to reduce delinquency rates for customer loans.
2. The bank has a more diversified loan portfolio.

There is one factor that would suggest an increase in default risk of the retail loans: The expected increase in personal bankruptcies. But note that the retail loans have declined as a percentage of the overall loan portfolio whereas commercial and real estate loans have increased. Overall, this would suggest a further reduction in provisions.

Another factor related to default risk is the increase in the allowance for impaired loans. Compared to an allowance of 12.5% last year, this year's allowance for impaired loans is 29.9%. This may represent specific impaired loans that were perhaps acquired from other banks. If so, this would justify a \$20m increase in allowance.

Finally, two additional pieces of data would help in assessing the accuracy of the loan loss provision:

1. How large are non-performing loans (as a percentage of loan loss allowance)?
2. Has there been an increase or decrease in non-performing loans?

In general, we expect changes in non-performing loans to be positively correlated with changes in default risk. One could use an option-based valuation technique to estimate the implied standard deviation of the bank's assets.² Again, an increase in this implied standard deviation would suggest an increase in the allowance.

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If Bellows uses the loan loss reserve to manage earnings the benefits to the bank, if any, will be short-lived since the true reserve level will become more apparent in the future.

² See Ronn and Verma, 1986, Pricing risk-adjusted deposit insurance: An options-based model, *Journal of Finance*, Vol. 41, 871-895.

Executive Summary

Jane Bellows, the controller at County National Bank, faces a conflict between supporting the proposed level of loan loss reserves—including a \$51 million increase—and keeping the provision at the same level as the previous year. She knows that the bank's loan committee has recommended the increase, but Bellows is not sure that economic conditions justify the change. Also, she believes that the bank's loan policies are conservative and therefore will cushion any economic downturn should it occur. Bellows knows that bank regulators prefer "healthy loan provisions," so if she pursues cutting back on the increase it may raise regulatory concerns. Moreover, she is aware of the importance of the financial statements in providing adequate information for the investment community about the bank's loan portfolio.

Stakeholders and Interests

The investment community is a major stakeholder since it relies on the accuracy of the bank's financial statements for investment decisions. If the loan loss reserve is kept at the same level as the previous year, and the bank subsequently experiences loan losses beyond that amount, then decisions will be made based on inaccurate information.

The bank regulators are important stakeholders because they are responsible for the soundness of the banking system. Bellows has a responsibility as the controller to provide accurate and reliable information to the regulators.

County National Bank is a stakeholder since the level of loan loss reserves will affect the bank's profitability. Bellows understands the danger in using the reserve to manage earnings because she is "troubled that some at the bank see loan loss estimates as a means to an end when it comes to profit rationalizations." However, the loan committee has recommended an increase in the reserve, and one at a level Bellows believes may be too high. She faces a conflict between not wanting to use the provision to manage earnings and keeping it at the level recommended by her own loan committee.

Ethical Issues

The facts of the case do not indicate whether Bellows is a CPA or CMA. Nevertheless, she has an obligation as the controller to be neutral in deciding on how best to reflect the level of reserve. Bellows appears to be making a good faith effort to meet that obligation. However, she does not provide convincing reasons to depart from the recommendation of the bank's loan committee.

The investment community and bank regulators have a right to expect the bank's financial statements, including the provision for loan losses, to be objectively determined. They rely on this information for their decision-making needs. If Bellows uses the loan loss reserve to manage earnings, then these stakeholders will be harmed. The benefits to the bank, if any, will be short-lived since the true reserve level will become more apparent in the future and the bank may have to absorb larger losses at that time.

Alternatives

Bellows identifies two alternatives in the last paragraph of the case. She can allow the recommended increase to be recorded, which will provide a better rating when the bank regulators examine the data. Alternatively, Bellows can open up discussions with the loan committee and attempt to reduce or eliminate the increase in the reserve for the current year. As the controller, Bellows has an

obligation to the loan committee, the bank and the regulators to open the lines of communication before deciding to forego the increase in reserves. The ethical principle of objectivity requires that she act fairly toward all the stakeholders. Perhaps an open discussion of the issues would clarify the bank's responsibility to its stakeholders to maintain the quality of its earnings and not manage them by ignoring justified increases in the provision for loan losses.

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His practice focuses on securities enforcement, regulation and litigation matters. McLucas served as Director of Enforcement at the Securities and Exchange Commission for eight years.

Jane Bellows' dilemma is very real. Many commercial banks face conflicting messages from their principal federal regulators, the Securities and Exchange Commission and the banking regulators.

While the SEC has been insisting that reserves be kept reasonably low, bank regulators prefer that federally insured institutions maintain reserves adequate to withstand potential economic downturns. That big picture tension, however, is only the beginning of Ms. Bellows' problem. Her real concern is that, were she to ignore pressures from within her bank to increase the loan loss reserves (which appears contrary to her natural inclination), she might be subject to criticism from inside and outside the bank.

In a situation like this, where reasonable minds could likely differ, the first step is to establish a process that will withstand post hoc review, whatever Ms. Bellows decides. Ms. Bellows should therefore:

- Personally review the bank's financial results, including any supporting documentation for initial estimates of the loan loss reserve;
- Consult with the bank's accounting staff regarding current and historical financial results and trends;
- Confer with the bank's loan officers and loan committee concerning apparent trends in loan repayment and new loan generation;
- Seek guidance from the bank's economists regarding their fair estimates of future economic trends and their likely effect on the bank's loan portfolio;
- Discuss expected economic trends with outside resources, such as government economists and colleagues at peer institutions;
- Make preliminary inquiries of the bank's outside auditor regarding its opinion of the bank's current loan loss estimate and any modifications that it might consider positive; and
- Have initial discussions with the chief financial officer, chief operating officer and/or chief executive officer concerning their sense of the bank's historical reserves, its current position and its future prospects.

Ms. Bellows is the ultimate decision maker in this circumstance, and she will be accountable for whatever estimate the bank ultimately adopts. Notwithstanding how reasonable she believes her

decision is, she should document the steps that she took to reach it. Then, even if she's ultimately wrong about the long-term effect of the Federal Reserve's reduction in the discount rate or about whether last year's estimate anticipated this year's economic downturn, she will be able to point to a rational and reasonable process that led to her ultimate decision.

Just as Ms. Bellows' documentation will insulate her from fallout, the bank should consider how to make a management's discussion and analysis disclosure that is sufficiently clear so the market will understand the basis for its reserve. Even when disclosure does not appear in the bank's short-term interest, it will assist the bank in the long run because it will limit the risk of future litigation and enhance the bank's reputation among market participants.

Ms. Bellows seems to be on the way there. She has reviewed the bank's results and the basis for the current estimates, and she has discussed the estimate with the loan officers and the loan committee. She has not, however, used all of the resources at hand, and it is not clear whether she has adequately documented her review.

At a time when the bank is facing potential pressure from an economic downturn, Ms. Bellows should be particularly on her guard not only to make the decision that she believes is right but also to assemble and retain documentation supporting the reasonableness of her decision. She is not being held to a standard of perfection; rather, she is being asked to work with others at the bank to make a reasoned judgment, in a condition of uncertainty with myriad competing pressures.

In making her decision (and any decision here sounds reasonable), Ms. Bellows should ensure that she follows a reasoned process, that she uses all available resources and that she collects the data necessary to justify whatever conclusion she draws.

ACCOUNTING FOR IN-PROCESS R&D AT SIMPCO INCORPORATED

By Larry M. Prober, Ph.D., CPA

Simpco has used acquisitions along with restructurings to further their strategic goals. Is management right? Will projected earnings impress Wall Street analysts?

Abstract

Acquisitions at Simpco Incorporated have been instrumental in helping to develop and exploit new technologies. In these acquisitions the accounting for purchased research has usually meant large write-offs to in-process research and development. The following case highlights the accounting rules for this treatment and the issues involved in determining their application. It addresses the impact on the company's income statement and the perceptions of its significance as Kathy Oberlin, Simpco's controller, considers the underlying nature of this charge and its importance to the company's reported income.

Background

Simpco Incorporated is a global science and technology company that develops and manufactures a variety of plastic, agricultural and chemical-based products to customers in over 150 countries. Its operations, including services, consist of 12 global businesses that employ nearly 30,000 people throughout the world. After years of stagnating sales and litigation involving its ownership of a related company, the business has embarked on acquisitions that it hopes will refine and extend its product lines as well as offer increased sales opportunities.

Company executives have used acquisitions along with restructurings to further their strategic goals, and they are confident that future earnings will impress Wall Street analysts. While the accounting for these acquisitions has complied with generally accepted accounting principles and usually used the conceptually preferable purchase method for recording acquired firms, there is some concern at the company about recent developments regarding the valuing of acquired assets. Central to these concerns are the valuations for in-process research and development (IPR&D) recorded as part of the acquisitions. In the past the company has sought to include as much of a purchase price toward IPR&D as allowed. Often the final number for IPR&D was developed by valuation consultants who knew Simpco's preferences and sought to place as high a value on IPR&D as could be justified. Many at the company believe that purchased research should have the same identity as internally developed research, and that this philosophy is consistent with their overall accounting for R&D expenditures, which requires immediate expensing of such items.

Kathy Oberlin, Simpco's controller, has recently received several documents issued by the Securities and Exchange Commission that require more detailed accounting for the valuations used in mergers and acquisitions. The SEC is particularly concerned about the amount of IPR&D that companies are allowed to expense immediately under Financial Accounting Standards Board Statement No. 2, Accounting for Research and Development Costs, and FASB Interpretation No. 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method: an interpretation of FASB Statement No. The SEC has reservations about acquisition valuations when

the amount charged to IPR&D is a significant percentage of the acquisition price. They note that when IPR&D is based on future cash flows, inflated values for IPR&D imply significant profits after the project is completed. The SEC believes that to identify meaningful asset allocations, a close examination of the acquisition from a business perspective is necessary. Issues to be resolved include the purpose of the acquisition as well as the benefits obtained from access to new market channels, new customers, additional products with existing capacity and synergies through cost containment. Other information regarding presentations to the board of directors may also provide evidence of what motivated the transactions. Some of the problems identified with valuations for purchased R&D include failing to recognize the full value of existing products, incomplete analysis for determining the elements inherent in projects and the computation of an investment value for the R&D project, rather than its fair value. This last value would reflect the expected exchange price between a buyer and seller. Highly publicized adjustments of IPR&D for companies such as America Online concern Ms. Oberlin as she develops the final numbers to be used in 20X2.

The Problem

Kathy Oberlin is aware that certain income- and cash-based approaches were used in the IPR&D valuation of recently acquired Adelphi Industries. She also knows that the work of independent appraisers is both useful and necessary since it provides the objective valuations needed by the company and its auditors. Nevertheless, Ms. Oberlin has some reservations about the current valuation report received from DC&A Consultants. The consultants include several values for IPR&D that relate to R&D amounts from Adelphi that may have current value to Simpco. In these costs are \$10 million that should enhance some of Simpco's current product lines, and have future worth to the firm. In addition, amounts totaling another \$30 million may also be considered future value. Ms. Oberlin is worried that an SEC inquiry may necessitate an adjustment to the company's accounting for IPR&D as it now exists.

Ms. Oberlin also worries because the total of the IPR&D from the Adelphi deal is about 40% of the acquisition price. She believes this will present a red flag to the commission, and that they will scrutinize the category and perhaps discover other items for adjustment. She further worries that although other areas, such as accounting for restructuring costs, are well documented and in compliance with SEC rules, a thorough review of those costs may uncover other adjustments. Thus, she is considering another meeting with John Kramer, vice-president of the finance group, to bring these matters to his attention. She hopes that her fears can be put to rest but would like to know how upper management is prepared to deal with these issues.

Before her meeting with Mr. Kramer, Ms. Oberlin has sought some additional data from the product research staff. She believes that the company's experience with research efforts and its past successes in R&D are important inputs for the estimates needed in IPR&D valuations. She wants to make sure that before any decision is made on the final valuation of IPR&D all necessary personnel have been consulted and all relevant data have been considered so that the company cannot be accused of purposely using information to arrive at desired conclusions. She is also studying valuation methods and the rationales used by DC&A. Since this group has been used on several previous occasions, and their results rarely questioned, she has confidence that they can justify their current position. Nevertheless, she knows that SEC investigators are holding companies to a higher threshold in classifying IPR&D amounts than in previous years. In addition, she is aware that SEC

staff are concerned about the dual impact of other accounting issues, such as restructuring charges, and the impact that several items may have on a company's reported earnings and earnings trends. Finally, Ms. Oberlin has heard rumors that Simpco is considering another merger in the near future. Although she is not aware of any specific candidates, she believes that any publicity devoted to accounting irregularities may jeopardize the chance to have meaningful talks with any potential partner. Thus, even the hint of an accounting problem may have consequences for future strategic initiatives.

Financial Information

The following is abbreviated information pertaining to IPR&D and special charges as they pertain to the income statement.

IPR&D Charges

1. Purchased in-process research and development (IPR&D) is the value assigned in a purchase business combination to R&D projects of the acquired business that have commenced but have not yet been completed at the acquisition date and have no alternative future use.
2. The calculations for IPR&D were based on income or cash flow methods and included estimates of operating earnings, capital charges, trade name royalties, core technology charges and working capital requirements to support the cash flows attributed to the research efforts. Relevant stages of technology were also evaluated in this framework. The company's substantial experience in research and development projects for new products provides a solid basis for establishing realistic estimates for the completion of such projects and their expected completion dates.
3. In 20X2, the allocation of the purchase price of Dalton Inc. resulted in \$35 million of IPR&D. The projects associated with the technologies acquired in this purchase included process development of a selective herbicide, nutrient concentrates and fine chemicals. These projects should be completed by 20X3 year-end.
4. In 20X2, Simpco acquired shares of Adelphi Industries in two steps, resulting in an IPR&D allocation charge of \$105 million. Acquired projects yet to be completed include Bt technology, which is used to protect crops from insects, and various biotechnology initiatives that will enhance crop quality. These projects are expected to be completed in years 20X4 through 2X11 at an estimated additional cost of \$95 million.
5. In 20X2, Simpco completed an appraisal of an acquired 40% interest from Agrilin Inc. of SimElanco and recorded an IPR&D charge of \$135 million. Acquired projects include herbicides, fungicides and other biotechnology efforts to enhance crop output. Three of the projects are expected to be completed in 20X3, with the remaining ones accomplished in years 20X8 through 2X10 at an estimated additional cost of \$125 million.

20X2 Special Charges

A special charge of \$225 million was recorded in the first quarter of 20X2, including \$150 million for the write-down of several assets and \$75 million for severance. The asset-write downs included

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McNabb International and Simpco-Technology Products, both of which were subsequently sold. In the third quarter, based on changes in the estimated fair values, an \$18 million adjustment for the reduced values of the assets to be disposed was recorded.

In the fourth quarter of 20X2, a special charge of \$101 was recorded for the closure of the magnesium business and the associated manufacturing plant in Texas, and additional severance costs. The closure plan is expected to be completed in 20X3.

Preliminary Consolidated Statements of Income (\$000s)

	20X2	20X1	20X0
Net Sales	14,752	16,014	16,025
Operating Costs and Expenses			
Cost of sales	11,240	12,085	11,510
Research and development	605	590	575
Selling, general and administrative	1,341	1,504	1,710
Amortization of intangibles	62	48	29
Purchased in-process research and development	315	—	—
Special charges	365	—	—
Total operating costs and expenses	13,928	14,227	13,824
Operating income	824	1,787	2,201
Other income, various	780	401	321
Interest income, net	(110)	(145)	(230)
Income before income taxes	1,494	2,043	2,292
Provision for income taxes	522	715	802
Net Income	972	1,328	1,490

The Choices

Is Kathy Oberlin justified in recommending an adjustment to IPR&D? What issues should she consider in her decision? How will any adjustment impact Simpco's reported profits? Does the combined accounting for special charges and IPR&D provide any insights into the company's accounting strategy?

Comments on “Accounting for In-Process R & D at Simpco Incorporated”

Stephen J. Cosgrove is Vice President, Consumer Sector Finance, at Johnson and Johnson Inc.

Johnson and Johnson is engaged in the manufacture and sale of a broad range of products in the health care field in many countries of the world.

Kathy should be reviewing the IPR&D valuation to carve out as goodwill any values due to synergies and alternative future uses of technologies.

Simpco Incorporated is a large, multinational company with a history of acquiring companies and successfully accounting for those acquisitions. Ms. Oberlin has the responsibility to make sure that in accounting for acquisitions at Simpco, the methodologies used to determine in-process research and development are in line with the new guidelines developed by the Securities and Exchange Commission and the AICPA task force.

Simpco seems to have a robust process for valuing acquisitions and has used a reputable consultant, DC&A, to help in the valuation process. Despite this history, Ms. Oberlin is right to take steps to challenge the internal and external valuation processes that will become the basis for accounting for acquisitions to determine if they comply with the new guidelines. She should rely on her external auditors for help in fully understanding if the company's procedures comply with the guidelines.

Two issues of concern to Ms. Oberlin are the company's past practice of including as much of the purchase price toward IPR&D as allowed and her fear that IPR&D exceeding 40% of the acquisition price will attract SEC scrutiny. Both of these issues can be resolved if Ms. Oberlin takes the steps necessary to ensure that the IPR&D guidelines are well understood inside the company and by the consultants. She has a responsibility to establish procedures that reflect those guidelines for the company to use when it decides to make an acquisition. In this regard she can ensure that all future acquisition decisions are made with a strong degree of confidence in the accounting treatments. She should ensure that DC&A uses the percentage-of-completion methodology favored by the SEC. If a different methodology has been used, she should require a comparison to ensure the results of the DC&A methods were not materially different from the percentage-of-completion method. If she does the right job, the company will meet the SEC guidelines—and as a result satisfy the company's own objective of taking the maximum allowed. If the guidelines are properly applied she should not be concerned with SEC scrutiny—no matter whether the IPR&D amount is 20%, 40% or 60% of the acquisition.

To deal with the current acquisition, Ms. Oberlin is taking positive steps to correctly account for a past acquisition. She should rely on the documented rationale the company used to make the acquisition and information obtained from the product research staff to determine the proper valuation splits for the acquisition. Among other issues, she should be reviewing the IPR&D valuation to carve out as goodwill any values due to synergies and alternative future uses of technologies.

By measuring existing procedures against the new guidelines and adjusting where necessary, Ms. Oberlin can strengthen what appears to be an already robust accounting process and fulfill her responsibility to accurately portray the results and quality of Simpco earnings.

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The more subjective and arbitrary the write-off is, the more it smacks of artificial earnings management.

Miss Oberlin is caught between two opposing accounting principles. In-process research and development is a nebulous asset whose value is very difficult to establish. The costs incurred bear no direct relationship to the ultimate benefits to be realized. Therefore, to maintain a conservative balance sheet, generally accepted accounting principles require that R&D expenses be charged to expense when they are incurred. As a corollary, it follows logically that when a company buys another business that has extensive R&D activities, part of the purchase price should be assigned to

those projects, and that assigned cost should be written off immediately. That is what Simpco is proposing to do, at the recommendation of DC&A Consultants.

But this conservative accounting treatment, when carried to an extreme, runs the risk of creating a different type of error. Writing off more costs this year sets the stage for charging fewer costs in future years. The more subjective and arbitrary the write-off is, the more it smacks of artificial earnings management. Income statements also should be conservative and should not reflect charges before the appropriate time. The preliminary statement of income for 20X2 reflects a concentration of IPR&D and special charges that, in combination with the decline in sales and operating income before these charges, hints at earnings management—an attempt to get all the bad news out of the way and set the stage for a dramatic recovery in later years.

The tension between these opposing principles creates the dilemma that threatens to KO Katherine Oberlin. She has to skate a fine line between the excesses on either side.

She should scrutinize and probe all aspects of the valuations established by DC&A and consider whether Simpco's board of directors' discussions about the Adelphi acquisition point to any other assets to which values should be assigned.

She most certainly should immediately alert John Kramer about the sensitive nature of the issues and the steps she plans to take to resolve them. She also should consult with Simpco's auditors sooner rather than later. They in turn will have to inform Simpco's audit committee about the sensitive estimates, the process management used in formulating those estimates and how the auditors satisfied themselves about the reasonableness of those estimates.

Looking ahead, the footnote discussion of these estimates in the 20X2 financial statements should be complete and candid, as should the discussion in Simpco's management discussion and analysis about significant known uncertainties.

The special charges seem, on their face, to be straightforward. But, in conjunction with the significant IPR&D, they probably will get increased scrutiny from security analysts and the Securities and Exchange Commission staff. Ms. Oberlin should be absolutely sure that those charges include only the direct effects of the disposals, and that they will happen within one year.

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She is the author of "How Frequently Do Managers Disclose Prospective Earnings Information?" The Journal of Financial Statement Analysis, Spring 1998. (Co-authors: C. Kile & G. Waymire).

Ms. Oberlin is justified in worrying that the auditors, analysts, investors and the SEC, will be skeptical about whether expense recognition is based on managers' best unbiased judgment.

This case provides an excellent scenario in which to consider issues related to the company's intentional management of reported net income to achieve some reporting goal other than the truthful and accurate measurement of profits during the period. In general, we think of the managers

of U.S. businesses as having incentives to overstate net income to achieve higher stock prices and higher managerial incentive compensation. However, in years in which net income, operating income, earnings per share or some other accounting construct for profitability will fall short of the level needed to preserve the positive trend in earnings, the company takes something called a “Big Bath.” In other words, the company purposely speeds up the recognition of expenses in a year in which earnings are below the long-term trend line to enhance accounting profitability in future years.

Examination of the abbreviated information given in the case, and particularly the Preliminary Consolidated Statements of Income, shows that Simpco’s sales, operating income and net income would have been lower than the prior year’s measurements even without the write-off of in-process research and development acquired in several takeovers and restructuring changes in 20X2. Therefore, Simpco’s 20X2 fiscal year was a good time to consider taking a Big Bath. By writing off as much of the purchase price of acquisitions as possible (by classifying the assets purchased in the acquisitions as IPR&D), Simpco avoids having to classify that part of the purchase price as goodwill (subject to amortization in future years) or other assets (subject to amortization and depreciation charges in future years). By doing so, Simpco anticipates expenses from future years into the current fiscal year, making a bad year even worse but setting up future years to be more profitable since the company will recognize lower expenses for depreciation and amortization than would be the case without the Big Bath.

The \$365 million in restructuring charges are also troublesome. Restructuring charges are subject to substantial managerial discretion both as to magnitude and timing. The company proposes to recognize large (relative to net income) restructuring charges in a fiscal year in which (a) sales, operating income and net income are low relative to the benchmark of the previous year—even without any unusual discretionary charges; and (b) significant portions of several acquisition prices are written off as IPR&D—arguably another instance of substantial managerial discretion. Ms. Oberlin is entirely justified in worrying that the SEC, as well as the company’s auditors, the analysts and current and potential investors, will be skeptical about the extent to which the recognition of the unusual charges is due to the managers’ best unbiased judgment about judgments and estimates embedded in the charges.

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Clyde Associates is a boutique consulting firm located in Dallas, TX where Nita specializes in accounting education with a particular emphasis on issues of professional ethics. She chairs the AICPA/NASBA Joint Committee on Continuing Professional Education Standards, as well as a Special Committee on Ethics in the CPA Profession. She is a past member of the AICPA Board of Directors, and is currently a member of its governing Council. Nita was a university professor for almost 20 years.

Controller Kathy Oberlin appears to be more obsessed with what she can “get away with” in her company’s Securities and Exchange Commission filings than in making a fair presentation of Simpco’s financial results. Without addressing what constitutes proper accounting for the various transactions, there are still several ethical issues to consider.

First of all, a CPA is obligated to follow generally accepted accounting principles, including, in this case, those established both by the SEC and the Financial Accounting Standards Board. Kathy worries that while some “hot” areas are well documented, there are others that might not bear close scrutiny and thus would be subject to adjustment.

Kathy has an obligation to diligently investigate the alternative methods of financial statement presentation available to the company. She and her staff must be competent in making their assessment of the various estimates, and her professional judgment cannot be influenced by pressure to present the company’s financial situation in the best light, regardless of what it takes to do so. Because her judgment is relied upon, she should share her concerns with management, including any reservations she may have about the work of DC&A Consultants. While there is always room for varying opinions relative to certain accounting issues, if Kathy is certain that elements of the financial presentation are misleading and/or inaccurate and management refuses to allow her correct them, she should remove herself from the situation. Her professional obligations extend beyond the company itself to current and prospective equity and debt providers.

This case is a good illustration of the complexity and inter-relatedness of various accounting and internal control issues, including the relations among managers’ personal incentives (including bonus payments and personal credibility), investor relations programs, earnings management, cost of capital and accounting controversies with auditors and regulators.

Turning first to the earnings management issues, although the abbreviated income statement shows a pattern that is consistent with Exozol having taken a Big Bath in 20X1 (intentionally accelerating the recognition of expenses in a year during which earnings are below the long-term trend line to improve accounting profitability in future years), the discretionary charges taken in 20X2 are not consistently of the income-increasing variety. In 20X1, Ed Keys took estimated restructuring charges in excess of the amount that was ultimately justified. In 20X2 some of the charges were reduced, but another set of restructuring charges was recognized, some of which (particularly those related to shutdown expenses for the production systems in the Midwestern plant) proved to be excessive before the end of the year. These 20X2 restructuring charges caused net income for that fiscal year to fall below the trend line, although not by as much. In addition, the issue is clouded by the pattern of research and development charges, which in 20X1 were summarily reduced from the percentage of commitment typically recognized in the industry but were also increased by the immediate charge-off of in-process R&D purchased in the acquisition of Puma Lubricants. Because a clear pattern does not emerge from these unusual charges, investors and analysts are likely to be confused about management’s intentions and are also likely to find it difficult to forecast future cash flows and earnings. This confusion could well lead to an increased cost of capital for Exozol, and to be inconsistent with Ed Keys’ stated focus on shareholder interests.

To his credit, James Linwood is concerned about his relationship with the investment community. He no doubt understands the results of the research on the inverse relations between increased disclosure and transparency in financial statements and cost of capital to a business. Other factors that have been shown to be inversely related to share prices are controversies with auditors and regulators that lead to restatements of prior year financial statements. These events should be avoided as part of a good investor relations program.

Exozol's main financial reporting problems appear to be a function of Ed Keys' autocratic management style. He is not committed to good process and proper authorization by the board of directors for plans and commitments. He does not respect chain of command in making accounting decisions, and appears to be using the suspension of bonuses for decision-making personnel as a tool to exercise power over managers rather than as an incentive structure to facilitate delegated decision making in shareholders' best interests. A useful exercise might be to attempt to construct and evaluate a justification of Ed Keys' actions, decisions and incentives.

VISION TECHNOLOGIES INCORPORATED: ISSUES IN REVENUE RECOGNITION

By Larry M. Prober, PhD, CPA

After years of impressive growth, Vision Technologies can attract employees via its stock option plan. CEO Denton fears a disruption to present policy. Should Archer insist on a prior period restatement?

Abstract

Vision Technologies Incorporated illustrates the significance of revenue recognition in the reported income of a growing business. It shows how the development of a new product platform can affect which revenue realization criteria management uses in recognizing sales. It also addresses the considerations that management faces in employing generally accepted accounting principles and the external pressures inherent in these decisions. Study the problems encountered by Tim Archer, chief financial officer, as he collides with chairman Gene Denton over the recognition of product and support revenue of the company's product lines. Decide for yourself whether a change in revenue realization policy is needed for the company's new product line. Determine if Tim Archer's concerns about auditor independence are justified.

Background

Vision Technologies Incorporated was founded 10 years ago by its chief executive officer and president, Gene Denton. The company employs over 500 people in the development, marketing and support of client/server database management systems. It also provides software and services for data warehouse applications and during the last year has begun to promote its new integrated intelligent vision e-commerce platform. This new platform includes electronic customer management, interactive broadcasting, supply-chain management, streaming analysis, e-commerce, enterprise portals and reporting, data mining and a host of decision support activities. These applications and Vision's total support system represent the company's continuing efforts to build on customer loyalty from a variety of the most prestigious names in business. As the company ends 20X2 with new offices in Europe, and expectations for a new one in Asia in 20X3, management looks for growth throughout the world to continue its recent trend in revenues and profitability.

Historically, revenues have come from product licenses and fees for technical support, consulting and educational services. Revenue has been recognized in accordance with company policy, which relies on Statement of Position (SOP) No. 97-2, Software Revenue Recognition, and SOP No. 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Tim Archer, Vision's chief financial officer and vice-president of finance, has recently become concerned about issues involving the accounting for revenues. Last year, shortly after being promoted to his current position, Mr. Archer became more aware of the company's aggressive revenue recognition policies. He remembers discussions with the auditors about recently signed contracts and the specific application of previously used criteria. Although there was some disagreement over the timing of revenues, the issue of consistency won out in the specific accounting for new agreements. Thus, some new contracts signed during the last few weeks of last year's fourth quarter were taken into the

revenue stream despite amounts of work needed to meet the company's support obligations. With five contracts signed during the last few weeks of 20X2, Mr. Archer sees a similar pattern emerging during that year's final quarter.

The Problem

Mr. Denton believes that two of these contracts should be fully booked into the current quarter, citing arguments similar to those made last year. He believes that the most significant constraint to sales is the signed contract and that, once signed, a contract all but assures the company of these revenues. He acknowledges how important these revenues are in maintaining the company's sales momentum, but assures Mr. Archer that Vision faces little risk of not being paid since these customers are among the elite of Wall Street. He further reasons that not acknowledging these contracts may give the false impression that Vision is unable to market its current offerings, when in fact the sales force has done an outstanding job of selling company products and services. Finally, Mr. Denton talks about the importance of the company's growth to investors/analysts and the role of expectations in the company's stock price. After several years of impressive growth, the company is now able to attract better employees via its stock option plan. He fears that a disruption of present policy may have negative consequences for all levels of management and create undue speculation both in and outside the company. He appeals to Mr. Archer to continue the company's revenue recognition policies in accordance with historical criteria that have been approved by the company's international accounting firm. "If anything was wrong, would they have provided their stamp of approval?" he asks.

Tim Archer knows the Securities and Exchange Commission has embarked on a campaign to tighten the revenue recognition rules. He is expecting a new document on this subject from the commission at any moment, and believes they will call for more detailed accounting in the allocation of revenues from multi-source transactions. Thus, he wants his staff to provide a more detailed breakdown of each contract, and the relative portions of revenue type resulting from each agreement. In that way he can more appropriately determine not only the type of revenue but also the remaining activity necessary to fully meet the company's commitment. This information will allow for revenue recognition on a subscription or percentage-of-completed-contract basis, which Mr. Archer believes is more appropriate. Mr. Denton argues that this additional information is provided during the course of the contract but is not necessary at the time of revenue recognition. Nevertheless, he understands this information is implicit in the contract negotiations and would help in evaluating the ultimate acceptance or rejection of the contract. Thus, it represents a good management control for company operations.

Mr. Archer's background in public and corporate accounting make him quite sensitive to the legal requirements of company management. While he would like to assure Mr. Denton he is a team player and continue the status quo, he realizes that if either the SEC or the Financial Accounting Standards Board issue new regulations for revenue recognition that are different from those now in use there is the potential for both legal action against the company, and an accounting restatement. Therefore, he reasons that it may be better to implement a more conservative deferral of revenue policy now rather than risk a more comprehensive full blown restatement later. He recalls the problems of Lionnel Industries after analysts questioned that company's accounting methods, perhaps unfairly, and stopped recommending the stock. He believes they will be even less forgiving

if Vision is forced into any type of restatement. He fervently believes that with the company's strong product line, analysts can be convinced that timing is not a major issue in regard to the company's overall prospects.

On the other hand, he considers a loss in confidence in the company to be potentially more serious. Mr. Archer knows that Vision competes in extremely competitive markets and that as long as the business has a competitive advantage and provides customers with enhanced value the revenue stream will follow. He does not want to give anyone a reason to switch their alliance, especially after all the investment in the company's new platform. Thus, revenue recognition may have a greater bearing on the company's prospects than management members anticipate. Likewise, Mr. Archer understands that everyone—from the janitors up to CEO—is excited about the company's recent stock price run up and he doesn't want to jeopardize his colleagues' future fortunes. He knows, too, that future funding for international expansion is likely to be financed by a stock offering expected sometime during the next year. Thus, Mr. Archer is doubly concerned about the negative impact that lower stock prices would have on future growth.

Finally, Mr. Archer has some reservations regarding the auditor-client relationship that existed before his hiring. He has learned that two years ago—before the merger of the current auditors—one of the merged firms performed only consulting services for Vision and helped sell Vision's software to other clients. The sales amounts were not significant, and shortly after the merger this sales relationship ended, but some may see it as less than desirable from an independence standpoint. Thus, he worries that the SEC may take a harsher stance with Vision in the event any revenue concerns are raised. He wonders if the auditors' support of previous accounting choices will be dismissed because of this prior relationship—even though it has little to do with the current issue at hand.

Key Information

The following information prior to the audit of 20X2 has been prepared by Tim Archer's staff.

1. Product license fees have generally been recognized upon execution of a contract and shipment of software if no significant obligation remains and collectibles are deemed likely.
2. Technical support revenues result from customer support agreements in connection with initial product license sales and subsequent renewals.
3. Revenues recognized from multiple-element software arrangements are allocated to each element—based on relative fair values of such elements—and include items such as software, upgrades, enhancements, support, installation and education.
4. Consulting and implementation services necessary for custom functionality of software are recognized in accordance with SOP No. 81-1 using the percentage -of-completion method. If the software license arrangement obligates the company to deliver unspecified future products, then revenue is recognized on the subscription basis, ratably over the term of the contract.
5. Beginning in the fourth quarter of 20X1, the company began selling products and services for large scale e-commerce applications. Unlike previous periods in which transactions were of a stand-alone nature, these transactions typically involve multiple software products and services by large numbers of users across a broad spectrum of channels. These large multiple element

transactions involve more complex licensing and product support arrangements than were used in previous periods.

The Options

Mr. Archer believes that accounting for the new integrated platform referred to above in compliance with SOP Nos. 97-2 and 81-1, and No. 98-4, Deferral of the Effective Date of a Provision of SOP-97-2, Software Revenue Recognition, will require changes from the past since revenue from many of these large multiple contracts is not recognizable upon full execution and delivery of the software product. He recommends that deferred revenue be recorded and product revenue recognized using the percentage-of-completion method based on cost inputs over the entire term of the contract. While product sales cycles may span nine months or more, the company has historically recognized a substantial portion of these revenues in the last month of a quarter, with revenues frequently concentrated in the last two weeks. Since booking orders can have a significant impact for a particular quarter, even a small delay of a large order can dramatically affect quarterly results as will the mix of product licenses, support agreements, implementation work and other specifics of the agreement.

A close examination of these and other orders during the last three years reveals that net revenues of \$24 million, \$5.2 million and \$1 million were prematurely recognized during the 20X2, 20X1 and 20X0 periods, respectively, if the deferral of these revenue types was warranted. Mr. Archer is concerned about this issue and must decide how to respond.

The following partial financial statement reflects the current and adjusted balances of income statement items based upon the above information.

	20X2		20X1		20X0	
	Reported	Adjusted	Reported	Adjusted	Reported	Adjusted
Revenues						
Product licenses	\$71,150	\$42,867	\$36,443	\$30,225	\$18,312	\$17,551
Product support	31,553	32,885	16,843	16,916	8,555	8,787
Income from Operations	<u>9450</u>	<u>(17665)</u>	<u>4623</u>	<u>(1250)</u>	<u>156</u>	<u>(308)</u>
Income taxes	<u>3780</u>	<u>611</u>	<u>1850</u>	<u>=</u>	<u>=</u>	<u>=</u>
Net Income	5670	(16854)	2773	(1250)	63	(426)
Per share data						
Basic	0.08	(0.21)	0.04	(0.02)	0.00	(0.01)
Diluted	0.07	(0.21)	0.03	(0.02)	0.00	(0.01)

Stock Price Data

	High	Low
20X1	11.25	5.25
20X2	45.25	14.25

Based on the above information, how would you recommend Tim Archer proceed? Consider the criteria for revenue recognition as it applies in this case and its role in investor expectations.

Comments on “Vision Technologies Incorporated”

Dan Hugo, CPA, is Director of External Reporting for EBay Inc.

Ebay pioneered a Web-based community in which buyers and sellers are brought together. EBay also engages in the traditional auction business and in online payment processing.

Once a company starts down the slippery slope of recognizing revenue early it is almost impossible to turn back.

This case study highlights one of the age-old struggles in most companies. Marketing and sales departments generally want to recognize as soon as possible, while finance/accounting departments tend to follow a more conservative approach. A common area of misunderstanding is the difference between signing the contract and providing the service. Sales personnel generally believe that the moment a contract is signed, revenue can be recognized, particularly when they are able to collect the cash in advance.

However, generally accepted accounting principles require that revenue has to be recognized in the period in which the service is provided. The mere fact that a contract has been signed or that cash has been received is inconsequential in determining whether revenue can be recognized.

A further complication occurs when a single contract is used to cover to a bundle of services for one set payment. For these types of multiple revenue arrangements, a fair value must be assigned to each of the components and normal revenue recognition principles have to be applied to each one. For some components the company may be able to recognize revenue, while for others revenue recognition may occur over the life of the contract. I agree with Mr. Archer’s approach that the best and only time to assign values to the different components will be at the date that the contract commences. Again, tracking the revenue recognition on each of these components may be fairly difficult.

It is important that sound principles rule in the area of revenue recognition. Once a company starts down the slippery slope of recognizing revenue early it is almost impossible to turn back. For example, in the next year, the company does not only have to reach the current year’s targets, but it also has to make up for the revenue that was recognized early in the previous year. This has a snowball effect and before long reaches such proportions that it is impossible to hide. Management starts to rely on accounting to make up the shortfall and before long loses track of the company’s overall goal—to be successful. As can be seen in the example, the revenue in question grew from \$1 million to \$24 million in only two years.

The main reason for continued success on Wall Street is investor confidence. Investor confidence reflects the company’s success, but most of all, it reflects the integrity of this success. Nothing hurts a company more than having to restate its financial results. A restatement will lead to numerous class action lawsuits and will distract management. Most damaging of all, if the company is genuinely successful, the market will always ask if it is for real.

Mr. Archer finds himself faced with a difficult decision, which is not uncommon in today’s business world. As more companies structure incentive compensation systems around their stock prices (as well as expansion and acquisition plans), chief executive officers become more and more sensitive to

stock performance. This means that the CEOs have a tendency to look to chief financial officers and controllers to maintain revenue and profit trends. The CEO sees any interruption of the trend or possible change in reporting practices as a breach of corporate duty.

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He is editor-in-chief of The Journal of Corporate Accounting & Finance and the author of “Progress on Impairments and Business Combinations”, The Journal of Corporate Accounting & Finance, November/December 2000.

*Mr. Archer should argue for deferral of revenue and restatement of the prior periods.
Obviously, the CEO will not be happy with this recommendation.*

While this is a difficult situation for Mr. Archer, he must remember that he has a responsibility—not only to his bosses but also to the board (and audit committee) and to the shareholders and other external stakeholders—to properly report the entity’s financial performance. Mr. Archer also would do well to note that the Securities and Exchange Commission has become increasingly likely to take action against company personnel (such as CFOs and controllers) when they discover that there were financial reporting problems under their watch. The SEC actions are even more severe when the facts show that the CFO knew about the problems and did not take appropriate steps to correct them.

As Mr. Archer knows, the SEC strengthened the revenue recognition rules when it issued Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements. Of key concern for Mr. Archer, SAB No. 101 closely parallels the existing guidance in Statement of Position No. 97-2, Software Revenue Recognition, which Vision Technologies asserts that it uses as the basis for recognizing revenue. SOP No. 97-2 requires that four conditions be met before revenue from sales of software and related services can be recognized:

- There is persuasive evidence of an arrangement.
- Delivery has occurred.
- The vendor’s fee is fixed or determinable.
- It is probable that revenue can be collected.

Additionally, since many of the contracts in question appear to involve multiple elements, Mr. Archer would be wise to consider the provisions of SOP No. 98-9, Modification of SOP 97-2, “Software Revenue Recognition,” With Respect to Certain Transactions. SOP No. 98-9 requires that entities be able to separate multiple element arrangements using vendor-specific objective evidence (VSOE) of fair value of the individual elements. If there is no VSOE for any of the undelivered elements, then the revenue must be deferred until all elements have been delivered. If the elements can be separated, then each one should be recognized when the four criteria above are met. A further complication is the fact that some of the contracts involve significant customization, which leads to contract accounting in accordance with SOP No. 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. An important point to note here is that if SOP No. 81-1 applies, the entire contract is subject to contract accounting (which will result in some deferral of the revenue under the contract).

Mr. Archer's analysis appears to show that certain revenue should be deferred for the current year and that some should have been deferred for the prior two years, as well. The question is how this situation should be handled. Given Mr. Archer's analysis, it appears clear that deferral for the current year is a must. Should he insist on restatement of the prior-period results as well?

The answer to that question depends upon the materiality of the impact on the prior period. This analysis is further complicated by the fact that a restatement often brings about a significant market reaction because of investor questions about the quality of the company's earnings. However, in making the materiality judgment relative to the prior-period results, Mr. Archer should carefully consider the guidance of SAB No. 99, Materiality, which notes that management (and auditors) should consider both quantitative and qualitative factors in judging materiality. One of the qualitative considerations is whether the amount changes the reported profit into a loss, which, in Vision's case, it does.

All of these considerations lead to the conclusion that Mr. Archer should argue for deferral of revenue and restatement of the prior periods. Obviously, the CEO will not be happy with this recommendation. And this is where the issue of the auditor's independence (or lack of it) comes in. The SEC revised its independence rules in 2000 and clearly indicated that it intends to more closely scrutinize auditor independence in the future. Mr. Archer may be able to use the independence issue as a justification for changing auditors, given the concerns about the existing auditor's independence. That could be important, since it would be much easier for a new auditor to approve a restatement than it would be for the existing auditor, which has previously expressed an unqualified opinion on those prior-period financial statements.

Stephen L. Key is the retired Executive Vice President and Chief Financial Officer of Textron Inc. He is a former Executive Vice President and Chief Financial Officer of ConAgra and a former managing partner of the Ernst and Young New York office.

The company must carefully review its communications with analysts and investors with respect to this change in business practice, and make necessary amendments.

Mr. Archer has valid concerns. Based on the facts presented, it would appear the Vision might have erred in not amending its accounting policies for the change in business that occurred in the fourth quarter of 20X1. (It is unclear, however, why the results for 20X0 would need to be adjusted). The facts presented would seem to support a boarder usage of the percentage-of-completion method beginning with the change in business practice that occurred in 20X1. The company must carefully review its communications with analysts and investors with respect to this change in business practice, and make necessary amendments.

Steven Wallman, J.D., is founder and CEO of FOLIOfn founded in 1998.

Using the FOLIOfn system, investors can purchase customized portfolios. He is a former commissioner of the U.S. Securities and Exchange Commission and a former partner, Covington and Burling. He is a non-resident senior fellow of economic study at Brookings.

Consistency, which Denton and the auditors rely on as their argument for continuing the old realization policies, is an alluring concept to many, however...

Tim Archer is in a tough place, but he is on the right track. When the development of new products begins to challenge the soundness of a company's existing revenue realization policies, the sooner the change is implemented the better.

Complex bundles of products and services require companies to make tough decisions about when to book revenues, no matter how sophisticated and detailed the rules are. The more complex the bundle, the more difficult to make the call. Archer has a mountain of complexity before him with the company's new "intelligent vision e-commerce platform."

Archer must use his skill and judgment to help the company make the transition to the cleaner and more transparent realization criteria. Unfortunately, existing accounting policies do not help him much. The current requirement of static, snapshot style quarterly accounting encourages rigid thinking about bright lines and artificial distinctions about quarterly recognition instead of a more reality-based approach. Even the practice Archer is now contemplating has plenty of artificial lines to be drawn, but it is clearly more reality based than one that puts all revenue in one quarter or another for massive contracts that take months to complete fully. However, his new approach is inconsistent with past practice—although that practice was based on the earlier platform's different characteristics—and one thing accounting and the markets favor is consistency. The reality of complex product-service bundles is that revenue is earned and therefore realized more in line with the percentage-of-completion approach that Archer is advocating. Not only does accounting for the progress of work and revenue recognition on a percentage-of-completion basis better inform company planning—as Denton, the company founder, acknowledges—but it also gives a better and more accurate picture of the company's metrics for investors.

(One objection to reporting information at this more granular level is that it will also inform competitors and, perhaps, the other party to the contract of sensitive company information. In this case it seems that there is little concern about sensitive information given that there is no suggestion that any one contract is so large that reporting this information at an aggregate level would provide sensitive data.)

Consistency, which Denton and the auditors rely on as their argument for continuing the old realization policies, is an alluring concept to many, but seldom, in my experience, to regulators once they are convinced that they have identified a problem. Archer is properly concerned that postponing a change will simply exacerbate any problem that the Securities and Exchange Commission might identify. The impact on shareholders and employees that Denton claims would occur because of a change in approach would only be worse if the change were postponed. Moreover, the rollout of the new platform, with its new level of complexity, gives the company a reasonable, appropriate and explainable opportunity to make the change. There is no doubt that applying the old recognition practices to the new platform will eventually lead, when discovered, to long and significantly adverse fallout from the market's perception that Vision is playing with its revenue recognition. This fallout will be much worse than any consequences from having to explain now that a new platform—with all its attendant opportunities for the company—also requires a new accounting treatment. The real concern for Archer should be the prior-year's reporting. However, based on the

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auditor's independent review, management's view of the contract revenue realization and the simpler version of the earlier platform supporting that view—and the accounting standards of the time—Archer will likely be justified in leaving the prior statements as they are, if the auditors concur, provided he adopts the new treatment going forward. Disclosure of the reason for the change will have to be carefully crafted to explain accurately what is occurring. But the significant differences between what was sold before and what is being sold now seem to support the auditor's view that the prior years' accounting was accurate, even if different from what Archer knows he has to do going forward.

Archer is also correct to be concerned that the consulting relationship with one of the pre-merger audit firms could be an adverse background factor should the SEC decide to act. On its own, however, the relationship should not be difficult to explain and defend, given that the sales channel relationship was terminated promptly after the merger and contributed *de minimis* revenues to the pre-merger firm. Even if there is an SEC action, Vision should be able to argue persuasively that the pre-merger firm's consulting had nothing to do with the accounting judgment behind the recognition of revenues policy and created no independence issue.

RESTRUCTURING AT EXOZOL?

By Larry M. Prober, PhD, CPA

Edward Keys hopes that new blood in the company will foster fresh and creative ideas to help achieve corporate objectives. What is the new CFOs' fiduciary responsibility?

Abstract

Restructuring at Exozol? addresses how restructuring charges can affect financial reports, and the influences of corporate management in the accounting for these costs. It highlights major points, from internal controls for adopting a restructuring plan to developing cost estimates and the year-to-year accounting for these items. The case illustrates some of the major corporate restructuring issues the Securities and Exchange Commission has addressed in its quest to reduce earnings management. Follow James Linwood as he uncovers several potential problems in his investigation of restructuring at the company.

Background

Exozol is a leading provider of lubricants for transportation and industry. Like others in the specialty chemicals industry, the company has recently experienced slowing growth. While this softness in the market can be attributed to the industry's maturity and factors such as improved engines and longer draining intervals, the company hopes that a series of acquisitions and cost cutting initiatives will help restore it to a more favorable status among those following the industry. To improve profitability, Exozol has recently hired James Linwood as its new chief financial officer. Mr. Linwood comes from a smaller industry competitor and brings a strong background in the development of strategic alliances and financial controls. Exozol's president and chief executive officer, Edward Keys, hopes that new blood in the company will foster fresh and creative ideas to help achieve corporate objectives.

Under its new organizational structure, Exozol has recently promoted Linda Sharp to controller, and Al Barkley to assistant controller. These two along with James Linwood are important team players as the company moves toward a more focused effort for accounting and finance to help combat competitive pressures. The importance of the CFO in strategic planning as well as accounting policy is one of the reasons for Mr. Linwood's appointment. These members of the finance team are expected to help minimize the company's cost of capital and provide leadership to meet analysts' revenue and profit growth expectations. Growth is a major concern of Edward Keys and he hopes that all employees, not just those in management, understand its importance to the company's future. This point was best illustrated when executive bonuses were suspended in 20X1 as a result of lackluster performance. Improved results in 20X2 are expected to make it possible to restore the company's bonus program.

As CFO, one of James Linwood's goals is to communicate more effectively with members of the financial community. He hopes to inform analysts and other interested parties of Exozol's efforts to develop a more comprehensive profitable product line for global customers. Included in this effort is the reduction of business risk through better management of foreign currencies and a series of

strategic alliances with foreign partners who possess more extensive knowledge of their local markets. Given that most future growth is expected to come from Asian and European demand, Mr. Linwood reasons that the company should make more efforts to take advantage of lower labor and production costs overseas.

One of the more immediate problems confronting the finance group as it embarks on its expanding role within the company is its relationship with Mr. Keys. Long known for his abrasive managerial style, Mr. Keys also pays close attention to industry competitors and Wall Street's reaction to industry trends. He believes that managers have a responsibility to the shareholders and management should do everything in its power to look out for shareholder interests. Accordingly, he has been known to tell the controller to "bend the rules where appropriate but never break them." Since Linda Sharp is acutely aware of the SEC's latest efforts to improve financial reporting, she has some concerns about the degree of power she possesses if Mr. Keys involves himself in specific accounting issues. With acquisitions and corporate restructurings in the works, she believes now is not the time to bend any rules. James Linwood also worries about the potential loose interpretation of accounting rules and believes his relationship with the investment community could be eroded if any problems develop early in his tenure as CFO. Thus, he has instructed the group to be overly cautious in the application of generally accepted accounting principles, since the last thing the company needs is an SEC investigation and subsequent restatement of earnings. He hopes that any differences in opinion can be resolved peacefully and that auditor disagreements can be kept to a minimum.

The Problem

As the 20X2 financial reporting season comes to a conclusion and financial statements are being prepared for auditor review, the finance group has several items to discuss. Chief among them is the accounting for restructuring charges taken last year and continuing this year. Since James Linwood was not employed by Exozol when the company first decided to restructure operations, he was not involved in some of the cost estimates used in last year's financial reports. Thus he has immersed himself in many of the details surrounding the firm's operations, including the \$15 million of cost savings that those changes were expected to deliver in 20X2. He believes that to achieve the company's objectives and the benefits of this program, he should understand as many details as possible. Unfortunately he has discovered a few problems that may make his job more difficult.

For example, he has some doubts regarding the initial approval to restructure operations. Although Mr. Linwood sees substantial benefits in consolidating component production and reducing certain product lines, he questions whether Mr. Keys had the proper authority to embark on the project since formal approval in prior years for similar activities was usually given by the company's board of directors. Since the decision to proceed with phase one of the restructuring was made late in 20X1, no formal meeting was held to discuss the matter in that year. While subsequent minutes note the board's unanimous approval and a reasonable plan/commitment date, Mr. Linwood would like to implement a formal process to avoid similar concerns in the future.

Also related to the operational closings are the estimated costs for plant shutdowns and the related separation payments to displaced employees. While the company has broken these items out and separated impairment costs as required under newly revised accounting standards, Mr. Linwood

notes that some estimates were quite high, leading to their reversal during the current year. A review of similar charges in the past shows the company consistently overstated these costs and later credited them to income. He is particularly concerned because some severance costs were estimated for employees and charged to expense even though the affected employees were not told of their job displacement until the subsequent quarter. He believes he should limit the adjustments made from earlier estimates. His discussions with Mr. Keys regarding this issue show the CEO has little concern about estimation error since he believes that “accountants cannot predict the future and would not be called upon to defend these immaterial amounts.”

Finally, Mr. Linwood has some questions regarding the relationship of other typical costs, such as research and development. He notes that in most years, industry requirements have justified a consistent percentage of R&D commitment. However, current-year allocations are below this established policy. While this issue may be managerial in nature he believes he should question this changes as part of his role as a strategic adviser. While he recognizes the improved profit that results from the lower expenditure, he also believes that it is likely to affect future profitability. Thus he wonders why the sudden change was needed. In a brief discussion with Ed Keys, he learns that in one of the 20X1 acquisitions there was some duplication of research efforts. Nevertheless, he wonders how the company can maintain its current competitive advantage in certain product lines if it reduces its R&D. In addition, he notes that in the 20X1 acquisition of Puma Lubricants, \$9.5 million was charged against income from technology under development. He knows the company’s policy is to write off these amounts if they have no future benefit but believes that some of these projects have already benefited the firm and will continue to do so (see Exhibit 1 for a listing of these accounting concerns).

Linda Sharp has also approached Mr. Linwood about her concerns regarding the company’s restructuring charges. She has to meet with the auditors in two days and wonders how the restructuring credit should be handled. She just attended a continuing professional education course where she learned that a new auditing standard about to be released would subject accounting estimates and resulting errors to a higher degree of scrutiny for materiality. She worries that previous estimates that seemed acceptable at the time—and at the worst immaterial—might now be considered material if they affect earnings trends, or other decisions in which the charge is involved. She is also concerned that the auditors will have questions about accounting quality.

Exhibit 1: James Linwood’s Concerns

Fourth quarter 20X1. Ed Keys’ approval of restructuring charges for operational shutdown and transfers, with board of directors’ approval in next quarter.

Fourth quarter 20X1. Booking of a \$29.975 million charge for restructuring consisting of the following costs:

1. Plant closings and other related charges of \$19.5 million
2. Employee separation costs of \$7.65 million, including \$1.5 million for 45 employees who were not notified of the action until the following quarter.
3. Asset writedowns of \$2.825 million.

First quarter 20X2. Additional expense of \$3.1 million recorded to reflect a greater amount for separation benefits, principally in Japan.

Second quarter 20X2. Reduction of \$4 million from previously estimated severance costs.

Third quarter 20X2. Recorded the second phase of downsizing, consisting of 3% of the workforce and 20 of 30 production systems in a Midwestern plant. Total charges of \$18.45 million included \$8.7 million for employee severance costs and \$9.75 million of other exit costs, including \$4.5 million related to asset impairments for production units taken out of service.

Fourth quarter 20X2. Reduced previous restructuring charge by \$2.8 million due to overestimate of original charges related to shutdown expense.

Exhibit 2: Abbreviated Exozol Income Statement Data for 20X2, 20X1 and 20X0

(\$000's)	20X2	20X1	20X0
Net sales	<u>1,166,565</u>	<u>1,052,876</u>	<u>1,101,762</u>
Cost of sales	779,986	738,224	735,664
Selling & administrative	125,865	115,545	107,285
Research & development	111,996	120,723	117,551
Total Costs & Expenses	<u>1,017,847</u>	<u>974,492</u>	<u>960,500</u>
Restructuring charges	(14,776)	(28,975)	
Gains from litigation	12,434	11,715	
Other income and expenses, net	<u>(17,556)</u>	<u>(12,565)</u>	
Income before taxes	<u>128,820</u>	<u>48,559</u>	<u>141,262</u>
Income taxes	<u>47,663</u>	<u>17,967</u>	<u>52,267</u>
Net Income	<u>81,157</u>	<u>30,592</u>	<u>88,995</u>

Based on the above information, how appropriate are the concerns expressed by James Linwood and Linda Sharp? Include in your considerations the financial reporting objectives that apply to these issues and the current standards for meeting these objectives.

Comments on “Restructuring at Exozol”

Stephen J. Cosgrove is Vice President, Consumer Sector Finance, at Johnson and Johnson Inc.

Johnson and Johnson is engaged in the manufacture and sale of a broad range of products in the health care field in many countries of the world.

If the chosen level of R&D spending doesn't support the business in the long run, the investment community will discount any short-term profit impact.

In today's business world, it is increasingly common for new finance teams to be hired into companies in the midst of transition. In the Exozol case, a new chief financial officer and his staff are faced with the opportunity of taking a fresh look at past accounting and management practices while simultaneously establishing credibility and providing financial leadership to a new organization. To succeed at both, the team will need a strong understanding of accounting practices and the ability to use their knowledge and experience to move the organization forward.

Mr. Linwood was hired because of his potential to be a key player in setting company strategic direction, as well as his ability to institute strong accounting practices. He was brought in to “foster fresh and creative ideas to help achieve corporate objectives.” This represents a wonderful opportunity for James Linwood and his staff.

However, in meeting this challenge, Mr. Linwood worries about his new boss’s style and perceived attitude toward accounting standards, which is to “bend the rules but never break them.” This type of uncertainty does not help in establishing the strong partnership that will be necessary for Mr. Linwood to bring about positive changes to the business while carrying out his professional responsibilities to accurately portray company results. One of the first steps Mr. Linwood should take is to “educate” Mr. Keys on the current Securities and Exchange Commission environment and the impact that could have on Exozol.

There are two separate business issues that Mr. Linwood and his staff need to address to provide value to the company while insuring proper compliance with generally accepted accounting principles. One has to do with the various compliance issues uncovered during the review of the prior year’s restructuring charge. The other is a business strategy issue concerning the business impact of the current year’s research and development spending. How Mr. Linwood handles the two issues will likely determine the health of his relationship with Mr. Keys.

There were clearly some mistakes made in establishing the restructuring reserves before Mr. Linwood came to Exozol. Proper board approvals, severed employee notifications and cost estimations all were problem areas. Given the threat of an SEC investigation and his desire to establish credibility with the investment community, Mr. Linwood urges his staff to be “overly cautious in the application of GAAP.” These instructions will probably cause a strain between the finance group and Mr. Keys. The finance team at Exozol has a fiduciary responsibility to accurately account for the company results using GAAP, not to be overly cautious, avoid SEC investigations or establish credibility with the investment community. Mr. Linwood can review with Mr. Keys the proper way to handle all of the issues arising from the restructuring accrual and how any adjustments must be reported. In particular, he should explain that gains due to restructuring reserves must be handled separately from ongoing results, under SEC Staff Accounting Bulletin 100, Restructuring and Impairment Charges. Accounting for these gains in any other fashion is not bending but breaking the rules.

Mr. Linwood is on the right track when he recommends establishing a procedure for proper documentation of the approval of major events, but he needs to create other procedures to enhance accounting controls in this area to ensure these issues are handled properly in the future.

The R&D issue gives Mr. Linwood an opportunity to learn more about Exozol, the potential R&D economies of a recent acquisition and the importance of understanding competitive investment levels. Selecting R&D spending levels is a critical strategic decision on which Mr. Linwood, as a member of the management team, should have input. Mr. Keys hired him, after all, in part because he could benchmark spending levels in other industry companies. Mr. Linwood should also explain to Mr. Keys that the investment community will focus on this critical area of spending. If the chosen spending doesn’t support the business in the long run, the investment community will discount any short-term profit impact.

Mr. Linwood's relationship with Mr. Keys will depend on how well the CFO communicates his assessment of the current situation, meeting all the GAAP reporting requirements while acting as a strong business partner and adviser. While some issues should not be negotiable, compliance does not mean being over cautious. Managing for the long-term health of a business must be a factor when making short-term spending decisions.

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He previously worked at Ernst & Young as a specialist in technical matters and before that he was a project manager with the FASB.

Mr. Keys has to learn that restructuring reserves are not cookie jars in which reserves can be stashed for future reversal when needed.

This case illustrates the extreme ethical pressures that weigh on senior financial executives, particularly when they work for Securities and Exchange Commission registrants under severe profit constraints. Such pressures can be much greater than those affecting CPA practitioners, who at worst will lose a client. Mr. Linwood is at risk of losing his job if he doesn't satisfy Mr. Keys, and suffering long-term damage to his career. But he also should be aware of the AICPA Ethics Interpretation ET 203.05, which provides that CPA employees who are responsible for the preparation of their employers' financial statements cannot state that those statements are in accordance with generally accepted accounting principles if they contain any departure from GAAP. Mr. Linwood will have to sign such a representation letter to Exozol's auditors and the Form 10-K, containing the financial statements, that is filed with the SEC. If he signs those documents, and Exozol's financial statements are later found to be materially inaccurate, he may be subject to severe ethical sanctions.

Mr. Linwood's focus should be to persuade Mr. Keys of the necessity to comply, to the letter, with the rigid, complex accounting standards that apply to restructurings. Mr. Keys has to learn that restructuring reserves are not cookie jars in which reserves can be stashed for future reversal when needed. Ms. Sharp, Mr. Barkley, Exozol's board of directors and its auditors all should be allies in this effort. Like most accounting problems, these issues are better addressed sooner rather than later. Mr. Linwood can point out that these restructuring charges will receive high-level scrutiny and heightened professional skepticism from the auditors. Failure to accurately estimate restructuring costs, as evidenced by subsequent significant adjustments, will damage the company's (and its top executives') credibility with analysts and may lead to embarrassing inquiries from the SEC staff. Those reserves must be accurately estimated, recorded in the proper period and fully disclosed.

The technical accounting standards dealing with restructuring charges are the consensus in EITF 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) and 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination; and SEC Staff Accounting Bulletin 100, Restructuring and Impairment Charges. It appears that in 20X1 Exozol has at least technically violated two of those standards. They provide that restructuring charges should not be recorded until "management having the appropriate level of authority" commits to the exit plan. Exozol recorded its charges before its board of directors approved the plan. In addition, employees must be notified of their pending involuntary termination before the charge is recorded. In this case, severance costs

were charged to expense before the employees were told of their displacement. Linwood should inform Keys of these significant problems—immediately—and enlist the help of the company's auditors to persuade Keys of the need for careful, thorough estimates of restructuring costs, and the importance of recording them in the proper periods.

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She is the author of "How Frequently Do Managers Disclose Prospective Earnings Information?" The Journal of Financial Statement Analysis, Spring 1998. (Co-authors: C. Kile & G Waymire).

Exozol's main financial reporting problems appear to be a function of Ed Keys' autocratic management style.

This case is a good illustration of the complexity and inter-relatedness of various accounting and internal control issues, including the relations among managers' personal incentives (including bonus payments and personal credibility), investor relations programs, earnings management, cost of capital and accounting controversies with auditors and regulators.

Turning first to the earnings management issues, although the abbreviated income statement shows a pattern that is consistent with Exozol having taken a Big Bath in 20X1 (intentionally accelerating the recognition of expenses in a year during which earnings are below the long-term trend line to improve accounting profitability in future years), the discretionary charges taken in 20X2 are not consistently of the income-increasing variety. In 20X1, Ed Keys took estimated restructuring charges in excess of the amount that was ultimately justified. In 20X2 some of the charges were reduced, but another set of restructuring charges was recognized, some of which (particularly those related to shutdown expenses for the production systems in the Midwestern plant) proved to be excessive before the end of the year. These 20X2 restructuring charges caused net income for that fiscal year to fall below the trend line, although not by as much. In addition, the issue is clouded by the pattern of research and development charges, which in 20X1 were summarily reduced from the percentage of commitment typically recognized in the industry but were also increased by the immediate charge-off of in-process R&D purchased in the acquisition of Puma Lubricants. Because a clear pattern does not emerge from these unusual charges, investors and analysts are likely to be confused about management's intentions and are also likely to find it difficult to forecast future cash flows and earnings. This confusion could well lead to an increased cost of capital for Exozol, and to be inconsistent with Ed Keys' stated focus on shareholder interests.

To his credit, James Linwood is concerned about his relationship with the investment community. He no doubt understands the results of the research on the inverse relations between increased disclosure and transparency in financial statements and cost of capital to a business. Other factors that have been shown to be inversely related to share prices are controversies with auditors and regulators that lead to restatements of prior year financial statements. These events should be avoided as part of a good investor relations program.

Exozol's main financial reporting problems appear to be a function of Ed Keys' autocratic management style. He is not committed to good process and proper authorization by the board of directors for plans and commitments. He does not respect chain of command in making accounting

decisions, and appears to be using the suspension of bonuses for decision-making personnel as a tool to exercise power over managers rather than as an incentive structure to facilitate delegated decision making in shareholders' best interests. A useful exercise might be to attempt to construct and evaluate a justification of Ed Keys' actions, decisions and incentives.

ACCOUNTING ISSUES AT NATIONAL TECHNOLOGY CORPORATION

By Larry M. Prober, PhD, CPA

Woods is concerned that some members of the financial community see the pension items, as vehicles the company uses to “smooth earnings.” What major issue should Woods consider?

Abstract

Jim Woods, controller of National Technology Corporation, a leading technology company, defends his company's recent changes in pension plan assumptions as appropriate and realistic. Nevertheless, he realizes that pension plans are long-term commitments and that short-term economic conditions will always differ to some degree from the long-term assumptions selected. Thus, he has second thoughts about his company's continuous attempts to adjust assumptions in calculating pension expense. His concerns are heightened by the impact of recent changes in the company's reported income and the criticism of some members of the investment community. Read the following case facts and determine if criticisms of the company's accounting are justified. Does Jim Woods have reason to be concerned?

Background

National Technology Corporation (NTC) is one of the world's largest technology companies. With offices in 45 countries, NTC provides a diversified line of computer hardware, system software and related services. Originally in the computer mainframe business, the company has significantly expanded its software, consulting and related services during the previous five years. The company continues to promote e-commerce applications while readying a new mainframe for introduction next year. With a solid reputation in research, NTC has garnered more worldwide patents than any company of its type and is readily acknowledged for its technical expertise throughout the industry.

Important advances during the previous decade in both hardware and software categories, as well as in e-commerce, have provided great opportunities and challenges for the company. Trading on its established name and through acquisitions in software and services, the company has provided investors with remarkable returns since a sharp decline in 1994. New management has helped NTC develop strategies to refocus sales and services on company strengths and use previous company inroads in networking and related areas of development. However, as the company begins the new millennium, its ability to maintain historical growth is being questioned by many industry analysts. Even though company profits have remained healthy, revenue growth has lagged behind some competitors. Consequently, there is concern about how best to meet growth expectations of the financial community, and restore some luster to the company's stock price, which has declined sharply over the previous 12 months.

Bob Beckett, NTC's financial vice-president, and Jim Woods, the company's controller, have worked well together carrying out policies to help minimize the company's cost of capital and maximize long-term profitability. They both feel the company has performed admirably given the intense competition in each segment in which it competes. For example, despite losing market share in desktop personal computers, the company has maintained its leadership position in mobile

computers. In addition, the divestiture of one global segment has freed up corporate resources and allowed the company to focus more sharply on its core competencies. With Y2K concerns laid to rest, the company hopes that information technology budgets will expand and NTC can make further progress in networking and other related services.

The Problem

As the current year comes to a close, several issues have been referred to Jim Woods for his evaluation of their impact on the company's financial statements. The most significant are the current adjustments from previous corporate restructurings and the company's accounting for pension expenses. While the restructuring charges relate to overestimates from a recent period, the pension costs are of a longer-term nature, reflecting investment decisions and accounting estimates for an extended period. Mr. Woods is concerned that some members of the financial community see these items, particularly the pension items, as vehicles the company uses to "smooth earnings." He argues that restructuring charges are difficult to estimate, and the effect of those items was immaterial. He also notes that in the previous year the company's changes in actuarial assumptions used in pension accounting lowered profitability despite above-average pension plan earnings. Thus the current year's adjustment for a higher discount rate within the plan was justified. He also counters that NTC's pension consultants gave full approval to all changes and that all assumptions used for both years are within ranges found in studies involving other large companies. Thus, Jim Woods is confident that NTC has met its financial reporting obligations by disclosing all necessary pension-related information and that assumptions used for both the income statement and balance sheet are reasonable. He cannot understand why anyone questions the company's changes since "anyone with the proper background can make appropriate analytical adjustments."

Jim Woods has also been questioned about past company purchases of its own stock. He claims that action was a finance-related decision based on the stock's then-current price and management's assessment of its intrinsic worth. He points out that anyone following the company should know enough about the industry to understand its volatility and company policy to purchase stock when management believes it is undervalued. This strategy is not new. In fact, he believes it is just good business based on investment opportunities. Thus, any benefit resulting from this strategy either in terms of earnings per share or stock price is justified since it represents sound financial management.

Mr. Woods is responsible for the company's financial reporting system, including the structure of financial reports and related disclosures. He knows that some of his decisions are influenced by concerns about analysts' ability to understand the company's operations and judge performance. Consequently, he usually consults with other members of the finance team before any significant changes are made. In recent years he has regularly held meetings with company management before implementing new accounting pronouncements (such as those involving segments) since management decision making and related information for internal purposes have a bearing on these required disclosures. Thus, Mr. Woods understands the inherent conflict between internal and external users and the growing need for outsiders to have relevant information. Likewise, he is reluctant to offer too much to potential users since strategic policy may be hampered by this knowledge. In recent months, Mr. Woods has acknowledged to some in the company his own concerns about the use of accounting policy to influence the bottom line. Although he defends the company's right to make acceptable changes, he does not want this to be a regular year-end activity.

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He believes that long-term items, such as pensions, should not necessarily be fine tuned even if the changes reflect current economic events, such as Federal Reserve policy or recent investment returns. Thus, he hopes that his informal discussions with members of the finance committee will make this the last time for a while that they embark on efforts to make pension related changes.

Financial Information

Here are the NTC condensed income statements for the 20X0-20X2 period.

	20X2	20X1	20X0
Revenues			
Hardware	29,650	28,330	29,304
Global services	25,600	23,120	20,146
Software	10,240	9,485	8,945
Financing	2,486	2,310	2,244
Other	<u>2,060</u>	<u>2,075</u>	<u>2,195</u>
Total Revenues	70,036	65,320	62,834
Costs			
Hardware	21,657	19,405	18,814
Global services	18,645	16,901	15,935
Software	1,795	1,808	2,230
Financing	1,157	1,208	1,188
Other	1,246	1,362	1,387
Total Costs	<u>44,500</u>	<u>40,684</u>	<u>39,554</u>
Gross profit	25,536	24,636	23,280
Operating expenses			
Selling, general and administrative	12,371	13,330	13,305
Research and development	4,220	4,037	3,902
Operating Income	8,945	7,269	6,073
Other Income	442	461	515
Interest Expense	561	558	562
Income Before Income Taxes	8,826	7,172	6,026
Income Taxes	<u>3,086</u>	<u>2,581</u>	<u>2,079</u>
Net Income	5,740	4,591	3,947

The above statements reflect the accounting adjustments discussed earlier. Their format highlights some of the concerns addressed by analysts when reversals for restructuring and adjustments for accounting changes necessitate a detailed review of the footnote disclosures.

The following partial information is taken from the summary and pension note included as part of NTC's financial statements.

Adoption of New Accounting Principles: (Details Omitted)

During the previous three years the company has adopted the following accounting principles:

- 1999 AICPA Statement of Position (SOP) 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.
- 1998 Financial Accounting Standards Board Statement No.131, Disclosures about Segments of an Enterprise & Related Information.
- 1998 FASB Statement No. 132, Employers Disclosures about Pension & Other Postretirement Benefits.
- 1998 FASB Statement No. 130, Reporting Comprehensive Income.
- 1998 AICPA SOP 97-2, Software Revenue Recognition.
- 1997 FASB Statement No. 128 Earnings Per Share.
- 1997 FASB Statement No. 125 Accounting for Transfers and Servicing of Financial Assets & Extinguishment of Liabilities.

Pensions

Condensed disclosures of U.S. and non-U.S. plans combined are as follows: (\$000,000)

	20X2	20X1	20X0
Service cost	829	750	610
Interest cost	2,950	2,785	2,718
Expected return on plan assets	(4,320)	(3,897)	(3,491)
Net amortization of unrecognized gains, etc.	(122)	(87)	(88)
Net pension provision	(663)	(449)	(251)

The effects on the company's results of operations and financial position from most changes in the assumptions and estimates used in calculations are mitigated by the delayed recognition provisions of FASB Statement No. 87, Employers Accounting for Pensions. The effects of settlement gains and early terminations are recognized immediately. In 20X2, the company increased the discount rate assumption by 1.25%, which resulted in an actuarial gain of \$4.001 billion. In 20X1, the company decreased the discount rate by 0.5%, which resulted in an actuarial loss of \$1.7 billion.

Weighted Average Assumptions Used In Pension Calculations

	20X2	20X1	20X0
Discount rate	7.8	6.5	7.0
Expected return on plan assets	9.5	9.5	9.5
Rate of salary progression	6.5	5.5	5.5

It is the company's practice to fund amounts for pensions sufficient to meet the minimum requirements set by accounting and tax regulations.

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A condensed summary of the benefit obligations and plan assets of combined U. S. and non-U. S. defined benefit plans for 20X2 and 20X1 is as follows: (000,000)

	20X2	20X1
Benefit obligation at end of year	44,963	46,887
Fair value of plan assets	58,741	53,508
Fair value of plan assets in excess of benefit obligations	13,778	6,621
Unrecognized net actuarial gains	9,280	2,904

What is your opinion of Jim Wood's role in the NTC reporting process? How would you handle this situation? What major issues should Mr. Woods consider?

Comments on "Accounting Issues at National Technology Corporation"

Martin S. Fridson, CFA, is Chief High Yield Strategist and Managing Director at Merrill Lynch. Mr. Fridson is author of several books on Financial Statement Analysis.

Note: Martin's comments are based on a fictitious case, any resemblance to person living or dead is coincidental.

Securities regulators can compel the accounting rulemakers to crack down further on year-to-year changes in retirement plan assumptions if they believe it would serve a useful social purpose.

Jim Woods' ambivalence is understandable. On the one hand, no company would proclaim with pride that it uses discretionary accounting decisions to make its profits appear less volatile than they truly are. On the other hand, Wood's comments about the ability of individuals with the proper background to make appropriate adjustments is valid. NTC can fairly claim to have achieved transparency, as long as it properly discloses items such as the changing actuarial assumptions in its notes to financial statements.

In the case of the pension fund adjustments, the smoothing lies in plain sight. There is no economic justification for fine-tuning the discount rate each year, but analysts can adjust the price-earnings multiple they assign to National Technology to take into account the true underlying volatility of its profits. Analysts can exact an additional valuation penalty if they believe the obvious smoothing effort reflects poorly on the company's management.

The restructuring charges are less visible. Woods is clearly rationalizing when he argues that these charges are difficult to estimate. It is just too convenient that NTC can move the restructuring costs up and down as necessary to maintain its gross profit growth in the face of declining margins in its largest business. If the item is immaterial, as Woods also claims, why bother to adjust it?

As for National Technology's segment reporting, one cannot be too critical because Woods has accommodated operating management's desire to limit disclosure. Over the years, corporate issuers have lobbied successfully against detailed product-line reporting that would genuinely enable outside analysts to understand and forecast earnings. Without stronger support from the accounting

rulemakers, Woods can push only so hard for NTC to be more forthcoming than its competitors. He could resign on principle, but doing so would not lead to more transparent segment reporting at NTC.

A final issue is the impact of earnings smoothing on unsophisticated users of financial statements. Small investors may take the company's reported income at face value, oblivious to the impact of discretionary accounting decisions that are fully disclosed. When earnings per share rise in response to dubious stock buybacks and changes in actuarial assumptions, small investors may bid up NTC's stock. They will thereby expose themselves to losses when management takes subsequent actions to reduce unusually large profits that it wishes to smooth downward.

Like segment reporting, this is an issue that can only be dealt with—if, indeed, it needs to be dealt with—on a broader front than NTC's accounting decisions. Securities regulators can compel the accounting rulemakers to crack down further on year-to-year changes in retirement plan assumptions if they believe it would serve a useful social purpose. At the same time, one can ask how far the financial reporting requirements should be tightened to protect unsophisticated users. After all, these individuals have the option of hiring professional money managers (by investing in mutual funds) instead of attempting to pick stocks on their own. In any event, Woods can have a clear conscience regarding actuarial assumptions and stock buybacks, as long as NTC enables professional analysts to discern the impact of these actions on its earnings.

Paul Munter, Ph.D., CPA, is KPMGPeat Marwick Professor of Accounting, University of Miami.

He is editor-in-chief of *The Journal of Corporate Accounting & Finance* and the author of "Progress on Impairments and Business Combinations", *The Journal of Corporate Accounting & Finance*, November/December 2000.

The company's financial reporting group is charged with meeting the statutory requirements as well as some aspects of investor relations—that is, responding to investors' information needs.

Mr. Woods finds himself in the same position as many controllers and directors of financial reporting: defending the company's accounting practices when questions arise. Indeed, Mr. Woods notes that there is an inherent conflict between the information needs of internal management and those of external parties. This is a conflict that financial reporting personnel face on a regular basis. Often upper management is reluctant to provide more than the absolute minimum amount of information to the external constituents (and even then sometimes only grudgingly so). Yet the company's financial reporting group is charged with meeting the statutory requirements as well as some aspects of investor relations—that is, responding to investors' information needs.

More and more frequently today, external parties focus not just on the company's earnings and/or earnings trend, but also on the quality of the company's earnings. Unfortunately, it is difficult to quantify the concept of earnings quality, but, fundamentally, it relates to the company's willingness to be open and frank with its investors as well as the sustainability of its earnings.

National Technology Corporation is running a serious risk of having investors question its earnings quality because of its reluctance to clearly show the impact of certain assumptions and revisions in

those assumptions. For example, the company reports the adoption of several new accounting pronouncements in the past three years, including Statement of Position No. 98-1 and 97-2 and Financial Accounting Standards Board Statement Nos. 131, 132, 130, 128 and 125. While some deal only with presentation and disclosure (FASB Statement Nos. 128, 130, 131 and 132), with a technology company an external party would be justified in asking about the effect of adopting SOP No. 98-1 (on the capitalization of computer software development costs) and SOP No. 97-2 (on the recognition of revenues from sales of software). That information is not given in the company's disclosures.

Additionally, there are implications for the company's financial reporting from changes in the discount rate assumption related to the defined benefit pension plans and with respect to the restructuring reserve. An external party does not know what line in the income statement includes these expenses or how much the expenses are affected by the adjustments—another failure to openly disclose information to the investors. This question is extremely interesting because the company has made significant adjustments to its pension discount rate assumption (from 7% down to 6.5% and back up to 7.75%). This has resulted in a \$5.7 billion change in the obligation from 20X1 to 20X2 (a gain of \$4 billion in 20X2 compared with a loss of \$1.7 billion in 20X1), yet little information is provided about the impact on current and future earnings.

Even more distressing is Mr. Woods' attitude. For example, he says that he cannot understand why anyone questions the company's changes since "anyone with a proper background can make appropriate analytical adjustments." While this may or may not be true (given the sparsity of the company's disclosures and the fact that changes in pension plan assumptions do not have a linear effect on company's earnings), the point is that investors shouldn't have to make the adjustments. The company's financial reporting should clearly provide the information. Additionally, Mr. Woods argues that the change in the discount rate is appropriate in light of the pension plan earnings. This displays a lack of knowledge about the discount rate computation. The discount rate relates to the pension plan obligation, not to the return on the pension plan assets.

The effect of the changes in assumptions on the pension plan has gotten to the point where the unrecognized amount is significant. From 20X1 to 20X2, the unrecognized amount increased by \$6.376 billion to \$9.28 billion. The unrecognized amount now represents 20.6% of the pension obligation and 67.3% of the net pension assets at year-end, compared with 6.1% and 43.9%, respectively, at the end of 20X1.

I believe that Mr. Woods and, in the long run, NTC would be better served by openly disclosing the impact of the changes in the assumptions (related to both the pension plan and the restructuring) and by clearly indicating where in the income statement these amounts are reported. Anything less could dilute investor confidence, which will ultimately lead to an increase in the company's cost of capital and a resulting reduction in long-term profitability.

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Jim Woods is right to think that the analysts will be suspicious of frequent changes in assumptions... to satisfy various earnings expectations.

Jim Woods is right on to be worried; in fact, he needs to be. But he should be confident that he has done the right thing and provided the correct advice to the finance committee, based on where the committee seems to be heading.

First, the market is fickle, and so are many analysts. Times change quickly and what seemed like a very reasonable long-term assumption a year ago may not seem so today. Only a couple of years ago, for example, the markets thought nothing of expecting stock price returns year-over-year in excess of 20%. They accepted companies with multiple-billion-dollar valuations and almost no earnings. Today, many find it hard to believe that previous market behavior. What's interesting, of course, is that no matter what happens for the next few years, circumstances will change again and these "corrected" markets will look out of place themselves. And analysts, including those who defended the markets of last year (and now are defending themselves), will once again look prescient.

There is no doubt also that analysts and other interested parties would prefer not to have to delve into financial statement footnotes in order to understand a company. Programs that analyze companies and look for outliers don't do that well when they have to read the footnotes and figure out what's really going on. Maybe that will be standard in a few years, but for now one strong reason to have financial statements with generally accepted means of presenting high-level information is so that users can make reasonable use of that information without having to search through the backup and do their own analysis (although that is what we would expect from someone making a substantial income as an analyst).

So what is Mr. Woods to do? He has every right to assume that even the most basic long-term assumptions well may change from year to year. And it is best to continue to adjust them and approximate them as well as one can as they change. If a company waits until outsiders believe they have changed materially from where they should have been, then it leaves itself open to lawsuits, investigations and claims of non-compliance.

On the other hand, there is the great potential for manipulation and "earnings management" when management conveniently makes some "appropriate" adjustments to assumptions to allow the company to enhance what it reports. Simply observing that those who want to second guess the company can get the information in the footnotes and figure it out for themselves ("anyone with the proper background can make appropriate analytical adjustments") is not a sufficient answer, even if it might insulate the company from certain forms of liability.

The bottom line is that Woods needs to do the right thing. The right thing here is to continue to make adjustments as needed, when there is a perception based on experience, observable data and other indicia that a change in base assumptions is necessary. It is not to second guess what changes management might like to see, or to allow the company's desire to meet certain earnings targets influence his decisions on the right assumptions or how best to change them.

He is also right that the analysts will be suspicious of frequent changes—especially changes that are always in the direction that one might expect management would advocate to satisfy various

earnings expectations. Were that to occur his credibility would quickly be lost. If his actions were found to be unjustified, his commitment to complying with legal requirements might be called into question, as well. But he cannot let that paralyze his judgment or lead him to postpone necessary changes.

This case study demonstrates that as long as we have a system that puts tremendous weight on a few top-line numbers there will always be the temptation to “manage” those numbers and some suspicion that such management is occurring even when it is not. If we move more towards a system that relies on presenting the raw numbers and data to users in a fashion that allows for easy use and analysis (as described in an article written by the author³ and as part of the AICPA’s mission in its XBRML initiative), some of these problems will disappear. At that time, Jim Wood’s will be correct to observe that since users have the information they can make changes as they want. But that day is still some time away, and so the hard decisions and work still sit squarely on the shoulders of good financial officers like Jim Woods.

³ “The Future of Accounting and Financial Reporting, Part IV: Access Accounting,” *Accounting Horizons* (June, 1997), Vol. 11, No. 2

IS IT OKAY TO BUY EARNINGS?

By Lorri Carpenter, CPA

Had Jed enjoyed making the deals so much he'd led himself to believe they were good for Rising Star, when in fact he was damaging the long-term prospects of the company he'd founded?

Abstract

Rising Star, an online discount retailer, has achieved success in a competitive market. To sustain that success, the company has made a series of strategic acquisitions. Now chief executive officer Jed Parker is faced with the possibility of accounting problems surrounding some of these deals—and the value of the deals themselves is even being called into question. Examine the facts presented for Rising Star and determine the course of action you believe Mr. Parker should follow.

Background

Jed Parker, CEO of Rising Star, Inc., wished Quinn Walker would just go away, and take his “bean counter” problem with him. The thought raised a twinge of guilt. Despite his irritation, he knew Quinn was simply doing his job.

As chief financial officer of Rising Star, the online discount retail company Jed had founded 14 years earlier, Quinn had always been zealous in his oversight of finance, strategic planning and mergers and acquisitions. Jed was sure part of Rising Star's success was due to Quinn's deft handling of everything from analysts to write-offs.

He was equally sure that his own contribution to the success of Rising Star was that he had the vision needed to take the company into the future. He loved making deals, not getting bogged down in the details. And a merger between Rising Star and RGL, Inc., one of the biggest name-brand franchisers in the country, was the deal of all deals. Or it would be, if he could concentrate on pulling it all together, instead of being distracted by accounting issues.

But he'd promised Quinn half an hour of his time, and he was a man of his word. More than slightly impatient, but still a man of his word. He stifled his annoyance and tuned back in to the conversation.

“Rennie Conway may be the greatest thing since broadband Internet access,” Quinn was saying. “But I don't think she has the strategic insight we need in a board member. She's too obsessed with the details.”

Jed steepled his fingers. Lauren ‘Rennie’ Conway was the newest member of Rising Star's audit committee. A retired CPA and the wife of a noted philanthropist, she'd brought to the position her experience from a long career in public accounting. Jed had thought her expertise would mesh well with Quinn's, but the two of them had clashed from day one. After three months, Jed was tired of trying to mediate their arguments.

“Seems like you’re not giving her a chance, Quinn,” he said, eyeing his CFO. “Rennie’s probably still trying to get a handle on everything.”

Quinn shook his head. “All she’s trying to do is drive me crazy. She’s going over past financials with a fine-tooth comb, examining every item and questioning me over nickel-and-dime issues. In a multi-billion dollar industry like ours, that’s no way for a board member to act. She may know accounting, but she has no business sense.”

Jed thought Quinn’s complaints sounded exactly the same as they had the last two times Quinn had come to him grumbling about Lauren Conway.

Instead of voicing that opinion, he said, “I don’t like personality conflicts between my board and my executives, Quinn. They tend to get aired publicly. And Arnie tells me that Rennie’s appointment to the board was looked on very favorably by Wall Street.” He paused, thinking about the conversation he’d had with Arnold Hall, one of six analysts who followed Rising Star stock. “You know how I feel about that, Quinn. I expect you to keep the analysts happy.”

“They’ve been happy,” Quinn protested. “Rising Star has met or exceeded earnings expectations every quarter. That’s why I’m so concerned now. Rennie Conway is talking about lowering our expectations for next quarter.”

“She wants to do what?!” Startled out of his impatience, Jed stared at Quinn.

His CFO nodded. “Yep. That’s what she said. I told her we couldn’t do anything that gets Wall Street concerned. And missing an estimate would sure do that. We upset the analysts, and the stock price goes down, reducing our market cap. That’ll trigger more selling, making the stock price go down again. And on and on. You get the picture. The overall effect is that we lose our ability to get financing to pursue merger opportunities.” Quinn paused. “But Rennie’s going to be hardheaded about this, Jed. She thinks we need to hold off on any more mergers until we make sure we haven’t made any mistakes in the way we’ve handled the ones we’ve already completed.”

“What’s wrong with the way we’ve handled them?” Jed wanted to know.

“That’s what I asked her,” Quinn replied. “We follow accounting rules. Our auditors have never had any complaints. But Rennie says that we’re manipulating earnings, because most of the growth in Rising Star’s earnings has been generated by the acquisitions. You know we’ve been growing faster than the industry average, Jed. Well, Rennie thinks that in order to keep up the current growth rate, we’ll have to take on more and more acquisitions, and that kind of strategy will lead to too much risk. In fact, she thinks Rising Star is at risk already—that we’ve paid too much for some of the companies we bought, and we can’t possibly deliver value to our shareholders.”

“What do you think she’s basing that on, Quinn?”

“Probably the last merger,” Quinn said, without hesitation. “Our post-integration efforts have fallen a bit behind our original plan. It’s taken longer to combine our product lines and merge the

administrative systems than I expected. But the window of opportunity to obtain those synergies hasn't closed yet. I'm confident that acquisition can still deliver value."

"Does Arnie think we can still meet the target we set?" Jed asked.

"He does," Quinn said. "But Rennie's obsessed with this. I'm warning you, Jed, she's going to cause us problems."

"That's not what I want to hear, Quinn. This is a critical time for Rising Star. We're growing, and mergers are our best option to stay with that trend. Our future looks way too bright for petty problems to jeopardize my plans. You and Rennie Conway are just going to have to work this out."

"Well, I'm trying." Quinn's tone was stiff. "But I'm telling you, Jed, she acts like she thinks I've been negligent in my handling of the books."

"Really?" Jed steepled his fingers and looked at his CFO. "Did she mention anything specific?"

"Well, no," Quinn admitted. "I guess maybe I'm just a bit paranoid because it's been difficult to keep our internal controls in place with the growth we've been experiencing."

Jed grinned. "You, paranoid? Never! But I'm sure that Rennie doesn't think you've been negligent. After all, I made it clear when she joined the board that I trusted you completely. She's probably just trying to understand everything we've done lately. As you say, with all the acquisitions, it's gotten a bit confusing."

"True," Quinn admitted again. "But the new management information system should take care of that, once we get the final bugs worked out. I expect it to be completely on line within the next week or two."

Jed nodded. "More than likely, this whole thing is a misunderstanding. There's never been a question about our earnings and the way they're growing." He glanced at his watch. "Sorry to rush you, Quinn, but I have a lunch appointment with Reilly Lippert."

Immediately interested, Quinn leaned forward. "You working on the merger with RGL?"

"Not officially," Jed replied with a grin. "But you know my motto."

"Yeah, I know." Quinn chuckled. "I know, because it's my motto, too. A merger a year keeps Rising Star a rising star."

It wasn't just a motto, Jed thought as he headed for the restaurant and his meeting with Reilly Lippert. It was the truth.

His vision had always been to bring together technology and retailing. He'd finally hit upon the idea of becoming the online middleman between manufacturers and consumers. At the Rising Star Web site, people could sign up and pay a fee for access to discounted merchandise. By charging

membership fees instead of making a profit on product mark-ups, Rising Star was able to keep prices low enough to be competitive with more traditional discount stores. Not having to build warehouses or buy expensive real estate had allowed him to put money where it counted—in computer systems and a Web site that delivered what was promised.

The concept had taken off beyond his wildest dreams. Customers loved the convenience of at-home shopping when it was safe, reliable and inexpensive, and Rising Star had become profitable early on. The company had gone public when it reached the milestone of more than a million items for sale on its Web site.

But growth had slowed a bit after that, and Jed began acquiring other companies in an effort to offer more products so Rising Star could continue to show increasing earnings. Now he was convinced that to keep Rising Star on the cutting edge, he needed to add brand name merchandise and services to the mix. He wanted Rising Star to expand into a more up-scale market.

RGL, Inc. was the perfect solution. The company owned nationally known rental car, hotel and real estate franchises. Jed believed a merger with RGL would position Rising Star to challenge—and overtake—large, established traditional retailing companies.

The thought had him smiling to himself as he walked into the restaurant. Not that he needed the money another expansion would bring. His stock in Rising Star had made him a millionaire several times over. No, he wasn't smiling over making more money. He was smiling because his vision of an ever-brighter future for Rising Star was finally turning into reality.

The Problem

He found himself smiling again as he strode into Rising Star's corporate headquarters two hours later. He and Reilly Lippert had done a bit of verbal fencing, but Jed had come away from the meeting with a sense of accomplishment. Reilly was definitely interested. They'd both decided to approach members of their respective boards. Even though Jed felt the asking price was high, he believed the scale economies and increased market power made it worthwhile. He was ready to make the next move. He'd had the steps planned for weeks.

He was so lost in thought as he entered his office that he nearly jumped when Lauren Conway said, "I'm glad you're back. I need to talk to you."

"About what, Rennie?" Jed settled warily into his chair, his euphoria vanishing. "Accounting stuff?"

She returned his look without a trace of humor. "You might say so. Specifically, about mergers, and how I think Rising Star is letting earnings-report considerations drive its timing."

He'd already heard enough. He said, "Then you really need to talk to Quinn."

"Oh, no," she said firmly. "Quinn and I don't talk, we argue. He's very territorial and extremely defensive."

“He has a right to feel that way.” Jed felt obligated to defend Quinn, though he knew she was right. “He helped Rising Star grow from next to nothing to where it is today.”

“That may be,” Rennie said. “But I’m not entirely comfortable with some of the accounting decisions that have brought us to this point. For example, I think we’ve been overly generous with our estimates of merger reserves.”

Jed frowned at her, remembering what Quinn had told him earlier about Rennie’s suspicions. “What exactly are you saying, Rennie? Do you think there’s something wrong with the way Quinn’s been handling the books?”

Rennie shook her head. “Not at all. Quinn is very good at his job. But, I know accounting, Jed, and the way Rising Star has been buying earnings with these acquisitions bothers me.” She held up a hand when he would have interrupted. “Hear me out, please. I understand earnings management. I even admit that many of the companies Rising Star bought in earlier years have been profitable because they bring in more income than it costs to finance the purchase. But I’ve analyzed the numbers, Jed. Lately our returns on those assets have been slipping. The problem is that every time Rising Star makes another acquisition, we’ve had to pay a higher premium. The cycle is never-ending. Higher costs lead to lower earnings, which means more acquisitions in order to keep up with expectations. And because all that’s left to buy are marginal companies, some of those acquisitions aren’t necessarily good business deals. They’re just means of increasing earnings to meet analyst’s expectations. Which I do admit we’ve done.”

She leaned forward. “I know you’re having merger talks with RGL, Jed. But I think we should concentrate on growing our core business to meet expectations. Instead, we’re financing our future with earnings that will cost more than the value they bring. Shareholders expect—and I think, deserve—solid earnings growth, not smoke and mirrors. I believe Rising Star should have a financial discipline we can all be proud of.”

She stood. “Please think it over before you decide to take the talks with RGL any further.”

The Dilemma

As the door swung gently closed behind Rennie, Jed thought about what she’d said. It was true that the cost of purchasing companies had grown. He suspected it might also be true that Rising Star had overpaid for a few of the companies they’d acquired. But he had agreed with Quinn that meeting growth and earnings expectations was important. And he’d always felt he was making good deals.

Comments on “Is it Okay to Buy Earnings?”

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Dan’s practice is limited to consulting services, including litigation involving accountant’s malpractice issues. His most recent book is *Audit Committees: A Guide for Directors, Management, and Consultants* (Aspen Law & Business).

There is nothing inherently wrong in aggressively making mergers and acquisitions (that is, buying earnings via acquisitions).

Rennie Conway, as a director of Rising Star, Inc., and a member of its audit committee, has a legitimate concern about certain risks and whether they are being properly controlled and managed. There is nothing inherently wrong in aggressively making mergers and acquisitions (that is, buying earnings via acquisitions). However, when companies engage in such activities, there is an increase in business, information systems and financial statement risk. In fact, if such risks are not identified and controlled, the risk associated with earnings management and financial statement manipulation (that is, cooking the books) significantly increases. Therefore, a vigilant audit committee member should ask penetrating and probing questions about whether those risks have been identified, whether appropriate controls have been implemented and if those controls are working effectively. These questions should be presented to and discussed with chief financial officer Quinn Walker, the chief executive officer and other members of the management team, the internal auditors and the external auditors.

A business combination usually requires the establishment of an accounting estimate for restructuring charges (that is, a merger reserve). Merger reserves cover one-time, merger-related costs, such as legal and other professional fees, anticipated losses on asset impairment and disposals, and expenses to integrate, consolidate, relocate and eliminate redundant operations, including provisions for employee termination. In purchase accounting, the debit is usually made to “goodwill” and a credit is made to a balance sheet liability account to establish a merger reserve.

Of course, the merger reserve is a complex accounting estimate and actual costs will probably differ from estimates. In purchase accounting, after one year, any change in the merger reserve should be reflected in the company’s income statement. Any material modifications to previously established merger reserves should be disclosed in the financial statement footnotes. In no case should merger reserves be manipulated to enable a company to meet Wall Street earnings projections.

One of Rennie’s apparent concerns is that past merger reserves have been high, perhaps even overstated. Therefore, she naturally would want an accurate accounting to write down any excessive reserves, including a restatement of past financial statements if misstatements were made when the merger reserves were established. She would want assurances from management and the auditors that under no circumstances were the excessive charges simply taken into income to bolster income to meet forecasts. Furthermore, she would want to make sure that management has implemented appropriate controls to prevent future mistakes in estimating merger reserves.

Consequently, Rennie has a valid concern that Rising Star should address. The company should analyze the merger reserves created in prior years to determine if they were properly established, used and adjusted. Based on that analysis, new or improved controls should be implemented to minimize the risks that could cause financial statement misstatements due to fraud or error. In the meantime, the board of directors should address her concern about overpaying for acquisitions and use the opportunity to examine the company’s acquisition strategy.

As Quinn and Jed Parker mull over Rennie’s concerns, they should be mindful of their primary responsibility for the fairness of Rising Star’s financial statements. In other words, it is imperative

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that they believe to the best of their knowledge that the financial statements are fairly presented in accordance with generally accepted accounting principles. This responsibility is evidenced by the fact that both Parker and Quinn will have to sign a management representation letter, which is addressed to the external auditor, as required by generally accepted auditing standards. The management representation letter explicitly states that Parker and Quinn believe the financial statements are fairly presented in accordance with GAAP. Moreover, the letter explicitly states that they believe that significant estimates (for example, merger reserves) have been properly recorded and disclosed in the financial statements.

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Author's note: The commentary below represents my own personal views and observations.

I believe that the capacity to integrate acquisitions diminishes as the number of acquisitions increases and diminishes exponentially as the span of time condenses.

This story is fairly typical of the high-tech, Internet market during the end of the 1990s and into 2000. Investors seemed to shower start-up companies with capital to fund the visions of entrepreneurs who were truly pioneering the electronic information era. The voracious appetite for capital at companies such as Rising Star led management to promise investors what they wanted to hear—revenue and earnings growth. For a while it seemed that other fundamentals, such as return on investment and payback period, were no longer interesting or requirements for garnering capital.

Someone once described this period as a type of “Western land grab,” reminiscent of the days where more land—regardless of quality—was considered essential. Doing deals, and “growing” by acquisition, was standard operating procedure. Since the capital was flowing in the front door, those making the deals believed they could pay a premium just to beat the other bidders. These deals were also typically based on multiples of revenue growth, and ignored profitability and cash flow. Once the capital flow stopped, many of these companies found themselves highly leveraged and still burning cash.

Lauren Conway offers sound advice to the chief executive officer. Solid earnings growth is critical to increasing shareholder value. Too many acquisitions in a relatively short time can cause tremendous downward pressure on earnings growth. I believe that the capacity to integrate acquisitions diminishes as the number of acquisitions increases and diminishes exponentially as the span of time condenses.

If companies buy earnings to avoid disappointing analysts, they are not avoiding the disappointment but merely postponing it.

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Jed Parker should proceed, as planned, with negotiations to acquire RGL. He should, however, be establishing acquisition criteria, which should be reviewed with his board.

These criteria, which should not be inviolate if an acquisition is a strategic imperative, would establish board-approved financial objectives that an acquisition should meet. They should address questions such as:

- How much earnings-per-share dilution is the company willing to incur, if any, in the first and second year?
- What is the company's leverage target, and what is the maximum leverage that the company is willing to incur? This leverage target should be both balance-sheet and earnings-coverage oriented, and should be designed to protect a minimum debt rating.
- What is the company's minimum goal for return on invested capital on capital projects, including acquisitions? How quickly must this goal be achieved?

In addition, Jed needs to educate his board about how analysts view the company's earnings prospects. For example, what are Wall Street's expectations for organic growth and margins? Do analyst projections include or exclude future unspecified acquisitions? If they include them (a highly unlikely prospect because the timing of acquisitions is unpredictable), Rennie Conway is overreacting that somehow the company is "buying earnings" to meet expectations. If, on the other hand, analyst expectations do not include future acquisitions, Rennie is still probably overreacting because their models will be adjusted once the terms of a merger are announced.

Jed needs to follow up with the company's outside auditors to determine whether they believe his chief financial officer has been overly aggressive in establishing so-called "merger reserves." Further he needs to ask if there has been any inappropriate use of such reserves. He should adopt a strict policy with respect to such items.

Finally, he needs to have a private meeting with Rennie Conway to review all of the above issues. If she has concerns, they should be discussed at a future board meeting.

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Jed Parker and Quinn Walker are allowing their desire to achieve a set goal—to meet or exceed financial analysts' earnings expectations—to influence their decisions.

Executive Summary

Jed Parker and Quinn Walker are allowing their desire to achieve a set goal—to meet or exceed financial analysts' earnings expectations—to influence the decision on whether continued mergers and acquisitions are in the best interests of the company and its stakeholders. Rennie Conway, a member of the audit committee, attempts to slow down the process by pointing out to Parker, the chief executive officer of Rising Star, Inc., that the company is managing earnings. She worries that the cost to acquire a company is increasing and future earnings are in jeopardy. The result may be to acquire more and more companies just to keep up with analysts' estimates of future earnings.

Parker suggests that Conway should back away from current discussions with RGL on a merger and “should concentrate on growing our core business to meet expectations.”

Stakeholders and Interests

The main stakeholders include the shareholders, financial analysts, Jed Parker and Quinn Walker and the company. The shareholders are of primary importance since they provide the funds that enable the company to continue its merger activity. Moreover, the value of their stock investment is at risk because future share prices may decline if the return on acquired assets continues to drop and the cost of taking over other companies continues to rise. The shareholders' best interests are not served by artificially increasing profits through designed merger and acquisition activity that masks true operating results.

Ethical Concerns

Jed Parker and Quinn Walker are in a difficult position. On the one hand, they believe that their responsibilities to the stockholders include meeting or exceeding earnings estimates, thereby satisfying the financial analysts and keeping stock prices high. On the other hand, they are aware of the increasing problem of maintaining efficient internal controls and reliable management information systems while expanding their operations.

Parker seems to be genuinely concerned when Conway says that the best interests of the shareholders are not served by jeopardizing the quality of earnings.

The stockholders' right to receive accurate and reliable financial information that portrays the true operating results of Rising Star is at risk. The company's reliance on mergers to create earnings to meet analysts' forecasts brings into question the predictability of future earnings, since the number of sound acquisition candidates is diminishing. The company appears to be caught up in a spiraling cycle of acquiring other companies to keep earnings levels high even though there may not be a sound business reason for such actions.

The company should honor the audit committee's rights to be involved in the advisory process on mergers and acquisitions. When Conway approaches Parker on her own, she fails to recognize the important financial reporting oversight role of the entire committee.

Alternatives

Parker has a variety of alternative courses of action. He can continue merger discussions with RGL, back away from additional acquisitions until the company's internal systems can be strengthened or bring the issue to the audit committee. As CEO, he has an ethical obligation to the stockholders to

exercise due care in carrying out his responsibilities. The stockholders place their trust in top management to make decisions that are in the company's best interests. Conway has exercised due diligence as a member of the audit committee in questioning the company's continued merger activity. The best alternative is to hold off on future acquisitions until the entire audit committee can discuss the effects on current and future earnings and the company can upgrade its internal controls and management information system.

A TROUBLED ACQUISITION FOR WEBSAVE

By a Fortune 100 Executive

Carmenez, VP Mergers and Acquisitions, is concerned about the board's reaction to merger results. What advice should CFO McGuire offer on the accounting for an acquisition that has not met her company's expectations?

Abstract

Chief financial officer Shirley McGuire must offer advice on the accounting for an acquisition that has not met her company's expectations. Evaluate each of the accounting options to improve the results of IVI and the accounting justifications for the positions taken. What hurdles would Websave face in attempting to apply pooling accounting to this transaction?

Background

It was December 15, 2000, at 10:00 p.m., and Max Carmenez, vice-president of mergers and acquisitions, and Shirley McGuire, chief financial officer, were preparing for a meeting with the board of directors of Websave the next morning. Carmenez was the driving force behind Websave's purchase of IVI Systems on January 30, 2000. IVI had created a new Internet browser package that offered commercial and consumer users a much more efficient and powerful search capability. Carmenez believed that there were innumerable potential operating synergies between IVI's product that could produce over \$100 million in incremental revenues from Websaves' existing customer base each year. More important, Carmenez saw significant cross-selling opportunities with IVI that could provide an immediate expansion to Websave's customer base. With McGuire's help, Carmenez had been successful in creating great excitement about this opportunity among Websave senior management and the board of directors. Amid competitive bidding, Websave ended up paying a whopping \$1.5 billion for the company, a \$500 million premium to the book value of IVI assets on the date of close.

Unfortunately for Websave, three of IVI's key engineers left the company shortly after the acquisition, leaving the company struggling to update software needed to introduce new products and to meet existing customers' specific needs. IVI sales had slowed, costs were up and Websave was staring at a \$25 million loss from operations on this business for the 11 months ended December 31, 2000. As champion of the deal, Carmenez was concerned about the board's reaction to IVI's results and the impact that this might have on his ability to gain approval for future acquisitions. For her part, McGuire had reviewed and approved the pro forma projections of the acquisition, which the Websave board relied on to approve the deal. The \$25 million loss now expected was a long way from the original planned income of \$30 million for this same period. McGuire was even more concerned about the potential impact these results would have on Websave's debt ratings once the rating agencies saw them.

McGuire explained that the accounting rules allowed up to 12 months after an acquisition is completed to "fine tune" the purchase accounting and related adjustments for the deal. She thought

that there might be room to improve the results using some “creative accounting.” She put together an agenda for Carmenez to discuss the following items related to the IVI purchase:

I. Goodwill Allocation Period

A 10-year amortization period was selected when the IVI acquisition was presented to the Websave board for investment approval. Although Accounting Principles Board Opinion No. 17 allows for an amortization of up to 40 years, 10 years was considered appropriate for the following reasons:

- The relatively short life of Websave’s technology in the quickly changing high tech area.
- Websave’s historical conservatism with respect to acquisition accounting. McGuire was concerned about a significant buildup of goodwill on the balance sheet.
- The potential impact of large goodwill balances on company reviews by Moody’s, Standard & Poor’s and other rating agencies.

Despite all of this, Carmenez and McGuire realized that an extension of the goodwill period could provide immediate earnings improvement for Websave. Based on the total recorded goodwill of \$513.8 million, even a five-year increase to the goodwill amortization period would produce incremental pretax earnings of \$17.1 million per year and \$10.3 million after tax.⁴ McGuire explained that such an adjustment was still allowed because the one-year purchase accounting remained open; however, they would need a sound basis to support this longer amortization period.

II. Discontinued Operations

As part of their due diligence, McGuire and Carmenez had contemplated closing IVI’s commercial browser department (CBD) due to overlap with existing operations. After several key engineers left the business, Websave did in fact shut down CBD operations, resulting in a \$1 million loss, detailed in exhibit one:

Exhibit One – Discontinued Operations

Category	(millions)
Assets of CBD written off	\$0.50
Severance to employees	\$0.20
Patents/trademarks	\$0.10
Facilities closure	\$0.10
Miscellaneous	\$0.10
Total write-off	\$1.00

4

Calculated as \$513.8/10 =	\$51.40
Less: \$513.8/15 =	\$34.30
Pre tax =	\$17.10
Taxes at 40%	\$6.80
Net after tax	\$10.30

McGuire explained that the accounting rules were somewhat gray in this area. She was not sure whether the charge should be treated as 1) a current-year loss on the income statement or 2) a capitalized charge added to goodwill to be amortized over the goodwill life.

III. Covenant Not to Compete

There were significant negotiations surrounding the question of whether IVI engineers could compete should they quit Websave after the acquisition. In the end, all IVI engineers agreed to a 10-year non-compete agreement. However, any engineer could terminate this agreement at five years at a cost of \$50,000 per engineer. Due to the huge technology benefits IVI brought to Websave, McGuire had ascribed significant value (\$3.75 million) to these non-compete agreements. McGuire and Carmenez were now considering the correct period over which to amortize these costs. Should they be amortized into expense over (1) the five-year guaranteed term of the agreement, (2) the longer potential 10-year term or (3) the amortization period for goodwill?

IV. Research and Development Costs

As an Internet development company, IVI was required to invest large sums of money to maintain its product and develop applications for new markets. The majority of these expenses (95%) related to the wages, benefits, travel and other costs of IVI engineers who developed these product enhancements. Before the acquisition, IVI had capitalized these expenses and amortized the related costs over the estimated useful life of the product developed. The expenses averaged \$10 million annually and were amortized over five years, resulting in a \$25 million research and development asset on IVI's balance sheet at the time of acquisition.

Gene Bis, Websave's controller, questioned IVI's accounting treatment for R&D expenses at the time of acquisition. As a public company, Websave's approach was that its accounting policies should be held to a higher standard, which included regulations promulgated by the Securities and Exchange Commission. Websave had consistently expensed all internally generated R&D costs as opposed to building an asset and deferring the related costs. This presented two questions for the acquisition accounting team that had been debated throughout the year and still had not been resolved by year-end:

1. *How should the \$25 million R&D asset on the closing date balance sheet for IVI be handled?*

One option would be simply to carry over the \$25 million asset on Websave's balance sheet and amortize the remaining balance over five years. A second would be to write off this asset in purchase accounting and increase goodwill by \$25 million. Carmenez preferred this option because it would result in a 10-year amortization period (in accordance with the 10-year goodwill life) versus the faster five-year period adopted by IVI.

2. *Should IVI's prospective R&D expenses continue to be capitalized or should they be expensed as incurred?*

Carmenez did not understand why this was even being debated. "Why should we change the way that these expenses were historically handled by IVI? If it was good enough for them, it should be good enough for us. When we modeled this acquisition, we assumed that these expenses would continue to be capitalized. If we now decide to expense them, we will never get this

business back to the pro forma projections presented to the board!” However, Bis argued that, as a public company, Websave was required to expense these costs. In addition, he did not see how Websave could have a wholly owned subsidiary (IVI) that had different accounting policies for R&D expenses from the parent company.

McGuire still had not made a decision on this point. However, she realized that there would be a significant increase to income from operations in the current year if she sided with Carmenez.

V. Purchase vs. Pooling Accounting

At the time of acquisition, Carmenez and McGuire did not think much about a possible pooling of interests. They had heard that the Financial Accounting Standards Board was planning to discontinue pooling of interests accounting effective December 31, 2000, and did not feel it was an option. Carmenez had some questions for McGuire, however, because a recent Wall Street Journal article indicated that perhaps pooling was not going away, certainly not by the end of 2000.

Carmenez was not an expert on pooling accounting because Websave had always accounted for acquisitions under a purchase accounting method. However, he remembered that pooling provided for a combination of businesses at their historical costs. In effect, the balance sheets of the two “merged” entities would be combined at the book values immediately before the acquisition. This avoided a fair market valuation of the balance sheet and recognition of a goodwill asset. The immediate benefit was that there was no charge to current period earnings for the amortization of the recorded goodwill. Given the large goodwill balance in the IVI deal, Carmenez felt that this could be a huge potential improvement to IVI’s operating results.

McGuire was much more skeptical about applying pooling of interests in this case. She realized that although the FASB still allowed pooling, there were substantial hurdles to get over to allow its application. Among other things, the acquiring entity had to prove that:

- The transaction was a “merger of equals” rather than one firm acquiring another. The deal must be accomplished by an exchange of stock between the two parties.
- There were no changes in the equity interests of the voting common stock of either company for two years before the acquisition.
- At the date of combination, each company was independent of each other.

McGuire was also concerned because Websave had entered into a \$10 million stock buyback program on January 1. She was not sure, but she thought that this program might limit Websave’s ability to apply pooling accounting. Carmenez understood all of these hurdles, but he was still pushing the idea. This decision would significantly affect the results of the IVI acquisition for the year.

Exhibit Two IVI Acquisition

Goodwill Reconciliation	(millions)
Cash paid	1,520.0
Asset book value at close	<u>1,010.0</u>
Total premium	510.0
Adjustments to Goodwill	
Asset FMV adjustment(1)	-1.0
Covenant not to compete (2)	3.8
Increase bad debt allowance (3)	<u>1.0</u>
Total goodwill	513.8
Goodwill amortization period	10 years
Pretax amortization per year	51.4
<i>Open: Capitalized R&D Costs (4)</i>	<i>25.0</i>

1. To adjust the historical cost of IVI assets to FMV at the date of close.
2. To establish a separate asset for the purchase price related to IVI's covenant not to compete for software engineers.
3. To adjust IVI's bad debt reserve to cover anticipated exposures.
4. Item remained open at December 15, 2000. Websave was still discussing how to treat this asset in purchase accounting.

How should Shirley McGuire handle the current situation? Are any changes from the original estimates necessary? What criteria or considerations should be used in making this determination?

Comments on "A Troubled Acquisition for Websave"

Paul Bialek, CPA, is Chief Financial Officer and Senior Vice President, Finance and Operations of RealNetworks, Inc.

RealNetworks is a provider of media delivery and digital distributions solutions designs for the internet.

To say the financial objectives were met—because the goodwill amortization period changed relative to the original assumption—is clearly misleading.

There are a variety of macro observations to be made at the outset of this case study.

1. The financial accounting rules for the purchase or pooling methods of accounting for business combinations are not elective. The transaction is evaluated based on its unique substance and form. This evaluation of the facts will determine which accounting method is to be used. Many companies prefer to account for transactions using the pooling-of-interests method. To do so requires careful upfront analysis to ascertain whether each of the companies met the specific

criteria, and then thoughtful consideration of how to structure the transaction to ensure it meets the specific and unique requirements associated with pooling of interests. If, for whatever reason, all of the conditions are not met, then the transaction must be accounted for using the purchase method.

In this case, one need not look very hard at the facts to conclude the pooling conditions are not met. The consideration issued in the transaction was cash not stock.

2. The allocation of the purchase price to net assets acquired generally requires an appraisal by a qualified independent expert. The allocation of value starts with current assets to long-lived assets to intangible assets. Intangible assets might be either identifiable (such as acquired software, patents and copyrights and the value of the workforce) and non-identifiable (which is classified as goodwill). Generally, value is allocated among the various elements of intangible assets to create tax basis. From a financial reporting perspective, there is virtually nothing to distinguish these attributes. The primary reason is that goodwill in a technology business has a very short life. In fact, in this case study, the goodwill has an assumed life of 10 years. It is my opinion that this time period is too long. Given the rate of innovation, anything greater than five years is questionable.
3. The analysis and reporting of how the company was performing after the transaction must be specific to the unique drivers of the business. That means evaluating the performance based on all of the goals and objectives, one element of which is the financial performance. The financial performance must be assessed not simply on the bottom line but, more important, on the individual criteria that were the basis for doing the deal. To say the financial objectives were met—because the goodwill amortization period changed relative to the original assumption—is clearly misleading.
4. The accounting policies of the parent and its subsidiaries must be consistent. That should have been taken into consideration in the financial modeling performed at the outset to evaluate the merits of the business combination. Again, to say that the financial goals of the transaction were met because of changed bookkeeping assumptions is misleading and inaccurate.
5. The one-year look-back window in accounting for business combinations is to be used to fine-tune the valuation of acquired assets and liabilities. It is not intended to be a vehicle to compensate for poor post-acquisition integration and management of the acquired entity.

Final Observations

At no point in this case did company executives discuss the fundamentals of the acquired business. All of the effort was placed on window dressing the bookkeeping. If they had focused on driving the business forward, the associated bookkeeping concerns would be a secondary issue. As for debt ratings, it is unlikely that increasing the time period over which goodwill was amortized would make any difference. Likewise, the financial results from operating activities are not at all substantively affected by the accounting method used in the transaction. The only substantive difference to the income statement is that there is a non-cash charge that can be clearly isolated as goodwill amortization if the purchase method of accounting is used. The balance sheet is affected by a different issue. In this case study, cash was the asset used as consideration—this fact alone would merit review by rating agencies. If stock were the consideration, there would likely be a different evaluation.

The hard part of business combinations is not in getting the deal done—it is managing the acquired company post transaction. Financial reporting can be an early warning indicator to operational management if the transaction's business objectives are not being met. To be effective, the goals and objectives must be defined in a measurable fashion. While some of these business objectives may not be directly measurable from a financial perspective, there are often ways to create reporting that will shed light on whether the business unit is on track. Effectiveness also depends on timeliness. To evaluate the financial performance 11 months after the closing date is poor financial and operational management.

It's very clear that the chief financial officer and vice-president of mergers and acquisitions were both confused about their overriding responsibilities. Perhaps a starting point to resolving these issues would be to replace the CFO.

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PSINet Inc is a global facilities-based provider of Internet access services and related products to businesses and also provides Internet Protocol and network backbone services. Prior to joining PSINet, Ms. Zoth was Controller and Chief Accounting Officer for Sodexho Marriott Services, Inc. (NYSE: SDH).

Author's note: The commentary below represents my own personal views and observations.

Ms. McGuire's overall approach is not correct. Accounting rules are not meant to be used to cover up poor forecasting or performance.

Many people in the corporate environment have differing views on mergers and acquisitions. Most often, those in business development seek acquisitions that build on possibilities. They tend to use surface-level reviews of the target company to emphasize the rosier end of the range of possible outcomes—most synergies, fewest disruptions. Once these scenarios are developed, it is difficult to be the cynical reviewer who is asking what could go wrong.

Websave seems to have followed this pattern. Mr. Carmenez pitched the acquisition of IVI based on an analysis that showed huge potential operating synergies and cross-selling opportunities, with seemingly little worry about execution risk. Ms. McGuire reviewed that analysis, and appeared to accept it. The fact pattern discussed in the case doesn't indicate that anyone—Mr. Carmenez, Ms. McGuire or the board—asked what could go wrong.

While there is some flexibility in the accounting rules for business combinations, Ms. McGuire's overall approach is not correct. Accounting rules are not meant to be used to cover up poor forecasting or performance. If IVI has a fundamental performance problem, all members of management should address it immediately so that it does not further diminish the value to the shareholders.

To examine specific options in this case:

- **Extending the goodwill allocation period from 10 to 15 years.** There is no evident basis for increasing the allocation period, and perhaps one could argue that 10 years is too long. This is not a viable alternative.
- **Timing of the discontinued operations.** Given the fact pattern outlined in the case, it would be difficult to conclude that this decision was made prior to or on the date of the acquisition. In that case, it should be treated as a current period expense rather than an addition to goodwill. With respect to the circumstances that gave rise to this loss, it would seem important that the board be made aware of the circumstances, particularly as it could significantly affect future IVI performance.
- **The value of investments made in start-up high technology companies.** It would be interesting to understand if Ms. McGuire had any basis for recording the value of the investments at other than the appraised value of \$5.5 million. Did she know of impairment in the underlying entities? Had market conditions deteriorated such that the underlying entities were experiencing funding problems? Based on the facts presented, it seems as if Ms. McGuire believed the “true” market value was \$5.5 million. In that case, the accounting treatment proposed by Ms. McGuire is not only risky, it is simply wrong.
- **Covenants not to compete and how to amortize them.** There is definitely some latitude here, but I would caution that the impact to earnings per share should not be the overriding consideration. Clearly the value of these agreements should be analyzed thoroughly, with particular emphasis on the extent to which Websave intends to enforce them. There should be evidence available, since three key engineers have already left IVI. While I don’t believe that there are enough facts presented to draw a conclusion, I would be hard pressed to believe that the value should be amortized over a period longer than the five-year guaranteed term.
- **Allowance for bad debts.** When did the receivable really go bad? If the receivables were bad on the date of acquisition, then the allowance for bad debts should be adjusted on the opening balance sheet even if it is 10 months after the original determination was made. If receivables are good but have not been easy to collect due to the distraction of the merger, then any conclusion to forego collection and write down the receivable should be viewed as a decision subsequent to the acquisition date and a charge to the income statement.
- **Treatment of IVI’s capitalized research and development costs, and the go-forward accounting policy for the combined companies’ R&D costs.** The accounting rules are fairly clear in this area. The key determining factor is whether the IVI “asset” has value, either as a tangible asset that has alternate uses or as an intangible asset relating to a specific project. In the first case, the asset with alternate uses most commonly would be a building or materials. This does not seem to be the case for the asset on IVI’s books. In IVI’s case, it appears that the costs relate to specific projects that had been or were in the process of being completed. These costs should have been expensed as incurred on IVI’s books. The company should examine whether there are any in-process R&D projects that Websave “valued” in its determination of the purchase price of IVI. If so, they should perform a valuation of those IPR&D projects and place a value on the opening balance sheet. Then Websave should take a charge for expensing the acquired R&D immediately after the acquisition.

- **Pooling vs. purchase.** The interesting fact here that cannot be ignored is that changing the accounting to pooling does not change the operating performance since acquisition, nor does it improve comparability to the pro forma results presented to the board. The pro forma results would have to be recast to reflect the “what if?” under the pooling method, and the poor operating performance would still be evident. Whether pooling is possible is a complex analysis that has to consider the fact pattern presented and many other items. In any case, the underlying operating performance should not be masked by the accounting choices that are made.

Dan Hugo, CPA, is Director of External Reporting for EBay Inc.

Ebay pioneered a Web-based community in which buyers and sellers are brought together. EBay also engages in the traditional auction business and in online payment processing

My recommendation would be to hire an independent valuator to assist in assigning fair values to each of these classes of intangible assets.

Unfortunately, this transaction was consummated without a thorough understanding of all the accounting consequences and it is difficult for the accounting to mitigate any of the unfavorable results now.

This transaction will most likely not qualify for pooling-of-interests as it appears that the entire purchase price was paid in cash. However, the effect on future earnings may not be as adverse as it appears. The Financial Accounting Standards Board is considering a new statement that will require accounting for all business combinations under the purchase method. Under the current proposal, goodwill associated with all acquisitions (including those that occurred before the effective date of the proposed new statement) will not be amortized but will only be assessed for impairment. Accordingly, even though impairment may still be at risk, the income statement will not be adversely affected by the amortization of the goodwill associated with the IVI acquisition.

Under purchase accounting, entities must assign fair values to the acquired company's identifiable assets and liabilities as of the date of the acquisition. A certain grace period, normally a year, is allowed to finalize the valuation of these identified assets and liabilities. This is permitted because companies may not necessarily have the information available at the time of the acquisition to finalize these valuations. Identifiable assets and liabilities would also include certain intangible assets, such as developed software, workforce in place, trademarks and customer base. My recommendation would be to hire an independent valuator to assist in assigning fair values to each of these classes of intangible assets. It would be inappropriate to assign values solely on current book values; for example, the capitalized cost of the research and development.

This case study highlights again the importance of planning and coordinating all transactions up front. Over the last few years, accounting rules and regulations have increased exponentially in difficulty and complexity. This complexity combined with added pressures from Wall Street should establish the accountants as integral parts of the decision-making process within each successful business organization. However, a lot of companies believe the role of accountants is merely to record past results without affecting the future. The challenge to all accountants should be to equip themselves with necessary tools to enable them to deliver value and to be the company's radar, identifying opportunities and risks long before they emerge.

Quality of Earnings

POLICY AND JUDGMENT—THE X SYSTEMS GROUP

A Corporate Training Case Study

The controller hears the plant manager say: “Ship a few unauthorized partials (untested and parts-missing machines) and keep the books open four extra shipping days.” What is the controller going to do?

Abstract

A controller enjoys the team spirit and success of a dynamic corporate division, until the numbers stop adding up. Examine the facts presented for X Systems Group and determine the course of action you believe should be taken.

Background

Sitting in your office at corporate headquarters you remember the events during that fourth quarter quite vividly.

You were the new group plant controller for The X Systems Group. For the last 18 months your group had produced the hottest products in the company and the volume shipment budgets had been raised three times as everyone recognized their market potential. Spending levels were up 50% from the original budget and the “can do” reputation of the group was the source of many jokes around the company about how they used black magic to keep growing shipments so fast.

Because of its success and high visibility, everyone in the group felt like winners. There was a real esprit de corps, and 10-hour days were the rule, with 12- and 14-hour days not at all exceptional. Everyone felt like members of a winning team, and no one wanted to fail or let others down.

The plant manager really used the group spirit as a positive motivator. Bumper stickers had been printed touting the productive power of the X Group, and lots of people wore baseball caps with some of the same themes. Headquarters would approve just about any capital project and there were many regular visits by senior corporate managers and outsiders.

The word was that the X Group would provide 45% of the company’s profits over the next three years, so there was much attention given at the corporate level to group growth forecasts.

The Problem

Despite all the enthusiasm, for many months you had been concerned about the feasibility of the forecasts. After much discussion, the plant manager had agreed there was a high probability the numbers could not be made. But he had been adamant that this should not be discussed in the plant or at the corporate level. He insisted that he wanted to use the pressure to make the numbers to keep people working hard and making personal sacrifices to do the impossible. He was an ex-Marine Captain and had the reputation as the best line manager in the company. He had interviewed seven people for the controller’s job and had picked you. You admired and respected the man because he

was dedicated, hard working and a natural leader, and most of all because you had seen him and his team do the impossible, bringing in the numbers quarter after quarter. Also, you considered your team members to be your friends and partners and didn't want to let them down.

As a result, you have consistently told corporate that you will make the forecasts, even though your people have developed analyses showing it probably can't be done, given available labor, space and materials limitations.

Looking back, you remember that some of the earlier performance had been achieved by dynamic and unusual management practices, such as hiring moonlighting workers from a competitor's plant, sending chartered jets to vendor sites to pick up parts, and, in a few cases, warehouse and slow truck shipments as well as paying a small vendor a bonus out of multiple petty cash vouchers to ship parts earmarked for another customer. You and the manager had even rented empty shopping centers without corporate approval or insurance coverage, paying the rent with weekly petty cash vouchers to stay within your disbursement authority and keep the buildings off the corporate books.

However, in the last 12 days of the quarter, the manager had run out of solutions and short-term fixes. There were plenty of orders; in fact, backlog had gone from 7 to 16 weeks. But the materials pipeline was dry, and testing problems had suddenly developed. The plant staff was also at the edge of sheer exhaustion. Tempers were short and morale was suddenly the lowest you had ever seen it in any organization. It was amazing how everything had changed in just a few short weeks.

According to your most optimistic estimates, you would miss the fourth quarter budget and forecast by at least \$75 million.

The Dilemma

The manager's secretary had called saying he wanted to have lunch with you. Sitting in his truck in front of the sub shop, he told you in his usual confident way that two steps would solve all the problems. "Ship a few unauthorized partials (untested and parts-missing machines) and keep the books open four extra shipping days." The thing you remember most is how convinced he was that there were really no other choices. This was just another business problem for a dynamic manager to solve. It was a simple matter of bending a few minor red tape rules or jeopardizing the welfare of the plant and all of its people.

"Everyone has worked so hard," he told you. "We can't let them down over a few million bucks of shipments. It would take months, maybe even years to recover the morale from that failure and disappointment. The company can't afford to let that happen; it needs this plant too much to lose the magic if everyone feels like a failure because we miss a few percent of the ship budget. There is no need to talk to corporate. They have their own problems to worry about. This is our job, and we have to do what's right."

Comments on “Policy and Judgment—The X Systems Group”

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Note: Martin’s comments are based on a fictitious case, any resemblance to person living or dead is coincidental.

Companies never “make it up” once they begin booking a little extra revenue in the current quarter. Instead, they dig themselves into a deeper and deeper hole as time passes.

Contrary to the group plant controller’s perception, everything has not changed in just a few short weeks at The X Systems Group. The system has been corrupt for a long time, making the present crisis inevitable. As is usually the case with financial fraud, borrowing profits from the future has created pressure to do more and more of the same. Companies never “make it up” once they begin booking a little extra revenue in the current quarter by using the classic gimmicks described in this case. Instead, they dig themselves into a deeper and deeper hole as time passes.

The progressive nature of dishonest practices is illustrated by the outright bribe (euphemistically labeled a “bonus”) paid to a vendor to divert a parts shipment from the rightful recipient. Now is the time for the group plant controller to pull the plug, despite having to face dismissal and perhaps even criminal charges. The personal consequences will only get worse if the fraud continues. Under no circumstances should the controller agree to abet the plant manager’s newest planned deceptions.

In the X Systems affair, we see the mask ripped off the “can-do” approach. Enthusiasm, motivation and tenacity all sound great, but they ring hollow when managers ignore legitimate rules and regulations. Setting targets is a powerful technique, yet a destructive one when they become objectives unto themselves, rather than reflections of actual economic performance. It is particularly insidious when managers use peer pressure (“Don’t let the team down”) to enforce participation in the unethical scheme.

The predictable conclusion of this story, sadly, is that senior management will escape all responsibility for the false financial reporting. Previous earnings will be restated and the accompanying press release will blame a “rogue manager.” Such a claim is preposterous in view of senior managers’ frequent visits to the plant and ultimate responsibility for operations. The top executives will not be forced to rescind the performance-related bonuses they received with the help of financial reporting gimmicks, which they will later deny knowing about. Regrettably, the demonstrated success of chief executive officers and chief financial officers in maintaining deniability ensures the regular recurrence of this sort of situation in the corporate world.

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She is the author of “Does Meeting Expectations Matter: Evidence from Analysts’ Forecast Revisions and Share Prices,”(with R. Kasznik), Stanford University Graduate School of Business working paper, 2001.

The earnings targets appear to come from corporate management with little input from X Systems about what is feasible.

This case presents the controller of X Systems with a very difficult choice: He can ship incomplete products and keep the books open four extra days or report in accordance with generally accepted accounting principles and fail to meet internal targets.

The controller's immediate concern is to determine what steps are acceptable to meet a target, but the case raises broader questions as well. In particular, the earnings targets appear to come from corporate management with little input from X Systems about what is feasible. Furthermore, spending levels increased 50% from the original budget. This suggests targets for production have been increased substantially relative to expectations held at the start of the budget year. If X Systems repeatedly resorts to heroic measures to meet these targets, corporate management may well have a false impression of what production is achievable and what level of sales growth is sustainable. Thus X Systems may face rising targets over time and declining prospects for meeting those targets using appropriate management practices. Overall, this raises the concern that manipulating information hinders corporate and division level planning and resource allocation decisions. An open question is the business' control environment and corporate management's role in its condition. Is X Systems a renegade division or is the group's manager responding to incentives designed by corporate management? Do existing controls motivate managers to act in the best interests of shareholders?⁵

Research shows that companies that consistently meet analysts' expectations are valued more highly by investors.⁶ However, this research also finds that businesses that meet expectations in only one or two years are valued based on their actual earnings, not their earnings relative to expectation. In other words, a company that reports earnings per share of \$1.20 when investors expect \$1.30 is valued similarly in the short run to one that reports EPS of \$1.20 when investors expect \$1.10.⁷ This finding suggests that the market rewards companies that consistently establish achievable expectations and meet them, but not those that manipulate expectations or earnings to meet a specific earnings target. Consistently meeting expectations requires the ability to properly set expectations and then motivate employees to meet them. X Systems will find this increasingly difficult because expectations are unlikely to be set properly without valid information. Also, by borrowing ahead to meet this period's revenue goal, it is likely to face greater pressure to perform. Although the manager of X Systems might believe that he is helping corporate management by achieving targets at any price, he is depriving them of the information they need to manage their business, allocate resources and communicate with investors.

⁵ For further discussion of related issues, see Accounting for Decision Making and Control by Jerrold Zimmerman (1995), Management Accounting by Atkinson, Banker, Kaplan and Young (1995) and Divisional Performance Measurement and Control by Solomons (1965). See also "Speech by SEC Chairman: Remarks Before the Conference on the Rise and Effectiveness of New Corporate Governance Standards" by SEC Chairman Arthur Levitt, December 12, 2000.

⁶ See "Does Meeting Expectations Matter: Evidence from Analysts' Forecast Revisions and Share Prices," April 2001, Stanford University Graduate School of Business working paper, by Ron Kasznik and Maureen McNichols.

⁷ Of course, the price reaction to the announcement is positive for the first company and negative for the second, but the value of these two companies is the same. Only by consistently meeting expectations do businesses appear to earn a market reward; that is, a value greater than that expected given their earnings.

With this as background, I recommend that the controller have a serious talk with the manager of X Systems. The manager needs to understand that as the manipulations escalate, they make future targets less attainable and set the stage for their ultimate disclosure. In other words, the manager has to think beyond the current quarter's numbers. For this reason, X Systems must tell corporate management that the current forecasts are unattainable. While the short-term consequences may seem very negative, the long-term fallout is surely worse. Corporate management should work with X Systems to develop better communication, budgeting and control procedures. Without them, the company risks a major control failure that would be very damaging to the business, its employees and investors. Academic research shows that investors do respond to lower earnings in valuing a company. However, the reaction is far more negative if investors perceive that the earnings numbers they have used to value the business are a product of creative accounting.

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Clyde Associates is a boutique consulting firm located in Dallas, TX where Nita specializes in accounting education with a particular emphasis on issues of professional ethics. She chairs the AICPA/NASBA Joint Committee on Continuing Professional Education Standards, as well as a Special Committee on Ethics in the CPA Profession. She is a past member of the AICPA Board of Directors, and is currently a member of its governing Council. Nita was a university professor for almost 20 years.

The controller should inform the plant manager that he or she will no longer be a party to any attempts to hide true operating status.

The group plant controller for The X Systems Group has allowed professional judgment to be influenced by misguided admiration and respect for the plant manager. While loyalty to a superior or fellow employee may be admirable, the controller's participation in the variety of schemes to improve group performance measures ignores the impact of these dubious actions on the company as a whole. Both the company and its owners have been placed at risk through the acquisition of surreptitiously rented facilities lacking proper insurance. By consistently assuring the corporate office that forecasts will be made, the controller has ignored the analyses of his or her immediate subordinates and become a participant in what can only be labeled a whitewash of the real plant operating results. Many would call the behavior fraudulent. It is troubling that the controller—while “concerned about the feasibility of the forecasts”—has done nothing to refute or modify the plant manager's problem-solving suggestions.

Further subordination of the controller's judgment to that of the plant manager carries such peril that “letting the team down” becomes an attractive alternative by contrast. The controller should inform the plant manager that he or she will no longer be a party to any attempts to hide true operating status and alert corporate management to the problems. Admission of his or her role in the various schemes may (and probably will) force the controller to seek other employment, but, to paraphrase the words of the plant manager: “This is [my] job, and [I] have to do what's right.”

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Being part of a hot team is extremely energizing. Who wants to be the skunk at the garden party when the reality of slow sales and high expenses sets in?

It's a shame. The situation described in this case study is a symptom of the pressures that the current system of static, "snapshot-style" quarterly accounting places on ordinary people trying to do their jobs. And it richly foreshadows the disastrous consequences that can follow.

It's easy to imagine being in the shoes of the group plant controller for The X Systems Group. Being part of a hot team is extremely energizing. Who wants to be the skunk at the garden party when the reality of slow sales and high expenses sets in? Under the current system, no one has to be, as long as there are a few more weeks or days in the quarter (whether the days are real or borrowed from the next quarter). The controller and his colleagues gave in to the temptation to double the bet and press on, hoping that the future would be better. It is easy to see in retrospect how they succumbed. But one has to have sympathy for the plant manager and the controller. The slowly unfolding disaster is one of those things that is hard to recognize as it is happening without the proper distance, objectivity and controls. It is always easy to think that the solution is just around the corner, especially if you have actually pulled together a solution quarter after quarter before.

Ironically, the incentives of the current reporting system exacerbated the problem from the perspective of the shareholders. Since the managers were free to try to "fix" the problem right up until the end of the quarter, they had plenty of time to make it worse, which is what they did. Their desire to hide the bad news from subordinates, superiors and shareholders was aided by the snapshot quarterly system. What might have been a soft landing is going to be a hard crash.

Imagine a radically different system in which a company's progress toward goals that affect shareholder equity is truly an open book, reported in real-time. Eventually there will be no reason, given financial systems software and the ubiquity of the Internet, for shareholders not to be given much more frequent, even daily, information about shipped units and other measures of performance. Even if shareholders were not given this information, at least senior management should have it. Had corporate headquarters seen the dry materials pipeline they would have known there could be trouble. But they were apparently clueless because they were relying on a quarterly number without knowing what was behind it. They were also caught relying on a plant manager who, at the end of this quarter, unfortunately thought the world would bend to his version of the rules. And now the controller is in the tough spot of having to explain that the rules here are unyielding, even though the controller abetted the previous cover-up with headquarters.

Now there is only one course, and there should be some measure of relief in the transparency. For people like X Systems Group's controller, the pressure of concealment and the ethical dilemma it creates must be removed from his daily concerns. There is a job to do and pretending will not solve the problem. The plant is sound, the backlog is growing, profits are there to be had—just not entirely in this quarter. The workers do not benefit from the current concealment, by the way, no matter how

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valuable their team spirit may be. The news cannot be hidden forever, and when it breaks, the concealment will only compound employees' bitterness and shock about the company's shortfall.

Transparency going forward will also counterbalance X Systems Group's grave lack of meaningful controls. It's hard to imagine an excuse for headquarters' laissez faire attitude toward capital expenditures and production planning, and even harder to explain an approach to expenditures so lax that it would condone chartering of jets and renting real estate, with headquarters none the wiser. A somewhat more real time and granular reporting requirement, at least internally, could have smartened everyone up. But until it is here, full disclosure of the real end-of-quarter numbers—using a real end of quarter, not one with some extra days in it—is the only permissible course of action.

INVENTORY VALUATION ISSUES AT AKL

By Grace S. Morin, CPA

The president probably won't support Matt unless he ignores the inventory problem. Does Matt's job hang in the balance?

Abstract

Matt, the new controller of a promising manufacturing company, is troubled by the inventory valuation practices he finds. Examine the facts for AKL and determine the course of action you believe should be taken.

Background

AKL was a job-shop. It manufactured and designed equipment for radio transmission towers. Tight specifications were required for microwaves to travel with integrity through the rectangular, elliptical or round metal pipe-like conduits. Usually the equipment systems were unique and, with normal wear and tear, replacement parts were often needed in five to seven years. The orders for replacement parts from the end-users were almost always sole-sourced to the company that made the original systems. Repair parts were considered to be an important and profitable element of sales.

AKL's component parts inventory was made up of 105,000 different item numbers. If you walked through the plant, you would see very large ductwork and other types of items that were easy to count and verify. Also, there were three room-size, secured "cages" that contained items very difficult to verify. In these cages, one could find precisely milled, small gold- and silver-plated fittings, with inventory valuations ranging from about \$500 to \$1,000 each, and often more. In total, the parts inventory value was several million dollars, a high investment for a company doing \$11 million in sales.

The small, milled items in inventory were made on computer-aided milling machines. A typical job at a milling machine involved a significant amount of time for set-up, the run of several pieces so the quality department could test them for very tight size tolerances, and then the run of however many pieces were requisitioned by the job. Sometimes several attempts, and many test pieces, were needed to get the tolerances through the quality department. Once approved, the actual run time was fast. For example, the set-up time of Item #34571 might be 4½ hours, the production of the test items and the quality check might take 45 minutes, and the run time might be 6 minutes each. So, the total time committed to make five acceptable units would be 5¾ hours, and the total time committed to make 10 acceptable units would be 6¼ hours. Clearly because of the set-up time, and reject material before the first good unit was milled, the unit carrying cost varied considerably, depending on how many units were made. As a result, the company almost always chose to make more units than immediately needed and put the excess into inventory to use as replacement parts that were expected to be sold in four to five years.

AKL was fixed-asset intensive, due to the amount of machinery needed. It had been in business seven years, and was founded by three talented engineers who used to work for a larger company.

None of the founders had much money to put into the business, but they were trying to keep the company privately held. Consequently, the company relied primarily on banks and equipment suppliers to provide the needed loans for plant and equipment, and for operating capital as the company grew. The asset-based loan for the operating cash meant at least quarterly audits by the bank, and close contact with the principal lending officer in charge of the account.

The company was located in a relatively rural part of the state, and was hiring more and more people as it grew. Currently it provided jobs for 137 local people. It trained them, provided good wages, urged continuing education and was considered a good place to work. The product was highly regarded, with dependable engineering and extremely high product quality.

The price competition in the market was significant. The rework in the company was not excessive, and AKL was growing, though struggling from time to time.

The Problem

One issue had always been there, but no one had known to look for it: the inventory valuation. The original CFO, Charlie, was the brother of one of the founders, and was a bright, likable, quick-witted person, with a good head for finance and accounting. From inception, the company had valued the inventory based on an equal costing of all of the units produced in each machine run. Using the previous example, if 10 units were produced, and the cost was a total of \$5,000, then each unit would be valued at \$500. If five units were actually required for the immediate order, then \$2,500 would be posted towards the cost of the job, and \$2,500 would be posted to inventory, as the other five units were put into general stock. The company assumed the leftover units were very good inventory parts that would, indeed, be sold in the upcoming years.

In year 6, Charlie the controller quit to start his own campground on the shore of a nearby lake. Matt, a CPA, was hired to be the new controller. Matt was familiar with engineered products and manufacturing companies, since he had audited several of them. Despite his experience, learning AKL's business was a formidable task, which included catching up on and building new systems, and managing with a lean staff. Matt did a good job, but it took over a year for him to really understand the business.

Matt found the inventory turnover distressing. His recent calculations showed that the turnover had decreased each year. Once the new computer systems were operational, he started running aged inventory reports. At first the data from the old, half-manual system wasn't in the new computer system, so he couldn't get the history he needed. But, as time went by, he realized just how much "old" inventory was in the cages. He had been suspicious because he often went into the cages to test count with the auditors, or just to walk around and familiarize himself with the pieces. Matt began to suspect he was going to find something amiss.

Towards the end of year 7, Matt went to the president with the problem. The president genuinely could not understand Matt's concerns, because he looked at the matter from a practical unit-cost point-of-view. However, not only was he starting to get information from the computer system, but Matt had also dug into old card files and found the age of some of the units. Five, six and even seven years was not uncommon.

Matt reminded the president that “inventory” was by definition a current asset. The president impatiently told Matt that all of the inventory would eventually be used. Some of the older inventory was the most valuable, he said, because it would be the most profitable when the systems for which the items were built broke down. The more time went by, the closer those systems were to needing repairs.

The president, as much as he liked Matt and appreciated the good job he had been doing, clearly looked worried, and frowned as Matt left the office to think things over. The president was very aware that the operating line of credit was “asset-based.” It provided the cash that paid the weekly payroll and the vendors. It relied mainly on the current asset balances to calculate the line’s upper limit, which was usually used to the fullest. The president wanted all of the current assets, including the parts inventory, at the highest value possible so money could be borrowed from the bank based on those values.

Matt was also very aware of the dilemma. Due to the old, semi-manual inventory system, or the technical and complex nature of the inventory items, or the inexperience of the bank auditors and the independent auditors, there had never been one question, as far as Matt knew, about whether the inventory was “good,” or current.

It was clear that the president believed the inventory approach was correct and wanted to maintain it. Since the independent auditors had accepted the inventory valuation every year, and since the bank auditors had allowed it every quarter, Matt set out to research how he could justify retaining the current approach.

The Choices

“Inventory” kept coming up in his research as something that had to be used sooner than a lot of the parts in his company’s inventory were being used. Matt decided to think aggressively. Maybe, as a compromise, he could create a new non-current account called “Investment in Parts.” Then Matt remembered that the president and other engineers had told him that systems would break in four to five years. Why, then, were parts left from seven years ago? Clearly, some of the systems took longer to break down. Or were these systems even in use anymore? Maybe they had since been decommissioned or blown away in tornadoes, for all Matt knew. It seemed possible these old parts would never be sold. Matt began to doubt if he could justify even a new, aggressive, non-current account for these items.

Matt groaned inwardly as he thought what would happen to the current financing arrangement if the inventory had to be significantly reduced. First, he would have to determine how much it should be reduced, which meant a battle with the president and the engineers. But who was more qualified than the engineers to help determine if inventory items would really be used currently? Who would be his ally on his quest to correct the valuation? The bank’s lending officer came to mind, but if Matt were to enlist his help, would it appear that the officer hadn’t properly reviewed the work of the bank auditors, or had succumbed to the hype of the optimistic president? Suddenly one of banker’s strongest clients would have an abrupt drop in its line of credit, and wouldn’t be able to pay its bills or payroll. All company assets were mortgaged or already used as collateral, so there was no cushion.

Could Matt enlist the help of the independent auditors? An investigation into inventory for the last several years would require a lot of extra audit fees, which the company could ill afford. Plus, the bank or the company might sue the auditors for failing to do a thorough job in previous years. Restated financials might well make the company miss the profit targets required by the loan covenants.

Matt thought about trying to institute a new policy, in which the company would still make production runs in excess of what was immediately required but would cost the overruns incrementally in general inventory. Thus, an immediate order would be charged with the lion's share of the cost, and the excess items manufactured would be costed very low. Matt quickly realized that if he implemented that system, there would be slimmer job margins and losses on many jobs. Had the company been fooling itself into thinking that it was profitable in the first place? Had the method of calculating a bidding quotation been erroneous from the very start?

If Matt started telling the engineers and the estimators that they were doing their jobs incorrectly, and informed the president that he had to notify the auditors and bank that the inventory was wrong, where would it end? Would Matt lose his job? Would everyone in the company lose their jobs, since the company might not "make payroll"? Would the banker lose his job? What would happen to the auditors who had been assigned to the job?

Matt wanted so much to go along with the existing approach. But by doing so, was he just postponing an inevitable demise? Would someone else discover this problem and blame Matt for not finding it, since he was the resident accounting professional? Matt felt that he might single-handedly be causing his company to fail and be putting his professional reputation in jeopardy.

Comments on "Inventory Valuation Issues at AKL"

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Dan's practice is limited to consulting services, including litigation involving accountant's malpractice issues. His most recent book is *Audit Committees: A Guide for Directors, Management, and Consultants* (Aspen Law & Business).

In deciding on whether an inventory write-down is called for, Matt should not focus primarily on losing his job.

There are two issues involving generally accepted accounting principles that Matt should recognize. The first relates to his concern about inventory turnover and the potential need to write down inventory to reflect obsolete and excessive spare parts. The second issue is how to price inventoried spare parts in the future.

Obsolete/Excessive Inventory

The AKL spare-parts inventory accounting is a complex accounting estimate. Management has made an economic decision to produce extra high-cost inventory items over and above what is needed for a given radio transmission tower job. The decision is driven in part by production run cost savings. AKL has used the average cost method for allocating parts to specific jobs and to spare-parts

inventory. Matt is concerned about whether the cost allocated to inventory is recoverable. The primary question at this point is whether the spare parts should be written down to net realizable value.

GAAP demands that the spare-parts inventory be analyzed, and, if excessive or obsolete/impaired inventory is present, that the inventory be written down to its net realizable value. AKL needs to undertake this task before issuing new financial statements. Moreover, if existing spare parts are deemed to be excessive, AKL should revamp its assumptions and policies for producing and inventorying future spare parts.

If inventory write-down is necessary, it should be accounted for as a change in an accounting estimate and recognized in the current period income statement. The write-down of inventory to realizable value usually is reflected in the cost of goods sold, unless the amount is unusually material, in which case GAAP requires that the loss be separately identified in the income statement as a part of income from operations.

In deciding on whether an inventory write-down is called for, Matt should not focus primarily on losing his job, on the possible actions of creditors or the demise of the company. These are certainly important concerns, but they are secondary issues, none of which would justify treating inventory amounts as assets when they are not. If Matt were to ignore the inventory valuation problem, the consequences of his action—civil and perhaps even criminal liability—would be far greater than the secondary concerns. Matt needs to do what GAAP requires and what is right. In carrying out this responsibility and making the difficult decisions that are involved, he, of course, should demonstrate empathy and compassion for those affected by his decision.

Future Inventory Pricing

The average cost method that AKL currently uses for spare-parts inventory may comply with GAAP. Again, the problem may be overproduction of spare parts, not costing the parts in excess of net realizable value. However, if the analysis of spare-parts inventory (discussed above) demonstrates that the cost charged to individual inventory parts exceeds net realizable value, then AKL should change its cost allocation method to reflect market reality.

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It is much more probable that the bank and other capital suppliers have factored the risk associated with long-term realization into their interest charges and sales prices, respectively.

AKL's new controller, Matt, has a true dilemma. While he suspects that the company's long-established method of valuing its inventory is inappropriate, he has no clear-cut evidence that (1) the valuation will not be justified upon eventual sale of the five- to seven-year-old parts or (2) that the

bank auditors and its lending officer and the outside financial auditors have been incorrect in accepting the company's valuations. Although he believes the expected realization of five to seven years indicates the parts inventory does not fit the definition of a current asset, Matt is also aware that both sets of auditors have accepted the company's evaluation and classification. Is the dilemma an ethical one or merely a case of differing views regarding professional judgment?

First of all, Matt has an obligation to test his opinion that some of the inventories may, in fact, be worthless because the systems for which the parts were being "saved" are no longer operative. Before confronting the president, bank and auditors with allegations of inappropriate behavior, he must back up his claims. A sample of the customers who have purchased systems from the company in the past should give him some idea of the systems' current usage. Are the systems operative (but working better than expected without needed replacement parts) or have they indeed been discarded for other systems? Armed with this information, Matt can proceed to satisfy his professional responsibilities.

If Matt's additional research convinces him the parts inventory is overvalued because of obsolescence, etc., he should bring his findings to the company's president, along with his suggestions for determining the appropriate valuation. If the president refuses to revalue the inventory, Matt must consider whether he should remain in his current position. Since the company's financial statements reflect the representations of management and Matt is part of that management, he does not want to be associated with false and/or misleading financial statements.

Assume, on the other hand, that the sample survey suggests the parts will eventually be sold, bearing out the president's allegation of their true value. Revaluation of the inventory may not be necessary, but disclosure of the lengthy time period over which the costs will be recovered should be considered. Despite Matt's concern that neither the bank's auditors nor the independent auditors have considered the possibility of non-current inventory, this is highly unlikely. It is much more probable that the bank and other capital suppliers have factored the risk associated with long-term realization into their interest charges and sales prices, respectively.

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The bank has a right to receive accurate and reliable information about the market value of the inventory if it is below the cost.

Executive Summary

Matt, the controller of AKL, has an ethical dilemma because inventory turnover of the replacement parts is decreasing each year and some parts have been carried in inventory for seven years. He is uncertain about the future usefulness of the parts since the president and other engineers told him that systems would break in four to five years. Matt has discussed the matter with the president, who reminded Matt that the older inventory would be used and was potentially more profitable than newer inventory because of its lower cost basis. Moreover, both the bank auditors and independent auditors allowed the inventory to be valued at the original cost every year. Matt knows that the president will resist any suggestion to lower the value of inventory because it is slow-moving since

bank loans are based on the level of current assets. If the bank reduces the loans because of an inventory write-down, then the company may be unable to pay its vendors and meet weekly payroll.

Stakeholders and Interests

The bank is a major stakeholder since it provides the funds that enable the company to meet operating needs. If Matt recommends a write-down of inventory, then the restated financials might prevent the company from meeting the profit targets required by the loan covenants. If Matt ignores the inventory problem, then the bank would not receive full disclosure and the loans will be based on inaccurate information.

Employee jobs and the company's existence may be in jeopardy if the bank reduces the amount of operating loans that it provides to AKL. Moreover, the equipment suppliers may be reluctant to continue to provide credit for the purchase of plant and equipment once it becomes known that the bank has lowered its lending.

Since the bank auditors and independent auditors have not questioned the carrying value of inventory in the past, they may wonder about the integrity of the company and its top management if Matt now raises questions about proper value. The company's relationship with its auditors may be affected by the disclosure.

Matt is a stakeholder since the president probably won't support Matt unless he ignores the inventory problem. The president is likely to use past inaction by the auditors to support keeping the inventory at its current level. Matt's job may hang in the balance.

Ethical Issues

The bank has a right to receive accurate and reliable information about the market value of the inventory if it is below the cost. Matt has a duty as the controller to make sure the financials provide such information. He would be violating his ethical obligations as a CPA if he allowed biased information to go forward to the bank. The profession's ethical standards require Matt to be objective and maintain integrity in carrying out his responsibilities as the company's controller.

Matt has a responsibility to the independent auditors because they rely on the controller's work in planning and executing the audit. He should not allow his relationship with the independent auditors to be jeopardized by the pressure the president will apply if he discloses his concerns about the inventory valuation.

Matt has a conflict between his loyalty to AKL and his ethical responsibilities to the bank and the independent auditors. He should not subordinate his judgment to that of the president merely out of a sense of loyalty. There should be a sound accounting reason to keep the inventory at its current level. It should not be done out of concern for the potential harm to the company if he insists on full disclosure.

Alternatives

Matt has already identified a variety of alternatives, including changing the company's policy to charge current orders with a larger share of the cost representing some of the over-production and discussing the matter with the independent auditors. He should enlist the help of the independent

auditors since they also have an ethical obligation to the bank. By working together, Matt and the independent auditors may be able to come up with a solution that respects the rights of the bank and the vendors as suppliers of credit to AKL to receive accurate and reliable financial information about the current market value of the inventory.

Matt should approach the president before going to the independent auditors. If the president denies permission for him to speak with the auditors, then he should consider resigning his position. Since AKL is privately held, there may not be a board of directors, but if the company does have one, then Matt should approach that group with his concerns about the need to resign. He may also choose to speak with a trusted adviser about the situation.

ACCOUNTING FOR A WINDFALL

By Grace Morin, CPA

Pierre Michaud has to decide whether to accede to the president's wishes and record the insurance payment as operating income. Can Pierre maintain neutrality?

Abstract

The president of Progressive Geriatric Equipment Design is pressuring controller Pierre Michaud to include a recent windfall from life insurance proceeds in the division's operating income. Examine the facts and determine the course of action you believe should be taken.

Background

Progressive Geriatric Equipment Design, or PGED, was facing a lot of pressure to show an operating profit on the financial statements. The loan covenants were based on the division's operating profits, as was the company contribution to the employees' 401(k) plan. And profits during these last few years were often hard to achieve. Somehow new products and markets just hadn't been found. PGED, one of five divisions owned by Prosthetics, Ltd., was working with a very lean staff in every department, and a commitment to try to minimize costs. Most employees were aware of the division's precarious situation. PGED knew that it could easily be consolidated into one of the other divisions located several states away, or even sold. The jobs of 201 people were on the line, and they all needed to do their best to keep their division going.

Gustav Jacobs was 46 years old when his father's Oldsmobile was struck from the side by another vehicle, severing his leg. When the man was given an artificial limb, Gustav, a mechanical engineer, immediately saw how many improvements he personally could imagine for the device. Diving into the project, Gustav designed and patented over 20 versions of artificial limbs in the next few years. Not satisfied with simply designing these limbs, Gustav found other enthusiastic experts to invent production equipment, run the manufacturing and even patent new materials that were softer to the touch. Led by Gustav, the four founded PGED, which manufactured the product to exacting standards. The company had been purchased by Prosthetics, Ltd. almost 20 years ago. Gustav and the others had approved of the purchase, believing they could achieve even greater growth with their new extensive distribution channels. Gustav had been happy to stay with the company when it was bought, having made a fair profit by the sale of his stock, and having been offered an attractive employment contract. Until computerization ushered in a new era in equipment, almost all of the most popular designs had been the result of his mechanical genius, personal compassion and drive.

Gustav had been responsible for the plant itself, which was located on 72-acres of former farmland, now an island surrounded by tightly-packed newer industrial buildings. Owners of nearby companies frequently offered to buy the PGED location to pack in more buildings and parking lots. Deer often peeked out from the woods in back of the PGED building, and countless nesting birds could be seen from the trails the employees enjoyed during their lunch breaks. Being very aware of the difficulties handicapped people can encounter when finding jobs, PGED tapped the talents of the market its

products served, and many of the employees used the very limbs made at the company. The outdoor trails were designed with them in mind, and were used extensively.

On the first of the previous month tragedy had struck when Gustav was stricken with a massive and fatal heart attack. He and the other three founders had life insurance policies paid for by the company. The company deducted the premiums each year. PGED sent the proceeds of Gustav's \$1 million policy to corporate headquarters where cash, though no other accounting functions, had been centralized a year ago. The proceeds were earmarked by corporate headquarters as research and development money for several divisions, though only a pittance was set aside for PGED.

The Problem

Controller Pierre Michaud had been thinking mainly about poor Gustav's death, and also about how to ensure the money allocated by corporate was used most effectively. Month-end came, the financial statements were generated and the assistant controller gave Pierre the first draft of the statements for his review. Unfortunately, as feared, the results of operations showed a small loss. Pierre knew that he could use his creativity to nudge the figure into the black. He had done it before, and shook his head as he looked at his notes from last month to see how he had done it then. The monthly accruals could be cut a little; they were still on the conservative side. Insurance accruals were a little high yet since headcount was being allowed to drop due to attrition, and the final insurance audit would come in lower than his accruals now totaled. The legal accruals could be cut some more, too. He'd issue a memo for everyone to see him first before calling for any advice: patent questions, personnel matters, product and contract issues. He found a few more. He could genuinely justify all of those, but this was the last month he could whittle them down. He gave the changes to the assistant controller, who grimaced and began to enter them into the computer. In about 15 minutes, Pierre had the new financials, which showed a miniscule profit, but at least it didn't show a loss. Pierre called the president to tell her the financials were ready for her review and their discussion any time she could schedule it. She told Pierre to drop off a copy of the statements on her desk and come to her office at 9 a.m. the next morning.

At 8 a.m. the next day, Pierre got a call from the president. How could there be such a small profit when they just got \$1 million of life insurance proceeds? What was the figure doing below the operating income line in "Other Income"? The premiums had been included in administration expenses every year, hadn't they? The company had to put up with those expenses going against operating income, so why wouldn't it be able to benefit from the proceeds? Pierre wanted very badly to research the accounting treatment of life insurance premiums and proceeds before he started arguing his position with the president, who was clearly very upset. However, the president wanted him in her office now.

As Pierre walked along the corridor, he thought of what must be going through the president's mind. He knew that she had fought hard with corporate management for the cash from the life insurance proceeds so that new computer engineers could be hired to redesign the products. He also knew that she had lost that fight, with corporate saying that there was more to be gained by investing the cash in other divisions. Now Pierre was telling her that the life insurance proceeds couldn't even help them on the financial statements. Seeing those statement drafts must have been quite a blow, and must have made the president feel desperate to keep the company going somehow, some way.

Still shaken from the president's demeanor, Pierre arrived at her office. He explained that since the proceeds were such a large amount, and an infrequent occurrence, they needed to be accounted for "below the line." Clearly irritated, the president said that didn't make sense. She told Pierre to amortize the proceeds over a period of years, just as the insurance premiums had occurred over a period of years. If he could do that, they could manage to keep an operating profit going for many months, or even many years. She insisted that he try very hard to find a way. This was the company founded by Gustav, and made proud by the valued employees. It was worth fighting for; it was worth bending a few rules. The president told Pierre to make the corrections by the end of the day and give her new copies of the statements. PGED's immediate future was, literally, in Pierre's capable hands.

Comments on "Accounting for a Windfall"

Dan M. Guy, Ph.D., CPA, lives and practices in Santa Fe, New Mexico.

Dan's practice is limited to consulting services, including litigation involving accountant's malpractice issues. His most recent book is *Audit Committees: A Guide for Directors, Management, and Consultants* (Aspen Law & Business).

Pierre should be mindful of his responsibility under the AICPA Code of Professional Conduct. Rule 501, which prohibits acts discreditable to the profession.

After leaving the president's office, Pierre should immediately research the accounting issues related to PGED's gain from the life insurance proceeds. In doing the research, Pierre should determine that generally accepted accounting procedures require that the \$1 million gain be reported separately as a component of income from operations (with appropriate footnote disclosure of the facts and circumstances). The gain should not be considered extraordinary because it is a normal business transaction. It may be unusual in nature, but it can be expected to recur (in fact, PGED has life insurance policies on the three remaining company founders). In other words, the gain is not extraordinary (both unusual and infrequent), but it is infrequent; therefore, it merits separate line item reporting in the income statement as a component of income from operations (displayed as "other revenues and gains" if desired).

Upon completing his review of the relevant GAAP authoritative literature, Pierre may want to discuss and confirm his conclusion by calling the AICPA's technical accounting and auditing hotline at (888) 777-7077.

Once Pierre has completed his research and consultation, he should meet with the president. He might initiate his discussion as follows: Good morning, I have some good news and some bad news. As the revised financial statements show, we can (and, in fact, should) treat the \$1 million as a component of income from operations. That's the good news. However, under no circumstances can we set up the gain as an asset and amortize it into income over future periods. That's the bad news. GAAP does not permit the latter since the gain is realized, and it is not contingent on anything in the future. Finally, not only is the amortization of the gain a violation of GAAP, but that treatment also would be illegal.

During this discussion, Pierre, as a CPA and AICPA member, should be mindful of his responsibility under the AICPA Code of Professional Conduct. Rule 501 prohibits acts discreditable to the

profession. If Pierre were to (1) make false or misleading journal entries, (2) sign a materially false or misleading financial statement, or (3) allow or direct others to do such things, he would be committing an act discreditable to the profession.

Steven M. Mintz, Ph.D., is a leading expert in the field of professional ethics for CPAs.

Dr. Mintz is Visiting Professor of Accounting at Chapman University. He is the author of more than twenty published papers in ethics and a casebook in accounting ethics.

Pierre has a dilemma because the company's very existence is at stake, as well as the jobs of his co-workers.

Executive Summary

The president of PGED is allowing her own self-interests and the perceived interests of the employees to dictate the reporting of the \$1 million life insurance payment for Gustav's death. Pierre Michaud, the company controller, already has lowered the accruals to create a small profit. To generate additional operating income over a number of years, the president asks him to allocate the insurance proceeds as an operating income item rather than report all of it currently as other income. Pierre has a dilemma because the company's very existence is at stake, as well as the jobs of 201 workers.

Stakeholders and Interests

The creditors are major stakeholders because they provide the funds to help the company operate. The company's ability to meet the loan covenants, which are based on the division's having operating profits, should be questioned since the dollar amount of accruals is being lowered to achieve desired operating results. Thus, earnings are being managed to achieve a desired result rather than reported in accordance with sound accounting practice.

PGED is one of five divisions owned by Prosthetics, Ltd. The company is a major stakeholder, as are PGED employees, who may lose their jobs if the division is consolidated into another unit or sold. Also, the company's contribution to the 401(k) plan is at risk, since the disputed operating profit is the basis for the contribution.

Pierre Michaud is a stakeholder since he has to decide whether to accede to the president's wishes and record the insurance payment as operating income rather than as he initially recorded it—other income. The president also is a stakeholder since the future viability of PGED as a separate entity is at risk. She is responsible to the employees whose jobs are in jeopardy, and they are users of the limbs made at the company.

Ethical Issues

The creditors' rights to receive accurate and reliable information to evaluate whether the company is meeting the loan covenants are at stake. The arbitrary way in which the PGED division created operating profits misleads the creditors into believing that the division is doing better than it really is.

Pierre's responsibility to the president does not include taking actions to manage earnings to achieve a desired result. Accounting information is supposed to be recorded in an unbiased manner. Pierre

has violated neutrality by arbitrarily lowering the accruals to report an operating profit. This action is unfair to the creditors.

PGED's ethical responsibility to its employees does not include managing operating profits to achieve a desired level to prevent the division's demise. If each of the divisions made operating or financial reporting decisions based on this goal, then all of their results would lack reliability and comparability.

Alternatives

Pierre has to weigh his responsibility to the company and its employees, as well as the president's desire to show a larger operating profit, against whether it is right to manage earnings to enhance PGED's short-term chances to continue as a separate division. He can go along with the president and allocate the insurance proceeds as operating income over a period of time or refuse to do so, since it is an improper practice. In making a decision, Pierre should consider PGED's responsibility to its creditors and the company's ability to demonstrate that it honestly met the loan covenant requirements.

Pierre may want to discuss the matter with a trusted adviser. However, he should not violate the creditors' rights regardless of the pressure applied by the president. As controller, he has an obligation to be objective in determining how to report the insurance proceeds.

Nita Clyde, Ph.D., CPA, is a partner at Clyde Associates.

Clyde Associates is a boutique consulting firm located in Dallas, TX where Nita specializes in accounting education with a particular emphasis on issues of professional ethics. She chairs the AICPA/NASBA Joint Committee on Continuing Professional Education Standards, as well as a Special Committee on Ethics in the CPA Profession. She is a past member of the AICPA Board of Directors, and is currently a member of its governing Council. Nita was a university professor for almost 20 years.

Pierre has obligations to the corporate office and to the company's shareholders to provide them with financial information that is useful for their decision-making.

Pierre's ethical issues in this case relate as much to his competence as to other issues. Without a sound knowledge of the proper accounting treatment for proceeds from life insurance policies, he cannot adequately address the demands of the president or justify to himself and others why a position was taken. However, even without resolving or discussing the accounting issues, there are some general lessons to be learned.

First, financial statements are filled with estimates based on sound professional judgment, which allows for differences of opinions and sometimes differences in treatment of what appear to be identical situations. The adjustments that Pierre made initially, bringing the bottom line from a loss to a small profit, appear to be within ethical boundaries. He was able to justify why the preliminary insurance accruals were too high and to limit legal expenses by offering to provide some advice himself. He also acknowledged that there was no more room for such adjustments in subsequent months.

Pierre's real dilemma may arise from the president's demands that the financial statements portray the receipt of the insurance proceeds in a manner that increases operating income, even if it means "bending a few rules." Although Pierre is undoubtedly sympathetic to the president's concern for the company and its employees, he also has obligations to the corporate office and to the company's shareholders to provide them with financial information that is useful for their decision making. Independent of how the current reporting issue is resolved, Pierre must ultimately decide whether he wants to continue in this environment. The constant pressure to find accounting treatments that benefit the company at the risk of placing himself in violation of professional reporting standards may be too high a price to pay.

THE AKER COMPUTER COMPANY

By Russell F. Briner, CPA

Abstract

Aker Computer Company, which has been a successful business, is now facing mounting losses, and some of its accounting choices have been called into question. Read the following case facts and determine if criticisms of the company's accounting are justified. Does Michelle Sanders have reason to be concerned?

Background

Randall French, the chief financial officer of Aker Computer Company, swiveled his chair to look at the view from his 10th floor office at company headquarters. He had just received a call from Michelle Sanders, chair of the audit committee of the board of directors. Michelle had told Randall that she would like him to meet with the audit committee on Friday (today was Wednesday). The topics of concern were some accounting questions raised by Barker and Staples, LLP, the company's independent auditors. The auditors wished to discuss some questions related to items on the 2000 financial statements that they had discovered in the just-completed audit fieldwork.

Aker Computer had begun its operations in 1990 when Mark Aker, the chief executive officer, had left a large personal computer maker and formed his own company to make and sell PCs. Because of Mark's entrepreneurial and managing skills the company had grown rapidly. The company had issued an initial public offering in 1995 and Randall had been hired that year as the company's first CFO. Aker's revenue had risen to \$1.926 billion by 2000 and the net income for 2000 was set currently at approximately \$39 million. The audit for 2000 was in its final stages.

The return on net sales was just over a 2%. This return was less than the 3.5% return of 1999 and the 9.8% return, the highest ever, of 1998. During 1997, because of lagging sales, the company had created a new division, AirDiscount.com, which offered discounts on airfares to Internet shoppers. Aker Computer had also purchased PAS Software, which installed software for accounting systems. These two moves had increased revenue and profits in 1998. In 1999 revenues increased, but the return on sales decreased. Randall French knew that the first quarter of 2001 would likely generate the first net loss from operations the company had suffered since the IPO. This loss was likely to exceed \$30 million just for one quarter!

Randall was perplexed about Michelle's call because he had met just last week with Ken Staples, the partner overseeing the Aker audit. Ken and Randall had discussed some of the problems with the financial statements. Although there was not complete agreement between the two, Randall felt that he had justified to Ken that the financial statements of the calendar year 2000 conformed to generally accepted accounting principles.

Ken Staples had contacted Michelle Sanders because of three different areas of concern on the 2000 financial statements. The first related to the Aker Computer's practices of handling the sales of personal computers, while the second touched on revenue reporting by AirDiscount.com. The third

the handling of software installation contracts by PAS Software. After the CPAs' discussion with the audit committee, the committee decided it wanted to hear Randall French's views on the questions raised.

Sales of Personal Computers

Aker Computer Company's normal practice was to record revenue on sale of PCs when they were shipped to the customer. All shipping terms were FOB shipping point. Over the years Aker had developed some continuing relationships with various corporate buyers who regularly purchased large quantities of PCs. Usually, these corporations placed purchase orders followed by a written sales agreement signed by both seller and buyer. In the last week of 1999 (Aker's fiscal year was the calendar year), Aker had received purchase orders totaling \$20 million. Aker had signed the sales agreement, but the buyers had not signed them until January of 2000. Aker recognized the sale of \$20 million in December of 1999 and Barker and Staples had made no comment on this practice during its audit of 1999.

In the last week of 2000 Aker received purchase orders of some \$9.2 million on which sales agreements were not yet signed. Ken Staples now maintained that the sale was not complete until the agreements were signed. In both 1999 and 2000, the PCs had been shipped to the buyer in December. Randall French had noted the practice of recognizing the revenue from 1999 and thought that Ken Staples had agreed to it.

Another issue Ken raised centered on \$5.6 million in sales related to purchase orders received from a company that had purchased large numbers of PCs in the past. The purchase order was received and filled in December 2000, but the PCs were not shipped because the buyer indicated that renovations were under way and space would not be available in their business location until April 2001. Aker segregated the PCs in its warehouse and labeled them as sold. Revenue was recognized in December 2000. The buyer had not entered into a written sales agreement in the past, but had taken delivery and subsequently paid upon the shipment and receipt of the PCs. Staples argued that revenue had not been earned and should not be recognized. French argued strenuously that—based on past practice—the sale was essentially complete.

Airfare Discounts

When PC sales started lagging in late 1996 and 1997, Sue Liker, vice-president of marketing, had an idea. Sue had joined Aker from an e-commerce venture that had been successful in creating new types of sales. Sue went on to create an Aker division called AirDiscount.com, which would create online sales with a minimum cost. AirDiscount.com, the seller, booked airfares for customers at a discounted rate. Customers contacted AirDiscount online with a request for travel by air to a specified location. AirDiscount searched for the lowest fare and offered it to the customer at a price slightly above AirDiscount's cost. If the customer accepted, AirDiscount completed the sale. In 1998 and 1999 this division was successful and generated over \$200 million in total revenues. Direct costs in those two years were about \$190 million. In 2000, the division revenues decreased to \$50 million while costs totaled about \$70 million.

AirDiscount.com recognized the amount of the sale in revenues and the cost of the airfare to AirDiscount in cost of goods sold. It purchased the airline ticket from the airline before it resold it to the seller. The airline ticket was purchased only when the seller acknowledged it would buy the ticket. AirDiscount required a credit card number from the potential buyer before it searched for the airline ticket.

Ken Staples had proposed an adjustment reversing the revenues and related costs previously recognized in 1998 and 1999 (\$190 million in revenues) and the \$50 million revenues in 2000. Only the net amount of revenues and costs would then be shown on the financial statements. Randall French had vociferously protested this adjustment. Ken had said he would think about it. Randall had not heard from Ken so he assumed Ken had dropped his proposal for the adjustment.

The PAS Subsidiary

Still on Wednesday, Randall called Pamela Martinez, the controller for PAS Software Corp., the subsidiary purchased in 1998. Randall told her about the coming meeting with the audit committee and asked for information on revenue recognized in 2000 on a PAS software installation contract with Crain Aviation Co. The revenue recognized during 2000 on this contract had totaled \$30 million. Randall had become very animated in the discussion. He was upset to learn only two days before the audit committee meeting that this amount of revenue was in question and he had not been informed.

Pam had definitely felt threatened by Randall's tone. Her discussion with Rick Tanner, audit manager at Barker and Staples, had involved some questions about software installation accounting issues, but Pam felt she had answered them adequately. The Crain Aviation contract, which had been signed early in 2000, was for \$50 million, with a completion date sometime in early 2002. After requesting information on the progress of the software installation from the PAS software engineers, Pam had been told by one engineer that he estimated 60% of the contract would be complete at the end of 2000, while another had estimated only 35% of the contract complete. When Pam asked about the difference, each had stood by his estimate. Costs incurred in the contract at year-end were about 40% of the total estimated costs while payment for about 20% of the contract had been received at the end of December 2000.

In conversations during the past year, Randall had often mentioned to Pam Aker's falling sales and the issue of developing a positive approach in finding ways to increase profits. As the year progressed, Pam had felt under a lot of pressure to show positive operating results from PAS. However, she felt very strongly that she not stooped to doing anything unethical.

A Final Resolution

Michelle Sanders sat in her office at Main National Bank on Thursday pondering the circumstances at Aker Computer. As chief executive officer for a local bank in the city where Aker Computer was headquartered, Michelle felt a strong attachment to Aker. After Mark Aker learned of the audit committee meeting on Friday, he told Michelle that she as chair could make any recommendations to the board that she wished. Mark had also mentioned that the audit results would be released shortly.

He was very concerned that the prices for Aker stock—which had fallen recently—would be further adversely affected if the return on sales for 2000 dropped below the already informally publicized 2%.

The auditors concerns left Michelle with an uneasy feeling. Were Aker revenues and net income fairly stated? She had carefully studied the issues surrounding the concerns raised by Barker and Staples. She was considered to be the most knowledgeable audit committee member in the areas of finance and accounting. In her further discussion of the issues with Randall French and Ken Staples, both were adamant that their views were correct. What was Michelle Sanders to do?

Comments on “The Aker Computer Company”

Bob Stefanowski, CPA, CFE, M.B.A., is an adjunct professor at the Stern School of Business and holds an M.B.A. in Finance from Cornell University.

Michelle, as chair of the audit committee, must keep in mind her fiduciary responsibilities to Aker shareholders.

Michelle Sanders has a very difficult job as chair of the audit committee of Aker Computer Company. She must attempt to provide an independent view of the numerous accounting issues surrounding this company. This will be particularly difficult due to the recent problems with Aker’s financial results, the declining stock price and pressure from company management to show good results. However, Michelle must keep in mind her fiduciary responsibilities to Aker shareholders and complete her task independently and fairly. Michelle should consider the following responses to the issues identified:

Sale of Personal Computers

Aker’s negotiated terms of FOB shipping point would normally allow the company to record sales even if the goods had not reached the customer location by the accounting cut-off date. However, in this case, the customer had not yet signed the sales agreement accepting delivery of the product by the end of Aker’s accounting period. As a result, title had not passed to the customer and risk of loss remained with Aker. Therefore, the \$30 million sale recorded in December 1999 should be reversed and booked as part of year 2000 activity.

Similarly, the \$5.6 million sale recognized in December 2000 should be reversed based on the fact pattern described. The personal computers had not been shipped by the end of the accounting period and Aker did not have a signed sales agreement from the customer. Therefore, the company had no basis to record the corresponding revenue in 2000.

Airfare Discounts

Aker’s revenues for the AirDiscount.com business unit should be reported net in accordance with Emerging Issues Task Force Issue 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent. The strongest indicator that these results should be net is the fact that the airline is the primary obligor from the customer’s perspective. In other words, the customer will make the ultimate decision whether to select a particular airline or flight, not AirDiscount.com. As a result, Ken Staples’ position is correct: The adjustment to revenues and costs should be accepted, with only the net amount of revenues and costs presented.

PAS Subsidiary

Given the recent volatility surrounding PAS operations, Aker had taken a very aggressive accounting position by recognizing \$30 million (60%) of the total contract revenue. Michelle Sanders should consider recommending a completed-contract method of accounting for the Crain Aviation Company software development contract. Under this accounting method, income is recognized only when the contract has been substantially completed. Costs incurred during the life of the contract are capitalized as an asset until an actual billing is made to the customer. The asset remaining on the books represents total costs incurred to date, less amounts that have been billed. Given the variability of different contractor's estimates regarding the stage of contract completion, this is a more conservative and desirable way to account for the revenues.

Marshall Pitman, Ph. D., CPA, CMA, is Associate Professor of Accounting at The University of Texas in San Antonio.

Michelle should read the SEC's Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements, for guidance.

This case presents three issues that current financial executives may face that affect the quality of earnings reported to the public. Each example deals with potential problems involving revenue recognition methods.

The first issue is when to recognize revenue on the sale of personal computers. The main question in this example is whether a written sales agreement, signed by both the seller and buyer, is necessary for the sale to be complete. Aker's chief financial officer relied on the fact that this practice had been used in prior years without objection from the independent auditors. It would seem that consistency is one of main elements in revenue recognition. However, Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements, says that it presumes that contractual customer acceptance provisions are substantive and, therefore, revenue should not be recognized until customer acceptance occurs. Customer sign-off is the best evidence of customer acceptance. Accordingly, Aker's practice of recognizing revenue before the sales agreement is signed by both parties may be considered aggressive and, therefore, may not add to the quality of earnings.

The second issue involves reselling airline tickets through an Internet company that is an Aker subsidiary. As more companies establish themselves on the Internet, more potential financial reporting problems related to the quality of earning seem to appear. The main issue is whether to recognize revenue in the gross amount of revenue billed to the customer (and the cost of the ticket purchased by the subsidiary) or simply to record the net amount (the amount of revenue billed to the customer minus the cost of the ticket purchased by the subsidiary). One might wonder what difference it makes since both methods would result in the same gross profit. However, some investors have begun to value companies, especially dot-coms, based on a multiple of revenues rather than a multiple of gross profit or earnings. Accordingly, the difference in recognizing revenue may be very important in investors' perceived valuation of a company. EITF 99-19, Recording Revenue Gross as a Principal versus Net as an Agent, discusses whether a company should recognize the revenue as gross or net. Financial executives should use their professional judgment, based on several factors or indicators, in each case in determining whether revenues should be reported at gross or net.

The final example deals with how much revenue to recognize during 2000 on a software installation contract that will not be completed until 2002. During 2000 the controller of the subsidiary had recognized 60% of the contract price as revenue, based on one engineer's estimate of completion. However, another engineer estimated that the completion was only 35%. Costs related to project were about 40% of total estimated costs while payments for about 20% of the contract have been received. In this example, the subsidiary's controller has chosen to use the estimate that allows for realization of the highest amount of revenue because she felt great pressure to show positive operating results for the subsidiary. This appears to be somewhat aggressive, adding to the erosion in the quality of earnings. Based on Accounting Research Bulletin No. 45, Long-Term Construction-Type Contracts, it would seem to be more appropriate to recognize revenue not exceeding 40% of the contract. In this case, it appears that the controller may be able to choose between 40% (the amount of the cost incurred), 35% (the amount estimated by one engineer), or 20% (if future receipts are questionable) of the contract price.

RESTATEMENTS AT VESANIA NETWORKS

By Jim Moulton

Vesania told everyone they could grow 3% to 5% faster than the industry. Can Vesania Network recapture credibility with Wall Street?

Abstract

Lynn Holland, the new chief financial officer of Vesania Networks, quickly realizes the company's accounting practices reflect a desire to please Wall Street analysts. Examine the facts and determine the course of action you believe should be taken.

Background

"This move was absolutely necessary." Dorothy Jenkins, vice-president of public and investor relations, was speaking of the board's decision to fire Vesania's chief executive officer, Dan Gilbert, and replace him temporarily with Jeremy Cress, a former board member. "Investors have lost patience with us, and our business appears to be going from bad to worse."

The executive council was in an emergency meeting this October morning. Jeremy called the meeting in hopes of finding a group consensus on the need for significant changes, and he wanted to settle on a timetable for identifying remedial actions.

An exasperated division president, Bill Wilkins, proved that consensus was yet to build. "Our business isn't broke. The stock tanked. So what? This too shall pass. I'm not saying the board shouldn't have acted, and firing CEOs is how boards show they feel investors' pain. But we'll be back, maybe even next quarter."

Another division head said, "I don't see how you can be so optimistic, Bill. It's obvious we're late to the party in some sectors. We can't turn on a dime. Our time-to-market was never the best. I agree with Dorothy. We need real change."

The vice-president of corporate development added, "What we can and should do about our product mix can't be the problem. Analysts know our products and markets and nothing has changed that dramatically since last year. I think our problem is the widespread view that management is dysfunctional. Dorothy talks to reporters every day. I want to hear more of what she's hearing."

Feeling vindicated, Dorothy continued. "Management has no credibility, period. Why? Let me count the reasons. We kept saying our problems were behind us, or under control, or temporary, and that everything would be fine next quarter. It would be even better after that. Then next quarter comes. Boom! We're not going to make it. We issue another warning. We repeat the same litany. One pundit now suggests we schedule quarterly warnings.

"We never said we had real problems, that we had promised too much, that we simply couldn't deliver growth at the rate we said we could. We told everyone we could grow 3% to 5% faster than

the industry. This despite the fact that the industry is growing at 15%, despite the fact that we're huge, despite our getting most of our revenues from older technologies, where sales are declining.

"When we missed, we blamed the market, currency exchange rates, vendor supplies, timing of product introductions and 50 other reasons I don't even remember. It was never our fault. We never mismanaged. We weren't responsible.

"Investors just think we lied to them. Maybe Dan and the operations guys really believed what we fed the Street. Well, that's no consolation. If we weren't lying, we were stupid."

Nobody was anxious to comment, but Dorothy subsided. Lynn Holland, the CFO hired just six months before, considered how Dorothy must have felt. For months, Dorothy had upheld the official view on shortfalls when replying to angry investors who were losing three-quarters of their investment.

At last the vice-president of human resources spoke up. "I know everyone here realizes that our stock's collapse did a lot of damage. Morale is at an all-time low; 90% of outstanding options are under water; savings and retirement plans are devastated; and our best talent is leaving."

The general counsel added, "While we're discussing public perceptions, there's a host of class action suits, the kind you always see after a stock tanks. And in our case, because of our repeated guidance, it won't be so easy to get those suits dismissed. Another suit, small in terms of potential liability but quite harmful to perceptions, is a whistleblower suit. Lydia Paisano claims she was fired after telling Dan our revenue targets were unachievable. Notably, she cites our aggressive discounting and generous financing offers in prior quarters as a major obstacle to meeting future sales targets."

Jeremy glanced at Lynn. Just this morning they had discussed the adverse impact on the balance sheet from financing start-ups. Bill Wilkins asked, "What's wrong with discounts and financing? Those are standard practice among equipment vendors."

The counsel said, "Yes, it's common practice. But we were exceptionally aggressive. Lydia's allegations reinforce a perception we were managing earnings to meet analyst expectations. You know we also faced controversies about aggressive accounting. So beyond the negative perceptions, there's also a risk of Securities and Exchange Commission inquiries."

Lynn added, "I think it's pretty clear that some of our sales came from writing deals nobody else would touch. We've taken huge risks."

Bill was flustered. "Wait a minute here. We did this with our eyes open. We went after emerging carriers, especially abroad. They didn't have any money. We decided financing them was the right strategy: Win them as customers, then they'd keep buying from us. What suddenly changed?"

Lynn responded. "You're missing the point, Bill! Nobody's suggesting we give up on emerging carriers, or even that we stop using financing as part of our strategy for building share. The point is that we had this incredible string of earnings reports where we pumped revenues. That record's now beginning to resemble a stack of cards." After a short pause she added, "There's another point, as

long as you've raised it. In our current condition, I think we do have to tighten standards on financing. We don't have the resources, and we can't afford any more risk."

Bill spat back, "We're already falling short of sales targets and now you want to handicap us on financing?"

"In my opinion, we have no choice. We'll just have to compete on quality and service."

Bill searched the table, looking for support. No one offered any.

After several more hours of discussion and debate, Jeremy coaxed the meeting toward a close and summed up. "We're in for some tough times. We need to finalize a comprehensive plan within six weeks and announce it publicly by year-end."

The Problem

A few weeks later Fred Wilkins, controller, delivered an analysis of past performance that Lynn had requested. She had asked specifically where accounting decisions and methods were contributing to reported results.

Fred started with bad news. "Lynn, we have a problem. We just discovered that one of our sales teams wrote a contract giving the customer discounts on future purchases. We'll have to restate the earnings we just reported. It shouldn't have happened. It's a clear violation of policy. They just didn't communicate clearly with finance, and the submitted documentation was incomplete."

After further review, they called Jeremy and Dorothy and helped outline a press release that would alert investors to the misstatement and rescind earnings guidance for the next quarter. Lynn insisted it would be inadvisable to issue revised guidance, despite Dorothy's observation that the stock would be hit harder.

After hanging up, Lynn asked Fred, "Do you think we need a closer review of our revenue recognition practices?"

"It's already begun. In fact, that leads us right into our discussion of past performance."

That sounded alarming.

"Our sales process, our culture and Wall Street's demands together create a vicious cycle. The sales division makes its quota by loosening credit and raising discounts at quarter-end. That brings sales forward. The following quarter, they do it again, and so on. Over time they also get more aggressive. It's like an addict needing a bigger hit to get high. We've been doing this forever, but it was benign before our spin-off made us a public company. After that we had a fast-rising stock and everyone getting rich. We had an accident in the making."

Lynn prompted, "You seem to want to say something more."

“I don’t want you to misinterpret me. I believe our people have integrity. What I’m saying, I guess, is that the environment was ripe for some problems. With Dan’s direction, we got quite aggressive in setting sales targets. Sales felt the pressure. They pushed distributors to take delivery. I was once even asked if we could insert a distributor in front of our customers as a trick to boost sales and move inventories. We never did it, but you see what I mean.

“Then there’s another angle in this performance analysis. Take our financing of start-ups, for example. There could be a big difference between booked revenues and collections. We may collect most of it; I hope we do. But, in the meantime, especially with the economy heading South and capital drying up, there’s a legitimate question about how good those reported revenues were.

“Compounding the problem, from the standpoint of earnings, is the fact that, over two years, we reduced our bad debt allowance from over 5% of receivables to just over 3%.”

Lynn asked, “Are you saying reserves weren’t a function of experience?”

“I’m saying management judgment was that we were overly conservative two years ago, and reserves are set by management judgment.”

Lynn observed, “Some skeptics might suggest management judged meeting earnings targets more important than exercising its fiduciary duties.”

“Many managers believe they can either build reserves when results surpass targets or use a one-time catch-up after a string of bad quarters. That looks better than missing expectations by a penny or two to maintain reserves. And if you need a catch-up, you can exclude it from the pro forma results you talk about. Many analysts will play along and treat it as a nonrecurring item.”

Lynn observed, “But we’re including those uncollectible revenues in pro forma earnings when we book them. How does it compute to ignore the subsequent bad debts?”

“I’m just playing devil’s advocate. But it seems most analysts don’t really care, so long as your stock’s hot. They hear what they want. Of course, if the news turns bad”

“As we’re seeing,” Lynn said. “OK, I guess the same applies to inventory reserves. What else do you have?”

“I assumed you mainly wanted big things, things you can see in footnotes and such.” Lynn nodded. “Well, we had large restructuring reserves set up at the spin-off. We’ve been drawing against them for four years. They allowed us to do a lot of streamlining with no further impact on earnings. That strikes me as a performance issue.

“Then we also had reversals of restructuring reserves. The controversy here, if any, is whether it is prudent or ambitious accounting to estimate on the high side when you set up reserves.”

Lynn said, “It’s hard to fault a company for apparent prudence, but I know the pressure to take as big a charge as possible.”

“Next comes pension accounting. Since we changed methods in 1986, we’ve been amortizing the unrecognized gain on fund assets. It’s fully disclosed, but it’s a pretty big piece of our net and it goes largely unnoticed.”

“Every sophisticated investor knows about it,” Lynn said.

“Don’t get me wrong. I’m only saying that a large chunk of earnings has no connection to the demand for our products or the performance of our business.

“Taking it a step further, then, is our most recent change to pension accounting. We now recognize changes in market value more quickly. Given the bull market of the last decade, that change increased our pension income and also boosted earnings growth for the year following adoption. Again, it’s all disclosed, but I don’t recall any analysts quantifying the impact on earnings growth, and we sure didn’t highlight it.”

“I suppose we would have if it hurt comparisons?”

“No!” Fred said, in mock shock. “Well, those were the biggest items. But I’ve a word or two about some smaller items. First, we routinely make reclassifications and restatements that are immaterial without comment or disclosure. By some coincidence, though, these usually help comparisons. For example, because we told Wall Street we would lower SG&A in relation to revenues, we found opportunities to make reclassifications between costs and expense. In effect, some gross margin improvements were transformed into expense reductions. You get better press from cutting overhead than from savings in manufacturing and purchasing.”

Lynn observed, “When earnings growth depends too much on cost-cutting, that’s also often a cause for concern.”

“We knew cost-cutting had a limited shelf life. That’s why we became obsessed with top-line growth. If we could convince the Street we could grow faster than the industry and deliver on that promise, our stock would simply explode.”

“Hmm. It certainly exploded.”

“Yes. My last item is accounting changes we deem immaterial. For example, we changed from accruing all vacation pay at the start of the year to making monthly accruals.”

Lynn asked, “And you didn’t disclose that?”

“It was immaterial. We also argued we changed accounting for employee benefits all the time, so disclosing this one change was inappropriate.”

Lynn said, “Well, what’s done is done.” She could see that Fred had finished. “I see how you approached my question now, as how we portray earnings to investors. That’s not exactly the angle I expected, but it is really thought-provoking.”

Fred was pleased to discover that Lynn wasn't preparing to criticize his past accounting decisions.

She continued. "The accounting you discussed is entirely legal; it's in accordance with generally accepted accounting principles. You had your auditors' tacit acceptance of your accounting if not their wholehearted support. So the question really becomes one of how you'll spin your earnings. The final question is whether it's wrong to deliver what Wall Street wants, so long as you can do it legally. Good job! I want to think about this some more."

Three weeks later, Fred updated Lynn on the audit and the news was again bad. "We're going to need a bigger restatement," he said. "We have some additional issues with revenue recognition. We have another case in which sales offered future discounts and one case of a system that wasn't completely shipped. There's no choice but to restate for those. The larger issue isn't quite as clear-cut; it pertains to sales to distributors whose customers no longer want the equipment. The distributors want us to take it back. We haven't been able to confirm this, but the distributors claim they were promised we would."

The Choice

Later that week, Lynn was preparing for her meeting with Jeremy. He would be expecting her recommendations and comments on several issues. First, what should be in the restatement and how should the restatement be announced? Then she would need to propose characterizations of the deteriorating outlook for the coming year. More generally, and of much greater import, she needed to advocate changes in the company's approach to Wall Street expectations. Then she needed a position on further restructuring charges. Many of the executives were pushing for another "Big Bath." Last but not least, she needed to take action regarding weaknesses in the system of internal controls.

If you were Lynn, what would you do?

Comments on "Restatements at Vesania Networks"

Bob Stefanowski, CPA, CFE, M.B.A., is an adjunct professor at the Stern School of Business and holds an M.B.A. in Finance from Cornell University.

Vesania needs to inform Wall Street that short-term earnings will be hurt by the recent marketing activities.

As chief financial officer for Vesania Networks, Lynn needs to take immediate action in the following areas:

Restatement of Earnings

Vesania management has a moral and legal obligation to restate earnings for all errors that are violations of generally accepted accounting principles. The most troubling issues seem to surround Vesania's revenue recognition policies. For example, recognizing 100% of a sale that is tied to a future contingency is a clear violation of GAAP. If distributors did in fact have the ability to return product to Vesania for a full refund, then no revenue should have been recognized until the contingency period had expired. Similarly, if discounts were offered to stimulate sales, a portion of

the discounted amount should have been applied to offset current period earnings. Finally, no revenue should be recognized on any product that has not been shipped by the end of the accounting period unless title to the property and risk of loss has passed to the customer by this date. The Securities and Exchange Commission and the Financial Accounting Standards Board have focused on revenue recognition in recent years due to management abuses of the rules. Under the new rules, improper revenue recognition policies could even subject Vesania management to criminal penalties if a determination is made that fraud was involved.

Other potential areas for restatement include the reduction of receivable reserves from historical levels of 5% to 3% at year-end. Based on the company's declining fortunes, management should re-evaluate the adequacy of reserves and bring them back up to appropriate levels. Any other changes that were not in compliance with GAAP, whether or not material to the overall financial position of the company, should be considered for restatement.

Restructuring Reserve

Vesania's restructuring reserve should represent management's current estimate of charges that need to be taken to adequately restructure operations. Amounts in excess of those needed—"a big bath" in other words—should not be permitted. If the company has in fact overestimated the amount of reserves required in the past, then a subsequent reversal into income would be allowed. However, this reversal should be identified as "non-core" earnings and should not be included in earnings from continuing operations. This will help investors to analyze the true results from operations versus the impact of one-time, extraordinary events.

Wall Street Approach

Vesania's restatement of earnings must be communicated to Wall Street through an amended SEC filing, along with a description of the reasons for the revisions for analysts. Lynn should be honest and straightforward about the company's problems as well as management's plans to improve results. Vesania got itself into trouble through its effort to build sales, net income and market share, including:

1. Aggressive discounting and financing to distributors.
2. Aggressive marketing to emerging carriers, especially abroad.
3. More liberal credit policies to improve margins and stimulate earnings.
4. Efforts to push product sales through distributors.

Although aggressive and ill advised, management's actions were an attempt to grow the company to improve shareholder value. Lynn should try to assure Wall Street that the company will be more disciplined in its management practices going forward. Vesania will no longer sacrifice net income to gain market share. The company will still grow its core markets, but it will do so more carefully while maintaining a profit discipline. Vesania should institute a more formal system of internal controls for the early detection and elimination of the aggressive accounting tactics used in the past. Vesania needs to inform Wall Street that short-term earnings will be hurt by the recent marketing activities. However, by following a more disciplined and steady growth plan, Vesania can hope to regain its long-term profitability.

Carol A. Purcell, CPA, is the Chief Financial Officer at the Roman Catholic Archdiocese of Newark (NJ).

Carol spent 10 years at Coopers & Lybrand specializing in hospitals and not-for-profit organizations, in addition to having experiences in large commercial organizations. Following her years at Cooper & Lybrand, Carol was a senior financial executive at a major hospital corporation in Northern New Jersey, before taking her current position as CFO at the Roman Catholic Archdiocese of Newark.

As the new chief financial officer of Vesania Networks, one of Lynn Holland's tasks is to establish credibility with the investment community.

When an institution relies on investment returns to fund operations and pension obligations, the integrity of financial information reported to analysts is obviously a concern. As the new chief financial officer of Vesania Networks, one of Lynn Holland's tasks is to establish credibility in reporting information to the investment community. While further deterioration in stock price will be painful, she has a cooperative chief executive officer and management team.

This would seem like the right opportunity to correct any lingering problems and start building a successful business plan. Lynn will need to coordinate any discussion of past business practices with legal counsel in light of the class action suits.

Obviously, any restatement of earnings would have to be of a material nature. Lynn should discuss with the external auditors which items should be included in the restatement.

The reclassifications are characterized as immaterial and therefore are not subject to any further discussion.

Assuming the business fundamentals are sound, the deteriorating outlook for the coming year can be categorized as a result of developments in emerging markets requiring closer review and tighter requirements for the extension of financing terms.

In conjunction with the management team, Lynn should develop changes regarding dealing with Wall Street. A uniform corporate culture supporting honest dialogue needs to be created. The CEO should advocate this approach and set the example. As mentioned before, if the company's business fundamentals are sound and a talented management team is in place, the market will eventually reward performance. Keeping track of the strategies to meet earnings projections is demoralizing and distracts management from real business issues. Quarterly earnings releases tend to take priority over more important matters. The company should accept that being a "value stock" for a while is not all that bad.

As to restructuring charges, Lynn should address the issue with the external auditors to learn their position on these charges as well as on writing down any reserves. If they can develop an agreed-upon framework, it should deter outside pressures to use the reserves to meet earnings projections.

Finally, the weaknesses in internal controls should be addressed immediately. Once efforts have been made to communicate the bad news to the public, and the management team has established credibility with all interested parties, it would be foolish to allow these weaknesses to remain and create opportunities for recurrent earnings problems.

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Dan's practice is limited to consulting services, including litigation involving accountant's malpractice issues. His most recent book is *Audit Committees: A Guide for Directors, Management, and Consultants* (Aspen Law & Business).

Fraud starts with UNDUE PRESSURE to make the numbers, which are frequently extremely aggressive.

Vesania Networks is a classic example of earnings management apparently crossing the line from acceptable to unacceptable (in other words, deliberate misstatement of financial statements). Vesania has a host of problems, including:

- A 75% decline in shareholder value.
- Lack of credibility with its shareholders.
- Class-action lawsuits.
- A whistle-blower lawsuit.

Earnings management covers a wide variety of acceptable and unacceptable (i.e., fraudulent) company actions. Some of the earnings management efforts at Vesania involve legitimate discretionary choices of, for example, when and in what amount to grant discounts to customers. Such decisions increase or pump revenue and recognize that revenue under generally accepted accounting principles. This, of course, is acceptable under GAAP. Other actions—such as (1) reducing the bad debt allowance, (2) building up reserves to use in bad times and (3) drawing against restructuring reserves to reduce expenses unrelated to the restructuring—appear to be questionable and perhaps even fraudulent.

Vesania suffers from a culture that promotes playing with the numbers. In addition, the company apparently has significant deficiencies in its control system both at transaction levels (e.g., as revenue recognition) and at higher levels (e.g., oversight of its financial reporting policies and controls via its audit committee).

What must the acting chief executive officer and the new chief financial officer do? They must immediately clean up the accounting mess and make the required restatements and related disclosures. They must recognize that misreporting doesn't typically start with dishonesty. Instead, fraud starts with UNDUE PRESSURE to make the numbers, which are frequently extremely aggressive (e.g., an unreasonable growth rate that in Vesania's situation is 3% to 5% faster than the industry). Fraud usually starts out small and in areas involving accounting estimates (e.g., bad debt allowance and estimated liabilities) in which management thinks that it is still close enough to GAAP. Eventually, actions go beyond acceptable earnings management practices and cross the line into fraudulent financial reporting. The CEO, CFO and Vesania's board of directors and audit committee must change the company culture and establish one that communicates an unrelenting insistence that numbers are not to be massaged. That is, an unrelenting insistence upon truthfulness as the foremost objective of Vesania's financial reporting.

THE CASE OF BARTER TRANSACTIONS AND REVENUE RECOGNITION

By Chris Baker

Matt, eCrawler's curmudgeonly chief financial officer, wants this business to work with every bone in his body. Can he see his way through the company's planned IPO?

Abstract

eCrawler.com is entering the home stretch on the road to its initial public offering. Dreams are soon to be realized. Two significant deals are closing that, taken together, should drive eCrawler through a successful public financing. But upon closer review in light of recent Securities and Exchange Commission and Emerging Issues Task Force barter revenue interpretations, the two defining agreements may not afford recognition of the anticipated revenue. Without the momentum generated from this revenue, the entire IPO could sink. What should eCrawler.com do? Examine the facts and determine the course of action you believe should be taken.

Background

Matt Thurman was clearly frustrated as he prepared for his revenue update meeting with Ben Caliori, eCrawler.com's dynamic chief executive officer. Matt, eCrawler's curmudgeonly chief financial officer, wanted this business to work with every bone in his body. Matt had already invested two long years at eCrawler helping to take it from an idea to a real company. Matt had left a lucrative position with a respected financial consulting group to lead the financial and operations groups at eCrawler. Matt very much believed in the power of the Internet to reshape business and society. In particular, he had believed in eCrawler's vision and business plan. Now he wasn't so sure anymore. He was still very passionate about what eCrawler was trying to do. However, he was struggling to see his way through the company's planned IPO, which was less than two months away. As Matt reviewed the revenue numbers and two key contracts, he knew that some big decisions were in the making. He wasn't looking forward to his meeting with Ben.

eCrawler.com's business was to blanket the Web with custom-created specialized Internet search solutions. eCrawler was committed to delivering quality and highly relevant search results for business professionals. The frustrations that Web users experienced when querying the major Internet search portals provided the opportunity and niche for eCrawler. The Web sites and e-businesses that deployed eCrawler's tailored, private-labeled search engines paid eCrawler. eCrawler's customers were in turn rewarded with more and happier site visitors and Web customers.

The Problem

Matt and Ben met for lunch just outside their offices at a little San Francisco sandwich café catering to the South of Market dot-com crowd. "Ben," Matt began, "to date our revenues are generally in line with our projections and the expectations we've set. But I'm concerned about recognizing revenue on the wamSports search portal deal and also on our deal with iPortola. Without that

revenue we won't scale as projected and confidence in our business will be shattered before our credibility can be built."

Ben was clearly frustrated and immediately tore into Matt. "Didn't we discuss revenue recognition as a management team and with our auditors before drafting those deals?! We knew we were slightly in the gray area, but as I remember we received a 'thumbs up' on both deals. Why now the cold feet? It is simply unthinkable not to record the revenues on those deals—we've worked too hard and invested too much." It was true that revenue recognition for each deal had been discussed on more than one occasion and that the auditors were briefed before the deals were completed. However, everyone on the management team believed that Matt would perform his magic and left the revenue issues for him to resolve. The auditors were gun-shy from the beginning and hadn't committed to any specific accounting treatment for the contracts. Ben had been briefed on the auditors' noncommittal position, but sometimes he had a selective memory.

Matt was not prepared to let Ben off the hook. The company's future was literally at stake. He replied calmly, "Ben, I know how far we've come. I also know many startups never get close enough to smell the success that we've already started to taste. We've been good and lucky along the way. And many times we've done what we've had to do to stay in the game. But now the stakes are higher—for me personally, for you and certainly for our accountants and the IPO investors who will rely on our financial statements. The SEC has been coming down hard on Internet companies reporting revenue from barter advertising deals. The rules are different for us than most other companies. We are developing a whole new economic landscape based on a new medium. Sometimes the rules may not seem to make sense, but that doesn't change our fiduciary duty to follow them. We can't lose sight of that and I'm sure in the end, our accountants won't let us."

While different in style and character, Matt and Ben respected one another immensely. Ben had vision and could motivate a company and its stakeholders (employees, managers, investors and board members) around that vision. They both knew the company needed them to work through tough issues together. Matt continued, "Let's just once again review one of the deals and see if we can find our way out of this."

wamSports produced Web portals for major sporting events, including the Olympic games, Super Bowl, World Series, NBA finals, NFL playoffs and Nascar. eCrawler had been selected as their exclusive search engine partner. "In that deal, we both know that to interface our product to all those different event databases will require no small investment in time and people on our part. We will also reach literally millions of people with our name and search services. And we know that we do search services better than anyone. The tricky part is that wamSports also knows that we are relatively unknown compared to the larger search portals and therefore required us to pay them for the marketing services they were providing us through reaching their audience. We knew that the deal was still very smart for us, and that over time we would get better terms as users came to depend on our high-quality search services. But the SEC seems to be taking a very tough stance in its interpretation of Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions. That appears to restrict our ability to recognize the revenues from wamSports. In effect, we might have to offset what we are paying them against what they are paying us, even though they are for very different things.

“To recognize revenue in a barter exchange,” he continued, “we must either determine the fair market value of the services we are providing or the fair market value of the services we are receiving as if cash were exchanged in the open market. If no value can reasonably be determined, then we have to use the carrying value of the asset we are giving up. The problem is that the SEC doesn’t easily accept the value of what we are receiving as justification to recognize revenues for our services when what we are receiving is advertising. And it will be no easier determining the fair market value of the services we are providing. The SEC wants us to show a ‘historical practice’ of receiving or paying cash for similar transactions. The current guidance on how to demonstrate a ‘historical practice’ is murky and still being developed. Also, given our company’s short history and evolution, showing any ‘historical practice’ will be difficult. I can’t think of a cash deal that we’ve done recently that would neatly fit the established criteria for being similar to the wamSports deal. In our favor is that we could probably get reasonably close by estimating the marketing value we are getting from wamSports using industry standards and attempting to look at similar deals wamSports has completed with other service providers. But that doesn’t technically meet the standards for ‘historical practice’ as they are currently being applied by the SEC. It doesn’t help that we are paying wamSports 30% more than they are paying us. Now of course, we want to record the full value of the wamSports revenue to show the continued revenue growth that we’ve projected and also to increase momentum for our IPO. I know it’s absolutely critical we recognize that revenue. I’m just not sure how to do it.”

Ben was growing impatient with Matt’s continued rambling. But he did understand that the accounting rules were changing and the very future of his company depended on navigating through this sea of revenue recognition. He also respected Matt’s opinions and concerns. However, he had a company to run and survival now was more important than perfect accounting.

Ben interrupted Matt. “Listen, we simply have to recognize these revenues. They are legitimate revenues for us. We are doing tons of work in addition to leveraging our already developed search content platform. What about the matching principle? Match costs with revenues. You accurately said yourself that we have costs associated with these deals. I want to meet with our auditors as soon as you can set it up to discuss our alternatives here.”

Matt knew that Ben was right in so many ways, but in the end none of that mattered. The SEC could change the rules as it pleased. Matt knew the upcoming auditor meeting would be difficult, but he was also hopeful it would be valuable. Time was running out on making these revenue decisions.

Comments on “The Case of Barter Transactions and Revenue Recognition”

Dan Hugo, CPA, is Director of External Reporting for EBay Inc.

Ebay pioneered a Web-based community in which buyers and sellers are brought together. EBay also engages in the traditional auction business and in online payment processing.

It appears unlikely that any significant amount of revenue could be recognized under the barter advertising arrangements.

Most of the questions that Matt and Ben raised during lunch have already been addressed by the EITF, which reached a consensus in EITF 99-17, Accounting for Advertising Barter Transactions,

establishing criteria for barter advertising transactions. Barter revenue can be recognized on advertising transactions only when an entity has a history of receiving cash (including marketable securities, or other considerations that are readily convertible to a known amount of cash) for similar advertising transactions. It is important to note that the company has to have a history of receiving cash for advertising surrendered. Accordingly, if a company only has a history of paying cash, it will not be allowed to recognize any revenue on these barter advertising transactions. The only way that advertising surrendered for cash can be considered "similar" to the advertising being surrendered in the barter transaction is if the advertising surrendered has been in the same media and within the same advertising vehicle (for example, same publication, Web site or broadcast channel) as the advertising in the barter transaction. In addition, the characteristics of the advertising surrendered for cash must be reasonably similar to that being surrendered in the barter transaction with respect to:

1. Circulation, exposure or saturation within an intended market.
2. Timing (time of day, day of week, daily, weekly, 24 hours a day/7 days a week, and season of the year).
3. Prominence (page on Web site, section of periodical, location on page and size of advertisement).
4. Demographics of readers, viewers or customers.
5. Duration (length of time advertising will be displayed).

In addition, an entity can only consider cash receipts during the last six months as evidence that it receives cash for similar transactions. However, if economic circumstances have changed so that prior transactions don't represent current fair value for the advertising surrendered, then a shorter, more representational period should be used.

A past cash transaction can only support the recognition of revenue on advertising barter transactions up to the dollar amount of the cash transaction. In other words, the total revenue to be recognized under barter advertising transactions can never exceed the amount of cash received for similar transactions during the last six-month period. Based on the facts and circumstances provided in the case study it would appear unlikely that any significant amount of revenue could be recognized under the barter advertising arrangements.

Lota Zoth, CPA, is Senior Vice President and Corporate Controller at PSINet Inc.

PSINet Inc is a global facilities-based provider of Internet access services and related products to businesses and also provides Internet Protocol and network backbone services. Prior to joining PSINet, Ms. Zoth was Controller and Chief Accounting Officer for Sodexo Marriott Services, Inc. (NYSE: SDH).

Author's note: The commentary below represents my own personal views and observations.

I advise that Ben examine the negotiations with wamSports—including the “give and take” that led to the arrangement in place.

In the start-up environment, it is very common for companies to exchange services for their mutual benefit. Accounting for these non-monetary exchanges, also known as barter transactions, has been cause for much discussion among finance and accounting professionals for many years. The governing principles are in Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions, and Matt has articulated them well.

The troubling comment made in the case is this: “It doesn’t help that we (eCrawler) are paying wamSports 30% more than they are paying us.” The term “paying” here seems to mean the value attributed to the services being exchanged. Presumably, Matt calculated this by reference to eCrawler’s price list. For example, for \$100 worth of advertising from wamSports, eCrawler provides \$130 worth of services to wamSports.

It appears that eCrawler made a conscious decision to discount its services by 23% (\$30 discount divided by \$130 regular price). This, of course, presumes that the wamSports advertising is at a regular, or fair market, value. All of these aspects would have to be thoroughly analyzed before coming to a conclusion.

While I empathize with Ben’s initial reaction, I strongly advise that he thoroughly examine the negotiations with wamSports—including the “give and take” that led to the arrangement in place. This retrospective view, along with Matt’s analysis of pricing from both parties, should provide a basis for eCrawler and its auditors to decide on the appropriate amount to recognize as revenue.

Paul Bialek, CPA, is Chief Financial Officer and Senior Vice President, Finance and Operations of RealNetworks, Inc.

RealNetworks is a provider of media delivery and digital distributions solutions designs for the internet.

The chief financial officer must understand the long-term economics of the product line.

Revenue recognition policies and practices must be constructed so that the economics of the business are reflected in the company financial statements. The case study highlights a number of issues to which financial officers need to be particularly attuned. When looking at a single contract, and the financial reporting treatment afforded to that agreement, focusing solely on a financing event is very short sighted to say the least.

In the case cited, the chief financial officer must understand the long-term economics of the product line, how the products are to be sold and how the customer is using them. He should also understand the product road map and the overall competitive dynamics of the market place. The second part of the evaluation is the market awareness of the company’s product, and its overall performance in real world conditions. Revenue recognition practices begin with the economics of the transaction and the nature of the product or service will often dictate best business practice. To start by focusing on revenue recognition will lead to maximizing short-term revenue with an unmeasurable long-term opportunity cost. This particular case study does not provide enough detail to answer many of the questions above, and given that the topic is accounting for barter transactions, they are likely beyond

the scope of this case study. However, this is the single most important decision that is being made. Best practices always start with an emphasis on long-term economics.

In terms of barter transactions, if the assets being exchanged do not otherwise have scarcity value, recognizing the barter transaction is plain and simple fiction. If the assets being exchanged are in substance the same product—advertising space for advertising space in a world where the advertising inventory otherwise would not have been sold to an unaffiliated entity for cash—it's fiction to reflect such a transaction in the financial statements as revenue.

This is not to say a barter transaction is a bad business decision. They often can be of mutual benefit to both companies. But for a barter transaction to have validity in a company's financial statements, I believe there must be scarcity value to the asset being transferred, and there should have been an equivalent ability to monetize the asset in a cash transaction with an unaffiliated third party. Likewise, the reverse end of the exchange must be an asset or service that the company otherwise would have purchased in the ordinary course of business. If both conditions are met, there is an alignment of interests with a financing technique used to effect the transaction. In this case study, it's more likely that the motivation was nothing other than to create fictional revenue momentum. Not only is this misleading to financial statements users, it can lead to practices in which bookkeeping is the primary consideration, not maximizing long-term economic return.

As to the financing event, there are two ways to approach it.

1. **From a business perspective.** Large adoptions of a company's product or service by industry leaders are hugely relevant and valid in their own right. The company should focus on articulating the near- and long-term implications of the deal with wamSports. How will this affect gaining new customers? How will the company generate cash-based revenues from these deployments? What is the revenue cycle—one-time or annuity revenue? What are the future product extensions?
2. **From a financial perspective.** If the public market financing event depended on the company's ability to show a barter transaction as revenue, then it is my opinion that the company is not yet ready to be publicly held. If a company is stretching to reflect a single transaction in its financial statements as a prelude to an initial public offering, it's highly unlikely that the company has sufficient visibility to its financial prospects to be a public company. The fact pattern in this scenario is more akin to a company still in the early stages of evolution—in which private equity financing is more appropriate. The barter transaction summarized in the case study does not have economic underpinning and is of limited value in assessing future revenues to be generated by the product.

Maureen F. McNichols, Ph.D., CPA, is Marriner S. Eccles Professor of Public and Private Management, Stanford University.

She is the author of "Does Meeting Expectations Matter: Evidence from Analysts' Forecast Revisions and Share Prices,"(with R. Kasznik), Stanford University Graduate School of Business working paper, 2001.

One option for eCrawler.com is to restructure its deal with wamSports to receive cash instead of advertising... and to pay cash for advertising services from other Internet companies.

The eCrawler.com case presents an Internet company shortly before a planned initial public offering. The chief financial officer is facing pressure from the chief executive officer to recognize revenue from two deals that do not meet the requirements of EITF No. 99-17, Accounting for Advertising Barter Transactions. The case suggests the business has a great future developing customized search engines that provide superior search results. This future is in question, however, if the revenue targets are not met before the IPO. My commentary addresses a number of issues that the controller should consider, based largely on research findings in the accounting literature.

Recognizing Revenue

The case suggests that the wamSports deal does not meet the EITF No. 99-17 criteria for recognizing revenue. eCrawler.com receives advertising in exchange for allowing wamSports users access to a customized search engine. The case also suggests eCrawler pays wamSports three times as much as it receives, so its net exchange is one in which eCrawler gives up cash and support of a search engine for advertising. The EITF criteria require recognition to occur at the fair value of what is given or received if it can be reasonably determined. The difficulty with the present transaction comes in valuing the advertising that eCrawler receives: This could be stated at many possible values if the Securities and Exchange Commission did not require an historical basis for the recognized amount.

One option for eCrawler.com is to restructure its deal with wamSports to receive cash instead of advertising, and to acquire advertising and marketing services from other Internet companies for cash. This would provide a more objective basis for valuing its revenues and costs.

The IPO

If that is not possible, eCrawler must then consider whether it can undertake the IPO as planned. Investment bankers involved in underwriting high tech IPOs indicate that a key factor in timing is having a financial model and related metrics that show consistent progress and predictability. These numbers need not comply with generally accepted accounting principles and may rely on non-financial data. eCrawler could consider documenting its progress using non-financial metrics. Research by Trueman, Wong and Zhang (2000) documents that investors use both financial and non-financial measures to value Internet firms. Specifically, gross profits have significant explanatory power for share prices, and the number of visitors to a Web site and the number of page views have explanatory power after controlling for gross profits. These findings indicate that investors in Internet companies access a rich set of information rather than relying exclusively on financial measures.

eCrawler could also consider presenting pro forma results showing what past revenues would have been if reported under the new standard. This may show a trend in revenue growth that is similar to what would be found under more aggressive accounting. To the extent that the revenue numbers are conservative, they can disclose information about deals that are being done for which revenue cannot yet be recognized, similar to order backlogs in manufacturing. Management needs to convey the essence of its financial story to its bankers and investors: how the financial model will translate into profits over time and what assumptions are being made in projections. Management should recognize, however, that the financial statements are not the only channel for communicating with

bankers, analysts and investors. Management also needs to consider the future as well as present consequences in setting its reporting policy. If there is a gamble associated with the realization of the advertising “revenue,” investors should be made aware of this so they receive an accurate picture of eCrawler’s earnings quality.

The controller should have a plan for what to do if the IPO is postponed. For example, the company’s cash position may be sustained through bank loans or by slowing growth. Although this may seem calamitous from the founder’s perspective, it is much less so than going public too soon and facing ever-increasing pressure to meet revenue targets and potential loss of wealth for the founder and eCrawler’s investors.

Research Literature

Literature on market efficiency indicates that prices aggregate information with considerable efficiency. Although several research studies find that investors misestimate the persistence of earnings, cash flows and accruals, the evidence also indicates that prices initially reflect a significant amount of the information in earnings and reflect it fully within a year. There is also substantial evidence that investors are fairly sophisticated in interpreting accounting numbers and that when there is adequate disclosure, investors place more weight on the components of earnings that are more persistent. For example, Beaver and McNichols (1998; 2000) find that investors anticipate over- and under-reserving by property casualty insurers, and assign lower (higher) share prices to those that underestimate (overestimate) their future claim losses, all else equal. This literature suggests that revenues that are not sustainable will ultimately be identified by investors and discounted relative to more sustainable earnings.

Another large part of the literature examines the behavior of share prices following IPOs. The research documents that newly public companies underperform their more seasoned counterparts significantly.⁸ Some researchers have hypothesized that this occurs because companies overstate their earnings before going public, and provide evidence consistent with that hypothesis.⁹ However, Beaver, McNichols and Nelson (2000) found no evidence to support this in their sample of property casualty insurers surrounding initial public or seasoned equity offerings. Lin and McNichols (2000) find that IPO companies receive overoptimistic growth forecasts and overly favorable recommendations from analysts affiliated with their underwriters, suggesting that investors may have less objective analyst coverage for these companies than for non-offering companies. Jones (1998) finds that the likelihood of shareholder suits increases significantly for businesses reporting revenue restatements. These findings suggest that newly public companies have a higher probability of experiencing negative returns and are the refore at higher risk of a shareholder suit, which would be increased even further with aggressive revenue recognition practices.

Other literature suggests that investors place a higher value on businesses that provide more disclosure to investors.¹⁰ Frankel, McNichols and Wilson (1995) find that companies accessing public capital markets are more likely to provide voluntary earnings forecasts. They are less likely to

⁸ See Ritter (1991), Loughran and Ritter (1995) and Brav, Geczy and Gompers (1999).

⁹ See Teoh, Welch and Wong (1998) and Rangan (1998).

¹⁰ See Merton (1987) and Botosan (1997).

do so immediately before securities offerings, however. Furthermore, forecasts issued before offerings are unbiased, suggesting that the legal sanctions associated with misleading investors before an offering are a significant deterrent to more optimistic projections.

Finally, research by Kasznik and McNichols (2001) documents that companies that consistently meet analysts' expectations are valued more highly by investors than would be expected based on their earnings. Companies meeting expectations in only one or two periods are valued based on their earnings but do not receive a reward for meeting expectations. Thus investors appear to reward companies that provide disclosure that allows analysts to more accurately set expectations that the company consistently meets.

Credibility First

To summarize, extant research suggests that any benefits to recognizing the revenue of the wamSports deal are likely to be short-lived and that the risks to the company and its stakeholders are considerable. The controller can best serve the company's interests and those of its shareholders by establishing credibility with the investment community and helping them to understand the promise of its technology, its business model and how its financial and non-financial measures reflect its progress and prospects.

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