

## Forensic Accounting Technical Notes: Revenue Recognition Control Structures

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Revenue recognition errors or irregularities account for over 70% of the allegations of financial accounting misstatements in securities litigation cases. These allegations typically involve: timing of recognition/out-of-period sales; contingent receivables; collectability; rights of return; and, matching of revenue with costs and expenses. In the extreme cases of out-and-out financial fraud, the schemes used to overstate or accelerate revenues (and associated assets, such as accounts receivable) include:

Out of Period Sales - Particularly in industries such as high technology, companies may receive a substantial volume of orders for products at the end of fiscal periods (i.e.- quarters). Holding open the books beyond period end can accelerate the timing of revenue recognition. Likewise, recording as sold products for which the transaction has not yet been consummated can overstate revenue in one period and understate it in the succeeding period when all of the contractual terms of sale actually are met. Those terms typically unmet at period end are contract signing, delivery or acceptance.

Bill and Hold - Transactions may be structured to appear to be a sale, in that an agreement is signed; however, the products are not actually delivered. Instead the goods remain with seller. This condition prompts the question of whether (or when) economic risk actually passes to buyer. Also, if payment terms are extended to some date subsequent to eventual future delivery of the goods, this calls into question the substance of the initial transaction - is it a completed sale, or merely a purchase commitment?

Consignment - While recorded as a sale, the actual terms of the transaction are structured by seller and buyer to be, in substance, a consignment arrangement. Particularly in transactions with distributors and other re-sellers (e.g.- OEM's), this scheme often takes the form of bill and ship to seller's warehouse, or extraordinary payment terms (i.e.- receivables which have terms of 90-, 120- or 180+ days, effectively matching their repayment with (and only until) the distributor has itself resold the goods.

Channel Stuffing - Unusual, end-of-period deals with buyers for sales of substantially more than normal orders of goods. In and of themselves, such arrangements may not be improper; however, if coupled either with consignment type conditions (e.g.- extraordinary payment terms) or rights of return (see below), these transactions may be non-sales.

Rights of Return - Such rights may legitimately exist in any valid sales transaction. However, when such rights of return are implied, or expressed in a side letter (see below), but not given effect to in the sales transaction, they may actually create a consignment arrangement, or constitute a contingent receivable (see below).

Side Letters - Sometimes a necessary element of a sales contract; sometimes the root of irregularity, involving undisclosed terms or conditions which change the economic and legal essence of the transaction in a way that negates a true sale. Examples include undertakings by the seller to credit the buyer for any unsold goods, or to provide future stock rotation rights, or to extend payment terms such that the transaction becomes a consignment.

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Contingent Receivable - Transactions with "straws" or related parties or companies lacking in the financial capacity to pay for the goods - any of these may create a gain contingency situation which is expressly proscribed by Statement of Financial Accounting Standards ("SFAS" or "FAS") No. 5, "Accounting for Contingencies."

Unrecognized Performance Obligations - Sales are recognized in full (or in substantial part) notwithstanding significant remaining unrecognized contractual obligations (express or implied) for: set-up, training, customization, modification, or additional deliveries of products or services.

The American Institute of Certified Public Accountants ("AICPA") Practice Alert 95-1, "Revenue Recognition Issues" discusses each of the above situations in detail, and provides additional examples of improper and unusual revenue recognition practices, such as:

- Transactions dependent upon customers receipt of financing from a third party.
- Sales with substantial uncertainty about seller's ability to comply with performance guarantees.
- Pre-invoicing of goods in process
- Recordation of sales for goods shipped in advance of scheduled shipment dates without customer's approval or consent.
- Improper application of the percentage-of-completion method of accounting (e.g.- use of improper measurement of contract fulfillment, or profit realization).
- Shipments based on canceled or duplicate orders, or to non-existent customers.
- Partial shipments of goods recorded as complete sales transactions, while remaining critical components remain to be delivered.

Each of these situations can lead to financial accounting misstatements which, if intentional, may constitute accounting irregularities. Each of these situations also represents a failure of internal control surrounding the revenue recognition process. Whether an intentional impropriety or accounting error, revenue recognition mistatements can be prevented (or their occurrence reduced) by a properly designed, implemented and executed control structure.

The Committee of Sponsoring organizations of the Treadway Commission ("COSO") defines internal control as: "...a process effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations.

Control structure in a corporation comprises its organization, operations, administration, information, governance and compliance systems. It pervades the organization with rules and regulations by which the entity conducts itself and its business, and with the business ethics by which the entity defines and achieves its values. Control structure also has governance and regulatory elements by which a corporation directs, measures and adjusts its actions. Finally, control structure mirrors the soul of an entity. It defines "the good" and professes a system of beliefs and practices by which the organization exists and by which it conducts its economic life.

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Control structure consist of a system of rules, regulations, policies, procedures, practices and measures employed by an entity to: (1) safeguard its assets and affairs from waste, fraud, inefficiency, diseconomic consequences, and unacceptable risk; (2) achieve accuracy and reliability in its accounting and operating data; (3) communicate accurate, reliable and useful financial accounting information; (4) ensure compliance with corporate policy, and with laws and government regulations; and, (5) measure and judge the efficiency of operations. Control structure keeps management informed as to whether company policy is being carried out, whether laws and government regulations are being observed and adhered to, and whether the company's financial position is sound and its operations are profitable and its inter - (and intra-) departmental relationships are harmonious. The basic elements of any good control structure are:

1. A logical plan of organization, which establishes clear lines of authority and responsibility, and which segregates the operating, recording and custodial functions.
2. An adequate accounting structure, including: (a) planning, budgetary and cost accounting techniques; (b) a chart, text, definition and description of accounts; (c) policies and procedures manual(s) setting forth applicable generally accepted accounting principles ("GAAP") and the companies procedures and practices for applying GAAP to its accounting transactions; (d) charts, diagrams and illustrative examples of transaction flows, accounting applications of GAAP and accounting practices; and, (e) internal control elements (i.e.- reconciliation and analysis procedures, review and approval requirements, checks and balances features, and standards for realization, validation, measurement, estimation, consistency, comparability, and materiality.
3. Information systems designed to identify, gather, process, store and disseminate accurate economic, financial and accounting data.
4. Business ethics and corporate governance standards and policies which are clear, absolute, communicated and monitored, and enforced.
5. Compliance elements which include: (a) "tone at the top" and management by good example; (b) personal responsibility and an "honor code" of personal behavior; (c) Board of Directors surveillance and governance through the effective workings of the board and key committees such the Audit Committee; (d) internal audit function that is independent of operating management and of the finance and accounting departments, and that is charged with the responsibility of continuous survey, evaluation, and reporting to chief executive(s) and to the Audit Committee; and (e) a vigorous and vigilant external audit program.
6. Personnel with the internal skills, ability, experience, and integrity required to perform satisfactorily the responsibilities assigned to them, and to understand and execute their duties - to the company, its policies and procedures, and to external rules and regulations (e.g.- laws, governmental regulations, accounting standards, ethical practices, etc.)

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### Revenue Recognition Control Structure Elements

- A. Business Ethics Policies
  - 1. Comprehensiveness as to:
    - a. Compliance with securities laws and SEC regulations
    - b. Adoption and compliance with GAAP
    - c. Standards of reliability, validity and measurement of financial accounting information
    - d. Duties of care to challenging improper accounting or reporting
  - 2. Articulation of process for resolution of potential business ethics concerns
  - 3. Internal audit charter
    - a. Operational, financial accounting, and compliance scope of work
    - b. Direction to internally audit financial accounting transactions, account elements, and balances
    - c. Reporting duties and authority
    - d. Specific responsibility to review and evaluate corporate accounting policies and procedures for adherence to GAAP
  - 4. Articulation of compliance standards in respect of:
    - a. Confidentiality of information
    - b. Insider trading and buying and selling of company securities
    - c. Gifts and entertainment
    - d. Foreign Corrupt Practices
    - e. Dealings with competitors, suppliers, agents and customers
    - f. False Claims Act ("FCA")
    - g. Securities laws and SEC regulations
  - 5. Business ethics training and continuing education
  - 6. Annual evaluation and reporting of business ethics compliance
- B. Compliance Systems
  - 1. Independence and objectivity of compliance monitoring and reporting
  - 2. Annual review of control structure for:
    - a. Identification of new law, rules and regulations
    - b. GAAP update
    - c. Reevaluation of accounting policies and procedures
    - d. Key control features
    - e. Related party transactions
    - f. Accounting applied to complex and/or "judgmental" transactions
    - g. Personal competencies of key accounting and other control structure individuals.
  - 3. Positive response survey of key accounting and control structure personnel
    - a. Acknowledgment of understanding and adherence to business ethics policies and practices
    - b. Inquiry into and response to any concerns as to accounting policies, procedures or practices, and as to the handling of any specific accounting transactions
    - c. Knowledge of any potential accounting irregularities or illegal acts
    - d. Recommendations to improve business ethics or corporate compliance
  - 4. Definition of accounting errors, irregularities and illegal acts, in respect of:
    - a. Revenue recognition practices
    - b. Earnings management
    - c. Documentation, support and validation of transactions
    - d. Estimates and forward looking financial information
    - e. Adherence to GAAP and SEC regulations
    - f. FCPA and FCA laws and regulations

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5. Business planning, forecasting and budgeting standards
    - a. Complete independence of financial accounting from responsibility for achieving business plan goals, revenue and profit targets, etc.
    - b. De-coupling of compensation for key accounting personnel from business plan results
    - c. Articulation of standards for setting reasonable targets and the use of reasonable assumptions and estimates
  6. External professional resources
    - a. Securities law
    - b. Information technology
    - c. Compliance reporting and monitoring
    - d. Internal control reviews
    - e. External auditors
      - i. Audit Committee independent consultant
      - ii. Audit plan development
      - iii. Coordination with internal audit
      - iv. GAAP and SEC compliance review
      - v. Evaluation of auditor performance
    - f. Corporate counsel
  7. Internal resources
    - a. Internal audit review
    - b. Compliance Committee review
    - c. Legal department review
    - d. Accounting department review
- C. Board of Directors and Audit Committee
1. Independence from management
  2. Frequency and timeliness with which meetings are held with:
    - a. Chief financial officer
    - b. Controller and other accounting officers
    - c. Internal auditor
    - d. External auditor
  3. Sufficiency and timeliness with which information is provided to Audit Committee (and Board) to allow for:
    - a. Monitoring of management's objectives and strategies
    - b. Assessment of the entity's financial position and operating results
    - c. Understanding of the terms, accounting nature of and specific details of significant agreements, transactions and economic events
    - d. Appraisal of sensitive information, significant estimates and judgments and other matters which may involve uncertainties
    - e. Inquiry into potential irregularities, improper or illegal acts, significant litigation, regulatory investigations, defalcations, misuse of corporate assets, illegal payments, violations of insider trading rules, etc.
- D. Organization Structure
1. Appropriateness of organization structure as to:
    - a. Chain of reporting and control between the Board, the CEO and the CFO
    - b. Relationship of the CEO, CFO, COO, and senior operating officers
    - c. Relationship of Internal Auditor to Board, Audit Committee, CEO, CFO, COO and senior operating officers
    - d. Organization of the financial/accounting department(s)
    - e. Relation of planning to accounting
  2. Adequacy of definition of key managers' responsibilities and duties, and their understanding of those duties
  3. Adequacy of internal skills, knowledge and experience of key officers

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- E. Assignment of Authority and Responsibility
  - 1. Assignment of appropriate levels of responsibility and delegation of authority to appropriate officers and employees
  - 2. Appropriateness of control related standards to job descriptions (i.e.- competencies required of: CFO, Controller, key accounting personnel, etc.)
  - 3. Appropriate number and level of jobs for key areas
    - a. Finance/accounting
    - b. Internal audit
    - c. Planning and budgeting
    - d. Plant-level accounting/control
- F. General Control Structure
  - 1. Policies, procedures and practices are well-documented and properly updated
  - 2. Internal control features and practices are identified and documented as to:
    - a. Segregation of key duties
    - b. Review and supervision
    - c. Review and approval of accounting entries
    - d. Dual control (and responsibility) for certain kinds (e.g.- amounts, types, account elements) of accounting entries
    - e. Rotation of duties
    - f. Adequate supervision of the: CFO, Controller(s), accountants with access to the general ledger, Treasurer, and personnel with access to cash and/or authority for cash transactions
    - g. Analysis and reconciliation of accounts
    - h. Review of significant estimates and accounting judgments
    - i. Analysis of contingencies
  - 3. Accounting research resources are adequate
  - 4. Accounting positions are adequately defined and described as to:
    - a. Responsibilities, duties and authorities
    - b. Accounting tasks
    - c. Task instructions for key job elements
    - d. Supervisor(s)
    - e. Reporting lines for:
      - i. Questions as to performance of tasks
      - ii. Accounting for unusual transactions
      - iii. Reporting of potential errors or irregularities
  - 5. Quality control over accounting policies, procedures, practices and accounting transactions or estimates or judgments
    - a. Procedures for second review of accounting principles and the interpretation thereof
    - b. Schematic or narrative instruction for handling complex accounting areas/transactions
    - c. Check lists for key accounting areas such as:
      - i. Account analyses and reconciliations
      - ii. Closing schedules
      - iii. Documentation of significant accounting transactions, estimates, and judgments

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### G. Accounting Principles

1. Accounting principles selected have general acceptance and comport with GAAP
2. GAAP is understood and applied appropriately
3. Information needed to apply GAAP is accumulated, classified and summarized in an appropriate manner and with sufficient reliability and validity
4. Accounting treatments are applied consistently, systematically and rationally
5. Changes in accounting principles or methods are identified, understood, and properly analyzed as to:
  - a. Appropriateness
  - b. Acceptability (or preferability)
  - c. Effects
  - d. Comparability and consistency

### H. Revenue Recognition Accounting Procedures

1. Contract review and conformation with GAAP
  - a. Review and abstraction by legal counsel
  - b. Parallel review and abstraction by accounting for compliance with GAAP (e.g.- SOP 97-2, "Software Revenue Recognition", FAS 5, FAS 48, "Rights of Return, etc.)
  - c. Documentation of key contract terms and their GAAP implications
  - d. Use of contract precis or abstract forms
  - e. Analysis of all side letter or other written modifications
2. Customer negotiations
  - a. Communication to customers of the company's express prohibition of any of its employees making any non-written contract modifications or side letter agreements
  - b. Requirement that all sales agreements be in writing
  - c. Understanding that all contract modifications, to be binding, require sign-off by designated management representatives/legal counsel
3. Documentation
  - a. Requirement of signed sales agreement on or prior to date of recorded transaction (and prohibition of all contract back-dating)
  - b. Requirement of evidence of delivery and acceptance on or prior to date of recorded transaction
  - c. Documentation of all significant deliverables (products and services) which constitute the recorded transaction, and evidence of their satisfactory delivery
  - d. Measurement of costs and expenses associated with recorded transaction(s)
  - e. Apportionment of costs and expenses associated with any significant undelivered/unfulfilled transaction obligations
  - f. Documentation of any express or implied rights of return
  - g. Measurement of objectively determinable estimates of returns
  - h. Specific analysis and documentation of accounting to be applied to all large or unusual sales transactions

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4. Percentage-of-completion accounting
  - a. Documentation of accounting principles and procedures to be applied under percentage-of-completion
  - b. Establishment of objective criteria for percentage-of-completion treatment for specific transactions
  - c. Regularly updated measurement of physical and budget-to-actual completion measures
  - d. Documentation of the reasonableness of the matching of revenue recognized with costs incurred
5. End-of-period sales review
  - a. Specific identification of material end-of-period sales for second review of the reasonableness of accounting therefor
  - b. Affirmative cut-off at period end, and absolute prohibition of post-period transaction recognition
6. Transaction review matrix
  - a. Second review of all material transactions for compliance with established company policies and revenue recognition procedures
  - b. Identification and resolution of any identified revenue recognition risk areas, including:
    - i. Timing of signed agreement(s)
    - ii. Delivery date(s)
    - iii. Existence of remaining deliverables
    - iv. Acceptance
    - v. Existence of performance guarantees, trial periods, etc.
    - vi. Continuing seller obligations
    - vii. Percentage-of-completion accounting and measurement
    - viii. Distributor arrangements
    - ix. Rights of return
    - x. Side letters or contract modifications
    - xi. Complex accounting areas (e.g.- SOP 97-2)
7. Auditing and confirmation
  - a. Regular internal audit reviews of sales contracts and transactions for compliance with company policies and procedures and GAAP
  - b. Audit Committee planning with independent accountants for audit emphasis on specific revenue recognition areas/transactions
  - c. Periodic confirmation with customers of all significant terms and conditions, including positive inquiry as to the existence of implied terms, contract modifications, rights of return, etc.
  - d. Post-transaction examination of sales for evidence that the facts upon which the transaction originally was recorded are supported by subsequent events (e.g.- absence of unaccounted for returns, no material modifications of original deal, no unusual credits, etc.)