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BY THE BOOKS

Eye Financial Statements For Signs of Future Woes

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Improper revenue recognition has been identified in numerous studies to be at the core of many of the major accounting frauds. But in today's world of heightened expectations, the mere risk of restatement may be just as perilous.

"Stretching the rules" or "managing earnings" can result in unwanted media and investor attention, leading analysts and fund managers to demand restatements that would more accurately reflect a company's performance. And, as we've learned, restatements -- like the discovery of corporate fraud -- usually lead to rapid, painful declines in share price.

With accounting-related woes the issue *du jour*, we thought it might be helpful to discuss some warning signs that could help you avoid a messy restatement problem.

Two of the most common warning signs are changes in the corporate policy on revenue recognition, and unusual fluctuations in revenue registered in the fourth quarter.

Let's consider revenue-recognition policies first. Changes in policy are usually noted in a footnote to a company's financial statement, and it can't be emphasized enough that those footnotes, especially the first that describes the accounting policies of the company, shouldn't be ignored.

Unfortunately, understanding a company's policy isn't as simple as determining whether the company records its revenue when the product is shipped or when the customer receives it.

Revenue recognition is made more complex by the increasingly service-based economy. Many companies, particularly high-tech companies, continue to provide significant services after the initial product is delivered. Without those additional services, the product might have little value.

In keeping with the principle of matching revenue and expenses, large portions of services revenue must be deferred over an extended period of time. For example, Microsoft segregates maintenance revenue and recognizes the income over the contract period.

The other way companies can manipulate their bottom lines is by recognizing revenue in periods earlier than required by generally accepted accounting principles. Significant revenue variations from the first three quarters to the fourth quarter may indicate a company is doing that, but such revenue volatility isn't always a smoking gun. Many industries are highly cyclical, and one quarter may be significantly stronger than the rest for its business. For example, software maker Intuit, which observes a fiscal year of Aug. 1 through July 31, traditionally reports much stronger revenue in its Nov-Jan and Feb-Apr quarters, due in large part to sales of its tax-preparation products.

Also, keep in mind that revenue-recognition issues don't necessarily involve fraud. In their recently published book, "The Financial Numbers Game," Charles Mulford and Eugene Comiskey discuss the difference between fictitious and premature revenue. "Premature revenue recognition and fictitious revenue recognition differ in the degree to which aggressive accounting actions are taken. In the case of premature revenue, revenue is recognized for a legitimate sale in a period prior to that called for by generally accepted accounting principles. In contrast, fictitious revenue recognition entails the recording of revenue for a nonexistent sale."

Sometimes determining whether revenue is being recorded properly is difficult for experienced professionals, so for average investors there are other warning signs that can indicate danger.

First of all, use common sense. If a company's policy seems odd to you, perhaps it will be odd to others too.

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You also wouldn't be the first to ask if **AOL Time Warner** had prematurely recognized its advertising or subscription income. The issue first cropped up in a 1996, when AOL was forced to write off \$385 million in deferred marketing costs, and 1997's fourth quarter, when the SEC forced the company to make \$32 million of accounting adjustments.

Also, keep in mind that there are several ways companies treat revenue, or prepare for the future, that can tip you off to potential problems ahead. While these tools are perfectly legal, the unsophisticated or conservative investor might want to avoid the more exotic revenue techniques in order to reduce the likelihood of a further portfolio meltdown:

Hedging -- Hedging strategies often involve derivative instruments. As recent news from **Electronic Data Systems** shows, hedging strategies can be very risky. Unless you have a Ph.D. in economics you might want to steer clear -- then again Ph.D.'s didn't seem to help those who ran the highly complex, and spectacularly unsuccessful Long-Term Capital Management hedge fund.

Swaps -- It doesn't matter if it is credit, currency, interest rate, or price swaps. Unless you are prepared to read all of the fine print, the only thing they seem to swap is your money for their profits.

Mark-to-market -- A great way to meet quarterly targets. If the company is a little short in meeting First Call's quarterly estimate, asset gains from market fluctuations might fill the bill. Finding an expert who will substantiate the valuation needed to fill the bill is getting a little tougher now, but not if the appraiser has a MAI designation (Made As Instructed).

Complex capital structure -- Enron may have taken this to a different level, but Peter Lynch and Warren Buffett have issued sufficient warnings about investing in things that you don't understand.

Related-party transactions -- Do you know which entity needs the revenue to meet its short-term targets and which one needs the tax loss? Management does. Be wary of companies that have more than a smattering of related-party transactions. (For more, see our [Aug. 29 column](#)¹.)

Regulators continue to fine-tune the process, though. In 1999, the SEC issued Staff Accounting Bulletin 101 that delineated the key criteria that must be met in order to recognize revenue. They include:

- Persuasive evidence that an arrangement exists
- Delivery has occurred or services have been rendered
- The seller's prices to the buyer is fixed or determinable
- Collectibility is reasonably assured

In May 2002, the Financial Accounting Standards Board decided that more guidance was needed and put revenue recognition on their project agenda. While the accountants are determining how to ensure that companies properly report their revenue, we would suggest watching out for "channel stuffers."

"Channel stuffing," is a very complicated concept, and we'll take a more detailed look at that sometime in the future. For now, if you want to read more, you can read Tracy Byrnes's explanation from earlier this year. ("[Too Many Thin Mints: Spotting the Practice of 'Channel Stuffing'](#)"², Feb. 7, 2002.)

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