# Financial Statement Fraud: The Boundaries of Liability Under the Federal Securities Laws

*By Richard C. Sauer**

## INTRODUCTION

The price of any publicly traded stock will normally reflect, as primary factors, its issuer's earnings history and other reported results of operations.[1] The accuracy of issuer financial statements, as filed with the U.S. Securities and Exchange Commission (SEC or Commission), is therefore fundamental to the efficient operation of the capital markets.[2] As demonstrated by the financial scandals that periodically afflict issuers of Exchange-listed and Nasdaq stocks, however, the operating results of public companies are not immune from manipulation.[3] The result is the dis-

* Richard Sauer, B.A., University of California (Davis), J.D., Loyola of Los Angeles Law School, S.J.D., Harvard Law School, is an Assistant Director in the Division of Enforcement of the Securities and Exchange Commission. As a member of the SEC staff, he had direct or supervisory responsibility for certain enforcement actions discussed in this Article.

The Securities and Exchange Commission as a matter of policy disclaims any responsibility for any private publication or speech by any of its members or staff. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or the author's colleagues on the staff of the Commission. The information in this Article is based entirely on public Commission releases and orders and financial press reports. This Article does not contain any nonpublic information.

1. Although it is largely market predictions as to the *future* performance of an issuer that drives its stock price, such predictions derive in significant degree from information about recent performance and analysis of trends in historical results. *See* OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES, Statement of Financial Accounting Concepts No. 1, ¶ 42 (Financial Accounting Standards Bd. 1978). Moreover, there are forward-looking components to the disclosure required of public companies. This includes mandated Management's Discussion and Analysis (MD&A) of business trends that may affect the issuer's future results of operation. *See* Regulation S-K, 17 C.F.R. § 229.303 (2001).

2. "An investor's willingness to commit his capital to an impersonal market is dependent on the availability of accurate, material and timely information regarding the corporations in which he has invested or proposes to invest." Relationships Between Registrants and Independent Accountants, Accounting Release No. 296, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,318, at 62,934, 62,936 (Aug. 20, 1981), *reprinted in* Matters Relating to Independent Accountants, Codification of Financial Reporting Policies § 601.01, 7 Fed. Sec. L. Rep. (CCH) ¶ 73,251, at 62,882 (2000); *see also* U.S. GEN. ACCOUNTING OFFICE, THE ACCOUNTING PROFESSION, MAJOR ISSUES: PROGRESS AND CONCERNS 26 (1996).

3. As of this writing, efforts to affix blame for Enron's collapse dominate the financial pages, but Enron is far from the first high-profile financial scandal and will surely not be the last. *See* ABRAHAM J. BRILOFF, UNACCOUNTABLE ACCOUNTING (1972) (discussing the persistence of financial fraud); Paul K. Chaney & Craig M. Lewis, *Earnings Management and Firm Valuation Under Asymmetric Information*, 1 J. CORP. FIN. 319 (1995); Reed Abelson, *Truth or Consequences? Hardly: Excuses Aplenty When Companies Tinker With Their Profit Reports*, N.Y. TIMES, June 23, 1996, at 3-1; Assoc. Press, *Former Media Execs Face Fraud Charges*, L.A. TIMES, Sept. 6, 1995, at D3; Ford S. Worthy, *Manipulating Profits: How It's Done*, FORTUNE, June 25, 1984, at 50.

tortion of the capital markets' ability to allocate investor funds to their best uses. And with the exposure of the fraud comes the evaporation of many millions of dollars in market capitalization.

Motives for deceit are readily apparent. A company's financial performance, as perceived by analysts and investors, will determine whether and at what price it can sell equity or assume debt.[4] Maintaining access to capital markets is a particularly acute concern for developing companies with immediate capital needs they cannot satisfy from operations. To attract sufficient capital to survive, particularly in competitive industries in which speed to market is critical, such companies often must display at least the promise of profits.[5] If they cannot do so truthfully, the temptation to fabricate sales may be powerful.[6] Even well-established companies, however, are covetous of the high price to earnings ratios with which the securities markets reward steadily rising earnings, and may adopt tactics to inflate or "smooth" earnings quarter-to-quarter.[7]

Other incentives for financial fraud imperil less directly the integrity of the income statement than that of the balance sheet. Incentives to inflate the value of a company's assets include the need of many companies to remain in compliance with lenders' debt covenants[8] or, in the case of regulated entities such as banks and insurance companies, with regulatory capital requirements.[9] Further, some particularly egregious balance sheet frauds have involved the recognition of fictitious assets or overvaluation of real assets so as to appear in compliance with listing requirements for the Exchanges or Nasdaq.

Corporate conduct is determined through the decisions of particular individuals, primarily company executives. A company engages in financial fraud only if its reasons for doing so are consonant with the specific motivations of the individuals who control its reporting process. This, for example, may be the result of compensation packages that tie executive salaries or bonuses to the financial performance of the company.[10] Sales personnel, moreover, are often paid on a commission basis, providing a substantial incentive to represent every transaction

4. *See generally* David Burgstahler & Ilia Dichev, *Earnings Management to Avoid Earnings Decreases and Losses*, 24 J. ACCT. & ECON. 99 (1997).

5. Greg Ip, *Growth Companies Feel Pressure to Book Sales*, WALL ST. J., Sept. 16, 1997, at C1; *see also* Pinnacle Micro, Inc., Accounting and Auditing Enforcement Release No. 975, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,490, at 63,639 (Oct. 3, 1997); SEC v. Polansky, Accounting and Auditing Enforcement Release No. 810, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,325, at 63,297 (Sept. 4, 1996).

6. *See Borrowing From Peter*. . . , INVESTORS NEWS DAILY, Sept. 21, 1995, at 1.

7. Chaney & Lewis, *supra* note 3, at 321; Brett Trueman & Sheridan Titman, *An Explanation for Accounting Income Smoothing*, 26 J. ACCT. RES. 127 (Supp. 1988); Elizabeth MacDonald, *FASB Rule Will Offer Walk on Wild Side*, WALL ST. J., Sept. 30, 1997, at C1.

8. *See* Mark L. DeFond & James Jiambalvo, *Debt Covenant Violation and Manipulation of Accruals*, 17 J. ACCT. & ECON. 145, 147 (1994); Amy Patricia Sweeney, *Debt-Covenant Violations and Managers' Accounting Responses*, 17 J. ACCT. & ECON. 281 (1994).

9. *See*, *e.g.*, Gunther Int'l Ltd., Exchange Act Release No. 37,073, 61 SEC Docket 2089 (Apr. 5, 1996); SEC v. Sands, Accounting and Auditing Enforcement Release No. 814, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,329, at 63,304 (Sept. 16, 1996).

10. *See* MARTIN S. FRIDSON, FINANCIAL STATEMENT ANALYSIS: A PRACTITIONER'S GUIDE 62 (2d ed. 1991); CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, Statement of Auditing Standards No. 82, (1997); SEC v. Grendi, Accounting and Auditing Enforcement Release No. 811, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,326, at 63,297 (Sept. 5, 1996).

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_957 05/17/2002 08:43AM Plate # 0 pg 957 # 3



as a consummated sale. In addition, many executives hold substantial positions in the stock or stock options of their employer, the value of which will be materially influenced by reported earnings.[11]

The specific motives for financial fraud will determine not only the likelihood of its occurrence but also the form it will assume. Company officers preparing to launch a management buyout, for example, may be tempted to manipulate earnings in the opposite direction from the upward trend they would otherwise seek.[12] Moreover, the sort of misrepresentations that occur in specific cases will be influenced by the company's business environment. The presentation of consignment sales as completed revenue transactions, for example, is most easily accomplished by a company that sells to a few large distributors whose interests are sufficiently intertwined with those of the company that they willingly participate in transactions structured to deceive.

Taking examples from SEC enforcement actions, this Article describes common techniques used to misrepresent the financial performance of public companies. Although changes that occur over time in the goods and services delivered by our economy also result in occasional adjustments in the way we measure business performance, the basic profit and loss dynamics of market capitalism remain reasonably consistent. This suggests a similar consistency in the basic mechanisms of falsifying measurements of performance. Indeed, beneath the surface novelty that characterizes the more successful financial frauds, there often lies some variation on a limited catalog of established themes. Hence, particular cases are selected for their generic implications.

In addition, this Article considers the present reach of the securities laws in remedying instances of financial misstatement. Not all conduct that may be described as earnings management is illegal.[13] For example, a company may properly delay the introduction of a potentially profitable new product until a reporting period when it might otherwise experience an embarrassing decline in earnings. Moreover, Generally Accepted Accounting Principles (GAAP) may permit a company substantial latitude to decide when it may book revenue or expenses.[14] For example, more than one accounting treatment is permitted in the valuation of inventory and allocation of depreciation expenses.[15]

It is precisely because earnings management is not per se illegal, and the valuation of assets and liabilities often contains an element of legitimate subjectivity that the line between aggressive accounting and violative conduct requires careful attention. Hence, this Article is concerned less with crude financial statement frauds, the legal implications of which are clear, than with those more sophisticated manipulations that test the ability of GAAP to clearly define the economic

11. *See* Robert W. Holthausen et al., *Annual Bonus Schemes and the Manipulation of Earnings*, 19 J. ACCT. & ECON. 29 (1995); Paul M. Healy, *The Effect of Bonus Schemes on Accounting Decisions*, 7 J. ACCT. & ECON. 85 (1985).

12. *See* Y. Woody Wu, *Management Buyouts and Earnings Management*, 12 J. ACCT. AUDITING & FIN. 373 (1997).

13. *See* Harry DeAngelo et al., *Accounting Choice in Troubled Companies*, 17 J. ACCT. & ECON. 113 (1994); Julie Hilsenrath, *On the Books, More Fact and Less Fiction*, N.Y. TIMES, Feb. 16, 1997, at 3-1.

14. *See* Roger Lowenstein, *Earnings Not Always What They Seem*, WALL ST. J., Feb. 15, 1996, at C1.

15. Chaney & Lewis, *supra* note 3, at 334.

substance of business transactions. The first half of this Article deals primarily with techniques of earnings management, including both revenue inflation and understatement of expenses; the latter half with the falsification of a company's balance sheet through inflation of assets or understatement of liabilities. It should be remembered, however, that the interactive nature of financial statements renders these categories imprecise. The misstatement of any item on a firm's financial statements will, in most instances, distort other items as well.

## EARNINGS MANAGEMENT

### REVENUE INFLATION

#### Illusory Transactions

Under GAAP, which controls the content of financial statements incorporated in Commission filings,[16] an issuer's reported revenues should reflect the culmination of its earnings process;[17] the company has sold its product or rendered its services and has received or is reasonably assured of receiving payment from its customer.[18] Accurate financial statements permit the reader to ascertain when market-based transactions have resulted in economic benefits to the company. By contrast, revenue fraud consists in portraying particular transactions as providing the reporting firm with greater, more immediate, or more certain economic benefits than is actually the case.

The most basic form of revenue fraud involves reporting revenue from "sales" or other transactions that have little or no economic substance.[19] If the company has a product, it is not selling in the volume claimed. SEC enforcement proceedings provide numerous examples of companies that have recognized revenue from fictitious contracts, circular or wash transactions, sales to straw entities, or sales subject to hidden contingencies or givebacks.[20]

16. Regulation S-X provides that financial statements contained in periodic reports that are not prepared in accordance with GAAP will be presumed to be misleading. 17 C.F.R. § 210.4-01(a)(1) (2001).

17. Revenue should be recognized when it is both realized (or realizable) and earned. RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES, Statement of Financial Accounting Concepts No. 5, ¶ 83 (Financial Accounting Standards Bd. 1984) [hereinafter CON 5]. CON 5 states that revenue is realizable when a product is "exchanged for cash or claims to cash" and revenue is earned "when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues." *Id.*; *see also*, Revenue Recognition in Financial Statements, SEC Staff Accounting Bulletin No. 101 (SAB 101), 64 Fed. Reg. 68,936 (Dec. 3, 1999); Thomas J. Phillips Jr. et. al., *The Right Way to Recognize Revenue*, J. ACCT., June 2001, at 39.

18. Advanced Med. Prods., Inc., Accounting and Auditing Enforcement Release No. 812, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,327, at 63,298 (Sept. 5, 1996); RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS, Accounting Research Bulletin No. 43, ch. 1, § A, ¶ 1 (Financial Accounting Standards Bd. 1953) [hereinafter ARB 43].

19. SEC v. Lowrey, Accounting and Auditing Enforcement Release No. 794, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,309, at 63,276 (June 19, 1996); Alan Kappel, Accounting and Auditing Enforcement Release No. 552, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,012, at 63,389-34 (Apr. 22, 1994).

20. *See, e.g.*, Indus Int'l, Inc., Accounting and Auditing Enforcement Release No. 1437, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,952, at 63,134 (Sept. 5, 2001); Cambridge Biotech Corp., Accounting and Auditing Enforcement Release No. 843, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,358,

Such extreme instances of revenue inflation appear to occur most often with development stage companies attempting to present themselves as evolving into profitable businesses.[21] These companies are often controlled by a small group whose personal assets consist primarily of holdings of their company's securities, and who are therefore strongly motivated to enhance the market value of those securities (as well as to support the company's continued access quarter-to-quarter the capital markets) by reporting earnings that increase steadily quarter to quarter.[22] Moreover, there will likely be fewer checks on management's financial creativity at Joe's Discount Software than a Fortune 500 company.[23] Not only do smallcap companies tend to operate in environments of rudimentary internal controls, but they may also have insufficient operating history to allow analysis of factors that, over time, indicate poor quality earnings, such as aging receivables.

The securities laws require that public companies implement and maintain internal controls adequate to ensure that the company's financial statements are in compliance with GAAP.[24] Moreover, Generally Accepted Auditing Standards (GAAS) require that auditors obtain evidentiary matter sufficient to support their audit opinions.[25] With respect to sales recorded during a particular reporting period, auditors typically expect to see invoices or purchase orders documenting customer orders and shipping documents evidencing that the products were in fact shipped during the period.[26] If product has been shipped to a location other than the customer's place of business, the auditors will require documentation that this was done at the customer's direction and that the customer has in fact assumed the risks and rewards of ownership.[27] In addition, auditors will test outstanding receivables by confirming amounts due with selected customers.

Thus, avoiding (or at least postponing) auditor detection of phony sales may require such measures as the creation of fraudulent invoices or shipping documents and the physical concealment of unsold inventory.[28] The papering over of

at 63,370 (Oct. 17, 1996); SEC v. Automated Tel. Mgmt. Sys., Inc., Accounting and Auditing Enforcement Release No. 735, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,250, at 63,136 (Nov. 2, 1995); Barbara Knapp, Accounting and Auditing Enforcement Release No. 558, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,018, at 63,389-69 (May 5, 1994).

21. Mark S. Beasley et al., *Financial Reporting Fraud; Could It Happen to You?*, J. CORP. ACCT. & FIN. 3 (May/June 2001).

22. Joseph Pereira, *Former Kurzweil Executives Charged With Falsifying Revenues Before IPO*, WALL ST. J., July 27, 1995, at B12.

23. For a discussion on the importance of internal control structures in avoiding fraud, see WILLIAM T. THORNHILL, FORENSIC ACCOUNTING: HOW TO INVESTIGATE FINANCIAL FRAUD 78 (1995).

24. Securities Exchange Act of 1934 § 13(b)(2)(B), 15 U.S.C. § 78m(b)(2)(B) (2000).

25. Specifically, the third standard of fieldwork, AU § 326.01, states: "Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit." *See* VINCENT M. O'REILLY ET AL., MONTGOMERY'S AUDITING, fig. 31.1, at 31-7 (12th ed. 1998).

26. *See supra* note 17.

27. Cypress Bioscience Inc., Accounting and Auditing Enforcement Release No. 817, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,332, at 63,308, 63,310-11 (Sept. 19, 1996); Advanced Med. Prods., Inc., Accounting and Auditing Enforcement Release No. 812, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,327, at 63,299 (Sept. 5, 1996).

28. *See, e.g.*, SEC v. Madera Int'l, Inc., Accounting and Auditing Enforcement Release No. 1453, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,968, at 63,168 (Sept. 19, 2001); SEC v.

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_960 05/17/2002 08:43AM Plate # 0 pg 960 # 6



bogus transactions is an integral part of such schemes and adds violations of the "books and records" and "internal controls" provisions of the securities laws[29] to the basic violations of the "reporting"[30] and "anti-fraud provisions."[31] In the Kurzweil case, for example, managers forged customer signatures on purchase orders and surreptitiously shifted goods between warehouses to conceal the existence of quantities of product.[32] Similarly, management at Midisoft Corporation falsely recognized as sales purchase orders obtained on an understanding that no product would be shipped until the customer gave further instructions. Midisoft then shipped product to a warehouse and obtained false documents to make it appear that the product had been delivered to customers.[33] Often, in such cases, the company manages to induce some degree of complicity from its customers. Cambridge Biotech Corporation, for example, arranged to have certain customers accept deliveries of product with no obligation to pay for it.[34] To resolve the resulting problem of outstanding "receivables" that would never be collected, the company structured various transactions to create the false appearance that it had purchased unrelated goods and services from its customers when it had actually bought back its own product.

*Money for Nothing: Lernout & Hauspie.* One of the most well-publicized accounting scandals in recent years concerned the Belgian software company Lernout & Hauspie. Among many other improper accounting practices attributed to Lernout by the financial press, and largely admitted by the company, was Lernout's recognition of phony revenue from a purportedly voracious Korean market for its "speech recognition technology."[35] It appears that Lernout's Korean unit induced

Lowrey, Accounting and Auditing Enforcement Release No. 794, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,309, at 63,276 (June 19, 1996); Troy Lee Wood, Accounting and Auditing Enforcement Release No. 852, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,367, at 63,395, 63,397 (Oct. 31, 1996); SEC v. Automated Tel. Mgmt. Sys., Inc., Accounting and Auditing Enforcement Release No. 735, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,250, at 63,136, 63,137 (Nov. 2, 1995).

29. Securities Exchange Act of 1934 §§ 13(b)(2), (5), 15 U.S.C. § 78m (2000); 17 C.F.R. §§ 240.13b2-1, -2 (2001).

30. Securities Exchange Act of 1934 § 13(a), 15 U.S.C. § 78m; 17 C.F.R. §§ 240.13a-1, -13.

31. Securities Act of 1934 § 17(a), 15 U.S.C. § 77g; Securities Exchange Act of 1934, 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5.

32. Mark Maremont, *Anatomy of a Fraud: How Kurzweil's Straight-Arrow CEO Went Awry*, Bus. Wk., Sept. 16, 1996, at 90.

33. William D. Kyle, Accounting and Auditing Enforcement Release No. 941, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,456, at 63,559, 63,560 (July 28, 1997).

34. Cambridge Biotech Corp. Inc., Accounting and Auditing Enforcement Release No. 843, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,358, at 63,370, 63,371 (Oct. 17, 1996). Two-way transactions between a company and its purported customers are fertile ground for revenue fraud. *See, e.g.*, Salvatore T. Marino, Accounting and Auditing Enforcement Release No. 1435, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,950, at 63,131, 63,132 (Sept. 4, 2001).

35. The company has disclosed that it is presently the subject of a formal investigation by the SEC, but no civil or criminal action has been filed by any agency against Lernout to date. However, a report of the internal investigation by Lernout (and released over the Internet) and written submissions of its auditors to the Belgian court handling the Lernout bankruptcy acknowledge that the company's accounting was fraudulent. John Carreyrou, *Jo Lernout Confirms Fraud in Korean Unit's Accounting*, Wall St. J. Eur., Mar. 5, 2001, at 4.

various obscure companies to place their "chop marks" on contracts for over $100 million in Lernout software. These customers had no ability to pay for the product and were provided by Lernout with side-letters obviating any such obligation unless they should happen to find a commercial application for the product.[36] These "sales" were in substance licensing agreements with no definite payment terms, and therefore not within hailing distance of genuine revenue transactions.[37]

On these facts, the company's accounting fraud might appear commonplace. What elevated it to a higher level of originality, according to published reports, were the tactics used to prevent detection of the sales' lack of substance. The difficulty for Lernout, as is typically the case in revenue frauds, was disguising the failure of the "sales" to generate actual cash. Rising to this challenge, Lernout purported to factor the receivables on a non-recourse basis to various Korean banks, obtaining in return deposits to Lernout accounts at the same banks. These deposits, however impressive they looked on Lernout's balance sheet, were not accessible to fund the company's operations. Rather, they were pledged through side agreements as collateral for the factored receivables.[38] The purported "no-recourse" factoring arrangements were therefore mere paper transactions. When the receivables proved uncollectible, over $53 million in these "restricted time deposits" reverted to the banks.

Lernout Korea, further, constructed circular transactions through related parties and, again, complicit banks, to give the false impression that a second group of Korean licensing agreements were throwing off cash to the company. First, they caused their original customers to transfer their Lernout licensing agreements to entities controlled by Lernout officers. The transferees then obtained bank loans to fund payment of ten to twenty percent of the amounts due under the transfer agreements. These payments were passed through from the original "customers" to Lernout, and presented to its auditors as actual cash payments from the licensees. The catch, however, was that Lernout, through additional "restricted time deposits," had provided full security for the loans taken by the transferees. When the scheme collapsed, that security was forfeited.[39] Boiled down to its essence, Lernout had loaned itself money through paid intermediaries and mischaracterized the transactions as sales.

Lernout is also reported to have manufactured income by selling technology licenses to numerous private companies, many established for the very purpose of engaging in transactions with Lernout, under the understanding that Lernout

36. Alkman Granitsas, *Are Your Employees Ripping You Off? As Corporate Fraud in Asia Becomes More Pervasive, Sophisticated and Difficult To Detect, Companies Have To Do More To Protect Themselves*, FAR E. ECON. REV., Mar. 8, 2001, at 42.

37. *See* John Carreyrou, *Lernout Unit Booked Fictitious Sales, Says Probe*, WALL ST. J., Apr. 9, 2001, at B2; Mark Maremont & Jesse Eisinger, *SEC Probe Focuses on Asian Revenues of Belgian Tech Firm*, WALL ST. J., Sept. 22, 2000, at A1.

38. *See* Mark Maremont et al., *How High-Tech Dream at Lernout & Hauspie Crumbled in Scandal*, WALL ST. J., Dec. 7, 2000, at A1.

39. *See L&H Founder Jo Lernout Discusses Reasons for Company's Failings*, GROOT BIJGAARDEN DE STANDAARD, Mar. 4, 2001, at 1; *How Lernout & Hauspie Lost Big in Korea*, ASIA WEEK (Apr. 20, 2001), *available at* http://www.asiaweek.com/asiaweek/technology/article/0,8707,106053,00.html.

would repurchase the licenses (or acquire the customer and thereby the license) at a later date.[40] The true relationship between Lernout and these customers was obscured by locating—or at least incorporating—the customers in far-flung areas of the world. The up-front payment of cash against these sales gave them a patina of legitimacy.[41] Whether the true source of these payments was Lernout itself or third parties acting, in essence, as credit facilities, the result was the same: an elaborate paper transaction that fraudulently inflated reported income.[42]

*Farming Equity for Income: HealthCare Services Group.* Although it may seem that revenue from transactions that provide no economic benefits to the issuer should always be seen as fraudulent, some companies have come close to financial alchemy in providing at least a superficial plausibility to such accounting treatments. One of the most inventive was the approach used by HealthCare Services Group (HSG), a provider of housekeeping and other services to nursing and retirement homes, to recognize gain on circular transactions in its own stock.[43]

Immediately preceding a $23 million secondary offering of its common stock in 1990, HSG recognized approximately $1 million in purported "gain" from the appreciation in market value of shares of its stock it had, two years previously, used to acquire a subsidiary of Southmark Corporation. When the acquisition met legal obstacles and was unwound,[44] shares were returned to HSG. The $1 million in purported gain represented the increase in market price of the HSG stock over the two years since the acquisition. This almost doubled HSG's pretax income for the quarter preceding its public offering. In a later quarter, HSG, without disclosure, washed $2.5 million in "gain" from additional returned HSG stock against charges that would otherwise have been recorded as expenses. The

40. *See* William Drozdiak, *Lost in the Translation: Voice-Recognition Firm's Failure Holds Painful Lesson for Europeans*, WASH. POST, Dec. 17, 2000, at H1.

41. *See* KPMG AUDITORS, REPORT OF THE CIVIL CO-OPERATIVE COMPANY WITH LIMITED LIABILITY (ordered by the Court of Commerce of Ieper by judgment on January 5, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law); Maremont et al., *supra* note 38, at A1.

42. *See generally* RESEARCH AND DEV. ARRANGEMENTS, Statement of Financial Accounting Standards No. 68 (Financial Accounting Standards Bd. 1982); *see also A&O's Verbeke Probed over Client's Accounts*, THE LAWYER, July 23, 2001, 2001 WL 11472753 (page unavailable on-line).

43. SEC v. HealthCare Servs. Group, Inc., Accounting and Auditing Enforcement Release No. 842, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,357, at 63,369, 63,370 (Oct. 16, 1996).

44. Among many other ill-fated ventures, Southmark had syndicated numerous limited partnerships to acquire and operate nursing and retirement homes. As general partner of over 200 of these entities, Southmark caused them to grant to American Services Company, a subsidiary created for this purpose, the right to bind the partnerships to twenty-year contracts for the provision of housekeeping and other services. Southmark then sold American Services, with these contracts as its only significant asset, to HSG for $16 million in HSG securities. (Southmark's initial recognition of most of this amount as profit did not survive its year-end audit.) This transaction soon drew fire from Southmark's limited partners, who concluded that Southmark had sold what was in truth a partnership asset for its own benefit. Consequently, Southmark and HSG amended their agreement to provide that the HSG stock transferred to Southmark would be allocated to the various partnerships, which could then, if they chose to cancel their contracts with HSG, satisfy the contracts' substantial cancellation penalties through release of their allocation of HSG stock to HSG. Over a period of months, most of these facilities did exactly that.

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_963 05/17/2002 08:43AM Plate # 0 pg 963 # 9



Commission alleged that HSG's accounting ran afoul of GAAP's general prohibition against the recognition of income from transactions in a company's own securities.[45] In addition, HSG's wash transactions constituted a failure to properly recognize period expenses.[46]

*Revenue as an End In Itself: Aura Systems.* While the usual purpose of booking sales with no economic substance is to increase reported earnings, not all such transactions affect the company's bottom line. Firms sometimes engage in "window dressing" transactions in which revenue is increased by means of pass-through or circular transactions that, due to offsetting expenses, have no effect on earnings. These transactions are usually intended to give the impression that a firm is moving into *potentially* profitable new areas, so that margins can be expected to improve with sales volume or after costs attributable to the initial expansion are satisfied.[47]

Aura Systems, a company that achieved little success in developing a commercial niche for its electromagnetic technology, inflated its reported revenues by arranging sham transactions unconnected to its core business.[48] It purchased computer monitors manufactured by another company and forwarded them to end users in prearranged sales, adding no value to the product while charging a "fee" for its services that roughly corresponded to the cost of shipping the product from the manufacturer to the end user. Thus, Aura had inflated reported revenue without improving its bottom line. The Commission made no finding of financial fraud,[49] but determined that Aura had violated the reporting provi-

45. Accounting Principles Board (APB) Opinion No. 9 states, inter alia: "the following should be excluded from the determination of net income or the results of operations under all circumstances: (a) adjustments or charges or credits resulting from transactions in the company's own capital stock . . . ." REPORTING THE RESULTS OF OPERATIONS, APB Opinion No. 9, ¶ 28 (Financial Accounting Standards Bd. 1973).

46. APB Opinion No. 9, states, inter alia: "net income should reflect all items of profit and loss recognized during the period . . . ." *Id.* ¶ 17. Because the company disclosed certain aspects of its accounting treatment for cancellation fees in its public filings, if in the opaque wording so often favored when disclosure is reluctant, the Commission action brought against HSG and certain of its officers did not allege this particular transaction to be fraudulent, but rather that the distortion it caused to the company's financial statements violated the reporting and books and records provisions of the securities laws. As described below, however, other HSG accounting practices were alleged to have violated the anti-fraud provisions.

47. Elizabeth MacDonald, *Something Lost in Translation?*, FORBES, July 24, 2000, at 122. This sort of transaction may have particularly appealed to dot.com companies attempting to convince analysts they were making a successful play for market share. Andy Kessler, *CreativeAccounting.com*, WALL ST. J., July 24, 2000, at A26.

48. Aura Sys. Inc., Accounting and Auditing Enforcement Release No. 839, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,354, at 63,360, 63,362 (Oct. 2, 1996); *see also* Jaye Scholl, . . . *and Aura Systems Signs a Consent Decree*, BARRON'S, Oct. 14, 1996, at 12. One such application involved the production of vests to be worn by consumers of "virtual reality" entertainment. Electromagnetic devices in the vests added a tactile dimension to the visual body blows provided by computer animation. Unfortunately for Aura, few consumers proved inclined to pay for the experience of being assaulted by their clothing.

49. *But see* Spectrum Info. Techs., Inc., Accounting and Auditing Enforcement Release No. 930, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,445, at 63,534, 63,540-41 (June 25, 1997). In that case, the company licensed patent rights to certain entities, which, in separate documents, it

sions by failing to make adequate textual disclosure about these transactions.[50]

A second series of transactions was more complicated if no more substantive. Aura booked $1.5 million from the sale of engineering services it never rendered and which were paid for with Aura's own funds, routed through a compliant third party.[51] The three legs of the transaction were papered with bogus purchase orders, one of which required a small flooring company to render "thermal and structural analysis and drawings" to Aura, the same services Aura was purportedly rendering to its "customer." The Commission determined that the recognition of revenue on a transaction so clearly constructed for no other purpose than to give a false impression of the company's operations was fraudulent, whether or not the revenue was offset with expenses.[52]

### Barter Transactions

Barter transactions involve swapping a non-cash asset owned by the company for another of supposedly greater value. The difference between the recorded value of the asset given up and the asset acquired is profit to the company. GAAP does not forbid the recognition of gain from barter transactions, so long as the asset valuations are appropriate, but the potential for abuse from exchanges of assets not carrying clear price tags is obvious.

Barter transactions that have resulted in enforcement actions have typically been transparent shams; the acquired assets either do not exist or are blatantly overvalued.[53] For example, the Model Imperial case[54] concerned a transaction that apparently had only a paper life. Model Imperial, a perfume wholesaler, contracted to exchange inventories of perfume, carried on its books at $200,000, for "barter credits" it claimed could then be exchanged for advertising, travel, or other services. It valued the "barter credits" at $1.5 million and thus reported a $1.3 million

agreed to pay "advertising fees" that were scheduled to precisely offset amounts due under the licensing agreements. Spectrum immediately recognized as revenue amounts due under the "licensing agreements" while deferring amounts payable under the "advertising agreements" into future periods. In a settled administrative proceeding, this practice was found to violate the anti-fraud provisions. *Id.*

50. *Aura Sys.*, Enforcement Release No. 839, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,366. Specifically, the Commission found that Aura should have disclosed and discussed these "significant components of revenues" under Regulation S-K, items 101(c)(1)(i) ("Description of Business") and 303 ("MD&A"). *Id.* at 63,365.

51. James F. Peltz, *Aura Systems Settles SEC Fraud Case*, L.A. TIMES, Oct. 3, 1996, at D2.

52. *Aura Sys.*, Enforcement Release No. 839, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,365-66.

53. *See, e.g.*, SEC v. Itex Corp., Accounting and Auditing Enforcement Release No. 1175, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,682, at 63,210, 63,210-11 (Sept. 28, 1999) ("The barter deals involved difficult-to-value assets, such as artwork, pre-paid advertising due bills, and worthless stocks in public companies. Some . . . deals involved purely bogus assets such as leases on vacant property, a non-existent stamp collection, and highly-questionable unpatented and undeveloped mineral claims."); SEC v. Tendler, Accounting and Auditing Enforcement Release No. 1168, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,675, at 63,204 (Sept. 28, 1999) (involving obsolete products); SEC v. Human Edge, Accounting and Auditing Enforcement Release No. 136, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,605, at 63,031 (June 9, 1987) (involving dubious advertising services).

54. SEC v. Ickovics, Accounting and Auditing Enforcement Release No. 1186, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,693, at 63,225 (Sept. 28, 1999).

gain on the transaction. None of the "bartered" perfume, however, ever left Model Imperial's warehouse and the company never sought to use any of the "barter credits" obtained in exchange.

In this case and the other barter cases cited above, the Commission paid little heed to accounting niceties, simply labeling the transactions fraudulent and leaving matters at that.[55] It will undoubtedly occur, however, that more sophisticated exercises in earnings management will employ barter transactions more difficult to dismiss as simple fictions.

### Sales of Development Stage Products

False financial statements may also result when a company books sales on a product that needs further development or refinement to satisfy customers. Unlike purely illusory sales, these transactions involve real products, but also engage risk to the seller that the sales will be rescinded or require additional costs to the seller to satisfy the buyer's expectations.

GAAP does not require that a product be perfect before it can support the recognition of revenue. Indeed, certain products—in particular computer software—are rarely if ever rendered completely bug-free. As a general rule, however, it is improper to record revenue on a product that is subject to a right of return unless the seller can estimate the likelihood of returns and has booked appropriate reserves.[56] Moreover, as discussed below, recognition of revenue is generally inappropriate in cases in which the vendor delivers a dysfunctional product that it will have to complete or repair after delivery.[57]

One company that apparently yielded to the temptation to book revenue from a far from perfected product is Systems Software Associates (SSA).[58] SSA made software used to coordinate the operations of complex industrial enterprises, from finance department to assembly line. After achieving success in the 1980s with software designed to run on a simpler platform, SSA began to develop a new product line based on the increasingly popular but complex UNIX programming language. The ability to move into the UNIX market was seen as crucial to SSA's continuing success and, to the applause of analysts, SSA began to announce UNIX contracts in the mid-1990s.

According to the Commission's complaint, however, SSA's UNIX product, if not mere "vaporwear," was years away from market acceptability.[59] At the time of its initial release, the UNIX product had undergone limited in-house testing. Also, SSA apparently did not follow the industry practice of "beta-testing" its product

55. *Id.* at 63,226.

56. *See* Revenue Recognition When Right of Return Exists, Statement of Financial Accounting Standards No. 48 (Financial Accounting Standards Bd. 2000) [hereinafter FAS 48].

57. *See infra* notes 58-79 and accompanying text; CON 5, *supra* note 17, ¶ 83b.

58. SEC v. Sys. Software Assocs., Inc., Accounting and Auditing Enforcement Release No. 1285, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,792, at 63,439 (July 14, 2000).

59. The Commission also charged SSA with fraudulently booking revenue from transactions that, expressly or implicitly, conditioned the buyer's payment obligation on its resale of the product to an end-user. Conditional sales are considered in the next section.

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_966 05/17/2002 08:43AM Plate # 0 pg 966 # 12



in a real world environment prior to its commercial release. Lawsuits from SSA customers and numerous adjustments to its contract terms, involving price concessions, penalty fee payments, free technical supports and free hardware for UNIX users, invite the conclusion that the software as originally released was a troubled product.[60]

Additional iterations of SSA's UNIX product, released over a two-year period, did not fully resolve its failings. As it became apparent to the market that SSA did not have a commercially viable UNIX product, the price of SSA's stock declined, falling abruptly after its announcement that, at the behest of its auditors, it was reversing more than $30 million in improperly reported UNIX revenue.[61] With the company now in a bankruptcy proceeding, over $1 billion in market capitalization had evaporated as a result of the company's failure to catch the UNIX wave, despite its public representations to the contrary.

Revenue recognition on software licenses is governed by the American Institute of Certified Public Accountants (AICPA) *Statement of Position on Software Revenue Recognition 97-2*.[62] Under SOP 97-2, as under its predecessor pronouncement,[63] revenue cannot be recognized until, among other things, the software is delivered and collectibility of the contract price is probable.[64] The requirement that delivery have occurred comports with the general rule expressed in paragraph eighty-three of CON 5 that revenue must be "realized or realizable and earned" to be recognized.[65] To be earned, the seller must have "substantially accomplished what it must do to be entitled to the benefits represented by the revenues."[66] That collectibility be probable is also a GAAP requirement going beyond the area of computer software.[67]

60. Furthermore, because SSA had no prior experience developing UNIX products, it was unable to reasonably estimate its cost to complete a viable product. Had SSA had a proven history of estimating development costs for UNIX products, GAAP would have permitted the recognition of revenue on a percentage of completion basis. *See* ACCOUNTING FOR PERFORMANCE OF CONSTRUCTION-TYPE AND CERTAIN PRODUCTION-TYPE CONTRACTS, Statement of Position 81-1 (American Inst. of Certified Pub. Accountants 1981); ACCOUNTING FOR NONREFUNDABLE FEES AND COSTS ASSOCIATED WITH ORIGINATING OR ACQUIRING LOANS AND INITIAL DIRECT COSTS OF LEASES, Statement of Position 91 (American Inst. of Certified Pub. Accountants 1991) [hereinafter SOP 91].

61. The restatement, however, primarily involved the reversal of UNIX sales flawed in ways other than by the state of development of the software.

62. SOFTWARE REVENUE RECOGNITION, Statement of Position 97-2 (American Inst. of Certified Pub. Accountants 1997) [hereinafter SOP 97-2].

63. At the time of the conduct at issue in this case, revenue recognition from computer software was governed by SOP 91. SOP 91's prohibition against the recognition of revenue from software sales involving significant ongoing vendor obligations, not found in SOP 97-2, is an element of the Commission's case against SSA. The present analysis, however, addresses criteria common to both accounting pronouncements. For a discussion on the differences between the two, see Douglas R. Carmichael, *Is It Time to Record the Sale?; Software Revenue Recognition Under SOP 97-2*, CPA J., July 1998, *available at* http://www.nysscpa.org/cpajournal/1998/0798/Features/f440798.htm.

64. SOP 97-2, *supra* note 62, ¶ 8.

65. *See* SEC Staff Accounting Bulletin 101, 64 Fed. Reg. 68,936, 68,936 (Dec. 9, 1999).

66. CON 5, *supra* note 17, ¶ 83b.

67. *See* FASB Statement of Financial Accounting Standards No. 5 on when a company must reserve for probable loss contingencies. ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5 (Financial Accounting Standards Bd. 2001) [hereinafter FAS 5].

SSA failed to comport with these two requirements when it shipped software that would not perform in the hands of its customers. The requirement that the product be "delivered" reasonably presupposes that it be in working order. Otherwise the seller has not substantially accomplished what it must do to be entitled to payment. Although the qualification must be given that software need not necessarily be completely bug-free for the seller to have "substantially" performed, to accept as "delivery" any shipment of computer code, no matter how far from finished, reduces the rule to an absurdity. Secondly, collection may be far from "probable" when a customer finds it is being used as a guinea pig for testing development stage software. In short, SSA's sale of software represented a commercial gamble, not the consummated economic transaction required for a reportable sale.

### Conditional Sales

That sales of a nonexistent product should be given no income statement effect is axiomatic. Sales of a nonfunctional product also have no claim to validity. More problematic cases are presented when the product is commercially viable but the sale is structured in a manner that leaves an element of economic risk with the seller. Indeed, all sales that occur on other than a cash basis fall on a continuum of risk stretching from transactions almost certain to result in cash payment to the seller to those where ultimate collection is highly speculative.

At the high end of the risk continuum, and hence clearly not acceptable for revenue recognition under GAAP, are "conditional" or "contingent" sales transactions.[68] These involve situations in which the seller will receive payment only upon the occurrence of some event not fully under its control. For example, the seller may agree to defer collection on a "sale" to a retailer until the retailer has, in turn, resold the product to an end user.[69] Or, if the sale is directly to an end user, the seller may agree to permit the buyer a no-risk evaluation period, or agree to make payment contingent upon additional improvements to the product planned for the future.[70]

68. CON 5, *supra* note 17, ¶ 83; FAS 48, *supra* note 56, ¶¶ 6(b), (e); *see also* SEC v. Scientific Software-Intercomp, Inc., Accounting and Auditing Enforcement Release No. 956, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,471, at 63,585 (Sept. 11, 1997); William D. Kyle, Accounting and Auditing Enforcement Release No. 941, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,456, at 63,559, 63,560-61 (July 28, 1997); SEC v. Telematics Int'l Inc., Accounting and Auditing Enforcement Release No. 615, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,075, at 63,468, 63,469 (Oct. 7, 1994); SEC v. Structural Dynamics Research Corp., Accounting and Auditing Enforcement Release No. 905, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,420, at 63,499, 63,500 (Apr. 10, 1997).

69. SEC v. Ickovics, Litig. Release No. 16,309, 70 SEC Docket 2303 (D.D.C. Sept. 28, 1999); SEC v. FastComm Communications Corp., Accounting and Auditing Enforcement Release No. 1187, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,694, at 63,226, 63,227 (Sept. 28, 1999).

70. *See Scientific Software-Intercomp*, Enforcement Release No. 956, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,585; *Kyle*, Enforcement Release No. 941, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,560; *Structural Dynamics*, Enforcement Release No. 905, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,500; *Telematics Int'l*, Enforcement Release No. 615, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,469.

A notably aggressive practitioner of income statement manipulation through conditional sales was the Massachusetts computer company Kendall Square Research Corporation.[71] Before becoming notorious for accounting fraud, Kendall Square was a glamorous maker of supercomputers for research applications, with a market capitalization in excess of $300 million. Many of the company's customers were universities and research institutions dependent on grants from private foundations and government agencies to support their activities. Some obtained from Kendall Square agreements that they would not be obligated to pay for the company's expensive computer systems until they received such funding.[72] Other "customers" were distributors that Kendall Square knew would not pay for the systems they had received until they resold them to end users. Finally, certain Kendall Square customers were allowed to delay payment for systems delivered in the present until they received a subsequent iteration of that hardware.[73] Rather than appearing in the contracts themselves, these provisions were contained in "side letters" that were not shown to the company's auditors.[74] Kendall Square booked these various contingent sales as revenue transactions.

These sales cannot be dismissed as mere shams. In each case the customer received a valuable product for which it plausibly hoped to pay Kendall Square. But GAAP does not permit the recognition of revenue on the basis of what *The Wall Street Journal* concisely described as "shipments to universities that don't have funding, shipments to distributors that don't have customers and shipments where payment is contingent on the customer getting upgraded machines in the future."[75] Specifically, *Statement of Financial Accounting Concepts No. 5* requires that revenue be recognized only when it is both "realized or realizable" and "earned."[76] This occurs when the entity has exchanged its product "for cash or claims to cash" and "the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues."[77] *Accounting Research Bulletin No. 43*, moreover, states: "profit is deemed to be realized when a sale in the ordinary course of business is effected unless the circumstances are such that collection of

71. SEC v. Kendall Square Research Corp., Accounting and Auditing Enforcement Release No. 854, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,369, at 63,400 (Nov. 12, 1996).

72. A similar issue was presented in Mark Goldberg, Accounting and Auditing Enforcement Release No. 1424, 75 SEC Docket (CCH) 937 (July 18, 2001).

73. For a similar case on this issue, see Advanced Med. Prods., Inc., Accounting and Auditing Enforcement Release No. 812, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,327, at 63,298 (Sept. 5, 1996).

74. Side letters, like those utilized by Kendall Square, are among the simplest means of evading a company's internal controls in that, at least initially, they require no affirmative misrepresentations. There is no need to generate false documents, reprogram the company's computers, or hide inventory in the CFO's garage. To prevent the true nature of such sales from being discovered by the company's auditors, however, it may eventually be necessary to create or otherwise obtain customer confirmations of bogus receivables. Moreover, auditors typically require annual representations from company management that none of the company's revenue transactions are subject to material contingencies.

75. William M. Bulkeley, *Kendall Square Demotes 3 Top Officials, Restates Its Revenue Sharply Downward*, WALL ST. J., Dec. 2, 1993, at A3.

76. CON 5, *supra* note 17, ¶ 83.

77. *Id.*

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_969 05/17/2002 08:43AM Plate # 0 pg 969 # 15



the sale price is not reasonably assured."[78] In other words, the seller must have substantially satisfied its obligations under the sales agreement and be reasonably assured of collecting payment from its customer.

Kendall Square's recognition of revenue from contingent sales failed to meet these standards for the obvious reason that the company had no reason to assume the contingencies would be satisfied. Payment that is conditional upon the customer obtaining a grant from a third party or locating an end user for the product is not "reasonably assured." In the case of transactions in which Kendall Square's right to payment depended upon providing its customers with a subsequent iteration of its computer hardware, revenue recognition was improper because the company had not "substantially accomplished what it must do to be entitled to" the revenues.[79]

After its improper accounting practices came to light, Kendall Square reversed approximately fifty percent of the revenues it had reported over an eighteen-month period and, shortly thereafter, entered a bankruptcy proceeding that concluded with the liquidation of the company. In a settled civil injunctive action, the SEC obtained substantial sanctions against the company and several former officers, including approximately $1.1 million in monetary relief from its former president.

### Sales with a Right of Return

Involving a different risk calculation than contingent sales, and therefore treated differently under GAAP, are sales with a right of return. Unlike contingent sales, which normally do not transfer the risks and rewards of ownership to a sufficient degree to support revenue recognition, sales with a right of return may be treated as revenue transactions if they meet certain specific criteria. As established by the Financial Accounting Standards Board's (FASB's) *Statement of Financial Accounting Standards No. 48*, these include the requirement that "the amount of future returns can be reasonably estimated."[80] Once this condition is met, moreover, revenues must be reduced to reflect both actual past and estimated future returns through the establishment of a reserve for returned merchandise.[81]

When applied to a business with an established product line and a stable customer base, this approach accords comfortably with commercial reality. A lawn ornament manufacturer whose customers have exercised an unconditional right of return at a consistent rate over a period of years should indeed be able to recognize sales revenue immediately upon shipment of its product, subject to an appropriate reserve for returns. Difficulties may arise, however, when companies that market products based on rapidly changing technology attempt to extrapolate future return rates from past experience with products that are now becoming

78. ARB 43, *supra* note 18, ch. 11, ¶ 11.
79. CON 5, *supra* note 17, ¶ 83b.
80. FAS 48, *supra* note 56, ¶ 6 (footnote omitted).
81. For an application of these principles to a private securities fraud action, see Malone v. Microdyne Corp., 26 F.3d 471 (4th Cir. 1994).

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_970 05/17/2002 08:43AM Plate # 0 pg 970 # 16



obsolete, and therefore likely to be returned at a higher rate in the future. Companies also court problems when they assume that the return rate for a new iteration of an existing product will be similar to that for previous iterations or, perhaps, to the rate of return across all of the company's product lines. These situations may raise highly complex and subjective issues concerning changing commercial circumstances and product comparability.

Conceptually similar to sales with a right of return are sales subject to a "right of exchange" or "rotation." These provisions, common in agreements between producers and distributors of seasonal products, computer software and other items with limited shelf life, allow reseller-customers to exchange product they have been unable to market for a different product they hope will prove more successful. Again, GAAP premises revenue recognition on the seller's ability to estimate the amount of product that will be returned, and the posting of appropriate reserves.[82] According to SOP 97-2, with specific reference to software products, exchanges of software products for "dissimilar software products or for similar software products with more than minimal differences in price, functionality, or features are considered returns, and revenue . . . should be accounted for in conformity with FASB Statement No. 48."[83]

SEC enforcement actions and private litigation involving sales with rights of return or exchange have typically addressed situations in which the sales had little underlying substance, and the purported right of return was simply the means used to protect the "customer" from commercial liability for inventory it was merely warehousing for the "seller" or else attempting to resell on a consignment basis.[84] Although the legal analysis may follow FAS 48, the purported sales might as easily be dismissed as simply illusory. The recent *Microtest* case,[85] however, provides a thoughtful analysis of the effect on its ability to estimate future returns of a seller's decision to promote sales by liberalizing its return policy. That opinion also emphasizes that "stock rotation" provisions engage the same revenue recognition issues as do those designated "rights of return."[86]

82. FAS 48, *supra* note 56, ¶ 3.

83. SOP 97-2, *supra* note 62, ¶ 51.

84. The most significant pronouncement of the Commission on the evils of channel stuffing is its administrative order in the *Sunbeam* case, discussed in detail below. *See* Sunbeam Corp., Accounting and Auditing Enforcement Release No. 1393, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,908, at 63,023 (May 15, 2001); *infra* notes 197-215 and accompanying text; *see also Malone*, 26 F.3d at 478; Alan G. Lewis, Accounting and Auditing Enforcement Release No. 848, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,363, at 63,385 (Oct. 28, 1996); SEC v. Bollinger Indus., Inc., Accounting and Auditing Enforcement Release No. 834, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,349, at 63,357 (Sept. 30, 1996); SEC v. Fidelity Med., Inc., Accounting and Auditing Enforcement Release No. 572, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,032, at 63,389-109 (July 7, 1994); Theodore Hofmann, Accounting and Auditing Enforcement Release No. 513, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,972, at 63,337 (Jan. 4, 1994); SEC v. Electro-Catheter Corp., Litig. Release No. 11,347, 37 SEC Docket (CCH) 768 (Feb. 4. 1987); SEC v. FloraFax Int'l, Inc., Accounting and Auditing Enforcement Release No. 44, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,444, at 63,161, 63,161-62 (Nov. 27, 1984).

85. Microtest, Inc., Accounting and Auditing Enforcement Release No. 1397, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,912, at 63,038 (May 16, 2001).

86. *Id.* at 63,041.

### Channel Stuffing

Conditional sales and sales hedged with rights of return shade into cases in which the seller increases the amount of sales it books in a particular period by prevailing upon its distributors to accept product in advance of their actual needs. This practice, commonly known as "channel stuffing," allows a company to escape an immediate revenue shortfall by, in effect, borrowing revenue from future quarters.[87] As *The New York Times* has noted: "In a world where a failure to meet quarterly profit forecasts can be punished brutally by Wall Street, stuffing can seem like a wise, if risky, tactic."[88] That distributors may agree to play a role that has been described as "half warehouse and half bank" can be explained by the willingness of sellers to bribe them with discounts and other financial incentives.[89]

Revenue management through channel stuffing does not necessarily constitute financial statement fraud.[90] If the sales are unconditional and rights of return are properly addressed under FAS 48, they may be booked as revenue transactions even though they result in a substantial build-up in channel inventory. Frequently, however, distributors who accept excess inventory to accommodate the seller's revenue needs extract, in return, concessions that limit their exposure should the product prove unsaleable. These may be contained in "side letters" or oral agreements, or derive from an unstated but well-established course of dealing between the parties, and may render revenue recognition improper. In its action against Bausch & Lomb, for example, the SEC found that the company's insistence that its distributors accept vast amounts of inventory during particular fiscal periods resulted, at the regional sales level, in various agreements that absolved distributors of any obligation to pay for product they were unable to sell.[91] These provisions made the sales conditional and hence not appropriate for revenue recognition under GAAP.[92] Further, episodes of channel stuffing may result in a company's previously acceptable revenue recognition practices becoming insupportable. Specifically, a seller's ability to estimate the amount of product that will bounce back pursuant to a right of return, and reserve accordingly, may be impaired if it alters previous sales patterns to burden its distribution channels with amounts of product that exceed immediate retail demand.[93]

87. *See* Andy Pasztor, *Mattel Methods of Accounting Are Scrutinized*, WALL ST. J., Apr. 11, 1996, at C1; Mark Maremont, *Blind Ambition: How the Pursuit of Results Got Out of Hand at Bausch & Lomb,* BUS. WK., Oct. 23, 1995, at 78.

88. Floyd Norris, *At Coke, Less Fizz Than Met the Eye*, N.Y. TIMES, Oct. 27, 1996, at 3-1.

89. Mark Maremont, *Bausch & Lomb and Former Executives Settle SEC Accounting-Fraud Charges*, WALL ST. J., Nov. 18, 1997, at A6.

90. Rubin v. Trimble, No. C-95-4353 MMC, 1997 WL 227956, at *18 (N.D. Cal. Apr. 28, 1997); *see also* Floyd Norris, *Accounting Magic Erases Big Loss*, N.Y. TIMES, Oct. 19, 1997, at 3-1.

91. Bausch & Lomb Inc., Accounting and Auditing Enforcement Release No. 987, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,502, at 63,657, 63,661 (Nov. 17, 1997).

92. *Id*. at 63,663.

93. Letter from Lynn E. Turner, Chief Accountant, Office of the Chief Accountant to Thomas Ray, Director, Audit & Attest Standards, Am. Inst. of Certified Pub. Accountants (Oct. 9, 1998) (Commission Information: Regarding the 1998-1999 Audit Risk Alerts), *available at* http://www.sec.gov/info/accountants/staffletters/aclr1009.htm.

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_972 05/17/2002 08:43AM Plate # 0 pg 972 # 18



Even in situations in which channel stuffing does not result in improper revenue recognition, it may raise significant disclosure obligations. A company that accelerates sales revenue at the expense of future quarters may be required to disclose this as a business practice, and to discuss its financial implications for future periods, under Commission Regulation S-K, items 101(c)(1)(i) ("Description of Business") and 303 ("Management Discussion and Analysis"). Indeed, failure to meet this obligation may constitute actionable fraud.[94]

### Misdated Transactions

Revenue may also be borrowed from future periods by misrepresenting transaction dates. Typically in such cases the company will book period revenue on sales of product that has not been ordered or was not shipped before the witching hour of the final day of the period.[95] The more sophisticated the company's order tracking system, the more complicated pursuing a scheme of this type becomes. In one reported case, for example, company employees were directed to misdate packing lists, shipping records, and invoices and fail to advance the date of a computerized shipping log, all for the purpose of concealing that certain shipments were made after quarter end.[96]

More inventive instances of revenue acceleration have involved the misclassification of what is being sold. Revenue from service contracts, for example, is typically "earned," and therefore recognized, over the period the services are provided.[97] Revenue from the financed sale of a commodity, by contrast, may be recognized in full at the time product is shipped,[98] even though the payment schedule will not be completed until a later period. Disguising the former type of revenue as the latter may allow a company to conceal the untimely recognition of revenue.

According to the SEC, this is precisely what was done by HealthCare Services Group, whose creative accounting for transactions in its own stock is described in a previous section.[99] As noted, HSG is a provider of housekeeping and laundry services to nursing and retirement homes. HSG convinced certain of its customers to enter into financed "purchases" of the washers, dryers, and other equipment that HSG operated on their premises. These purchases were, in reality, disguised payment for services to be delivered in the future. HSG's periodic billings to the

94. Harvey M. Jasper Ret. Trust v. Ivax Corp., 920 F. Supp. 1260, 1266 (S.D. Fla. 1995); *In re* Lotus Dev. Corp. Sec. Litig., 875 F. Supp. 48, 52-53 (D. Mass. 1995); *In re* Compaq Sec. Litig., 848 F. Supp. 1307, 1320-21 (S.D. Tex. 1993).

95. *See, e.g.*, Gunther Int'l, Ltd., Accounting and Auditing Enforcement Release No. 1454, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,969, at 63,169 (Sept. 25, 2001).

96. Pinnacle Micro, Inc., Accounting and Auditing Enforcement Release No. 975, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,490, at 63,639, 63,641 (Oct. 3, 1997); *see also* SEC v. FastComm Communications Corp., Accounting and Auditing Enforcement Release No. 1187, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,694, at 63,226, 63,227 (Sept. 28, 1999).

97. CON 5, *supra* note 17, ¶ 84d.

98. Matthew Grant, Accounting and Auditing Enforcement Release No. 410, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,869, at 63,116, 63,117-18 (Aug. 24, 1992).

99. *See supra* notes 43-46 and accompanying text.

customer were often no different after the sales than before, but amounts formerly attributed to laundry and housekeeping services were now attributed to the financed purchase of washers and dryers. The SEC alleged that HSG's recognition of revenue on these transactions failed to comport with the GAAP requirement that revenue must not be recognized until it is earned.[100]

The software industry is particularly susceptible to the mischaracterization of service contracts as product sales. With respect to software transactions, GAAP adheres to the basic principle that revenue from product sales is normally recognized upon delivery of the product, while revenue from service contracts is recognized over the life of the contract (i.e., as the revenue is earned).[101] Many software transactions, however, contain elements of both. A customer that licenses software may also contract for ongoing consulting services or for customized applications yet to be developed. In such a hybrid transaction, GAAP requires that revenue not be recognized up front on the sale of the license unless (from the customer's vantage) it is "separable" from the service contract, and then only in the amount attributable to that component of the transaction.[102] If the contract is essentially all of a piece, revenue must be recognized over the life of the contract, not an attractive prospect to a software company with revenue problems.

The recent Commission action against MicroStrategy, Inc. illustrates the consequences that can occur when a company ignores this standard.[103] MicroStrategy, a provider of information services through a variety of electronic delivery systems, entered into hybrid transactions in which its customers would receive software from MicroStrategy as part of more complex relationships. According to the Commission, the company mischaracterized multi-element deals, in which the sale of product was inseparable from ongoing obligations of MicroStrategy, to allow it to accelerate revenue recognition. As an example, MicroStrategy entered into one transaction involving the sale of software, the provision of consulting and development services, and the sale of warrants to purchase MicroStrategy stock as if it were a simple product sale, booking the full contract price as revenue at the time of the transaction. When the deception was discovered and the company announced a three-year restatement, its previously high-flying stock fell sixty percent in one day.[104]

Also deserving mention as a method of accelerating revenue is the "bill and hold sale," in which the seller retains possession of the product for some period after recognizing revenue from the sale. Appropriate to those unusual circumstances in which a buyer needs to ensure access to a supply of product of uncertain availability before it has the capability to accept delivery, the bill and hold sale

100. *See* CON 5, *supra* note 17, ¶ 83b.

101. *Id.* ¶ 84d.

102. SOP 97-2, *supra* note 62, ¶¶ 63-66.

103. MicroStrategy, Inc., Accounting and Auditing Enforcement Release No. 1350, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,857, at 63,540, 63,545-47 (Dec. 14, 2000).

104. Although the SEC's action against MicroStrategy alleged only reporting, internal controls, and books and records violations, it charged three corporate officers with fraud. SEC v. Saylor, Accounting and Auditing Enforcement Release No 1352, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,859, at 63,549 (Dec. 14, 2000).

often has been abused to allow a seller to book sales at a time when its distribution channels are so inundated with product, or its sales so tentative, that its customers are simply unwilling to accept delivery of the product.[105] Typically, the seller will offer extended payment terms and pay the costs of insurance and transportation to and from the warehouse so that the buyer incurs no out-of-pocket expenses by signing a purchase order early, whether as a favor to the seller or in return for price or other concessions.[106]

## MISSTATEMENT OF EXPENSES

Earnings manipulation through the understatement of expenses is less common than through overstatement of revenues.[107] This is partly a result of the fact that the revenue potential of a company is theoretically infinite while the understatement of expenses is limited to their actual amount. Nevertheless, a number of enterprising financial frauds have utilized this approach.[108]

*Today's Expenses Tomorrow: The Fine Host and Waste Management Cases.* The SEC's actions against former officers and auditors of Fine Host Corporation[109] and the auditors of Waste Management Corporation[110] demonstrate that financial fraud is not limited to "new economy" companies with arcane products and virtual assets. Indeed, it can be committed as easily by purveyors of beer and hot dogs and haulers of trash.

105. *See, e.g.*, Mark Goldberg, Accounting and Auditing Enforcement Release No. 1424, 75 SEC Docket (CCH) 937 (July 18, 2001); Jill Pitts, Accounting and Auditing Enforcement Release No. 1240, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,747, at 63,327, 63,328 (Mar. 23, 2000); Cypress Bioscience, Inc., Accounting and Auditing Enforcement Release No. 817, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,332, at 63,308, 63,309-10 (Sept. 16, 1996); SEC v. Sheelen, Accounting and Auditing Enforcement Release No. 215, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,684, at 63,205, 63,205-06 (Feb. 8, 1989); *see also* ACCOUNTING IRREGULARITIES AND FINANCIAL FRAUD 100 (Michael R. Young ed., 2000).

106. The potential evils of the bill and hold sale are discussed in detail below in connection with the *Sunbeam* litigation. *See infra* notes 197-215 and accompanying text.

107. In fiscal year 1999, for example, the SEC brought thirty-two actions for improper revenue recognition, as compared to thirteen for improper failure to book expenses. Richard H. Walker, Behind the Numbers of the SEC's Recent Financial Fraud Cases, Address at the 27th Annual National AICPA Conference on Current SEC Developments (Dec. 7, 1999), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch334.htm.

108. *See, e.g.*, SEC v. Villares, Accounting and Auditing Enforcement Release No. 1171, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,678, at 63,206 (Sept. 28, 1999) (company improperly deferred or failed to recognize a variety of operating expenses); Venator Group, Inc., Accounting and Auditing Enforcement Release No. 1049, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,564, at 63,794, 63,795 (June 29, 1998); SEC v. Sachdeva, Litig. Release No. 15,596, 1997 WL 794477 (Dec. 18, 1997) (avoidance of expenses by defrauding company's suppliers); Robert Gossett, Accounting and Auditing Enforcement Release No. 992, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,507, at 63,669 (Dec. 1, 1997); SEC v. McDonnell Douglas Corp., Accounting and Auditing Enforcement Release No. 797, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,312, at 63,278 (June 24, 1996) (company failed to recognize cost overruns).

109. *See* SEC v. Barber, Accounting and Auditing Enforcement Release No. 1480, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,995, at 63,213 (Dec. 27, 2001).

110. *See* SEC v. Arthur Andersen LLP, Accounting and Auditing Enforcement Release No. 1410, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,925, at 63,069 (June 19, 2001).

A supplier of food and beverage concessions to sports arenas, schools, and prisons, Fine Host was a company that—simply put—never met an expense it could not defer.[111] Although GAAP allows companies to capitalize certain costs of obtaining business,[112] this does not include every outlay that might conceivably improve a company's prospects. Rather, there must be a high degree of certainty that the costs capitalized will be recovered through added revenues.[113] Fine Host went well beyond acceptable practice by routinely spreading a pool of selling, general, and administrative (SG&A) costs among the capitalized "contract rights" it attributed to individual facilities. The company capitalized, for example, certain employee compensation and costs of travel. Rather than matching costs to specific contracts, moreover, Fine Host pooled all contract acquisition costs for each fiscal period, then divided them among individual contracts on an arbitrarily determined percentage basis.

Obviously, a company that contrives to defer much of its SG&A expense will enjoy buoyant earnings in the short term. It has at least temporarily eliminated the downside of the equation determining business success: the cost of obtaining revenues. But as amortization of its growing collection of capitalized costs place a drag on income, it will eventually see its earnings targets recede into the distance. Such was the fate of Fine Host. Elements of management not involved in the fraud realized that amortization of capitalized contract rights was destroying its profit margins and began to question how the company had come to be in this state. They quickly learned that Fine Host had done so by ignoring GAAP. Its earnings restatement recognized that improper capitalization of SG&A expenses had more than doubled the company's reported income over a four-year period.

Nor was this the extent of the company's sins. Fine Host's acquisition of various other food service companies provided another vehicle to manipulate earnings. Reasonable estimates of the amounts that will be paid to discontinue activities of the acquired company, or to terminate or relocate its employees may be properly accrued in connection with a business acquisition.[114] By contrast, Fine Host's

111. *Barber*, Enforcement Release No. 1480, 7 Fed. Sec. L. Rep. (CCH) at 63,213; Jeffrey Bacsik, Accounting and Auditing Enforcement Release No. 1482, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,997, at 63,218 (Dec. 27, 2001); Barbara Horvath, Accounting and Auditing Enforcement Release No. 1483, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,998, at 63,223 (Dec. 27, 2001); Rachel Eckhaus, Accounting and Auditing Enforcement Release No. 1481, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,996, at 63,214 (Dec 27, 2001).

112. ELEMENTS OF FINANCIAL STATEMENTS, Statement of Financial Accounting Concepts. No. 6, ¶ 25 (Financial Accounting Standards Bd. 1996) [hereinafter CON 6]. The Financial Accounting Standards Board defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." *Id.* (footnote omitted). Moreover, "[t]he ultimate evidence of the existence of assets is the future economic benefit, not the costs incurred." *Id.* ¶ 180.

113. "[B]usiness enterprises engage in research and development activities, advertise, develop markets, open new branches or divisions, and the like, and spend significant funds to do so. The uncertainty is not about the intent to increase future economic benefits but about whether and, if so, to what extent they succeeded in doing so." *Id.* ¶ 175.

114. *See* FASB Emerging Issues Task Force (EITF), *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, *in* EITF ABSTRACTS: A SUMMARY OF PROCEEDINGS OF THE FASB EMERGING ISSUES Task Force as of September 20-21, 2000, No. 94-3, at 751 (Financial Accounting Standards Bd. 2000) FASB EITF, *Recognition of Liabilities in Connection with a Purchase Business Combination*, *in* EITF ABSTRACTS *supra* No. 95-3, at 787.

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_976 05/17/2002 08:43AM Plate # 0 pg 976 # 22



acquisition reserves were arbitrary numbers, not based on realistic estimates of such transition costs. Indeed, in many instances in which it took reserves, Fine Host incurred none of the expenses such reserves are intended to cover. The reserves, in fact, were set up as a mere "cookie jar" that management employed, at its discretion, to bolster subsequent reported income.

Finally, Fine Host improperly accounted for rebates and signing bonuses it received from its vendors. Its practice was to estimate the amount of rebates and signing bonuses it expected to receive throughout the year, then recognize the estimated income from those sources monthly on a pro rata basis. Because its estimates often proved excessive, Fine Host recognized income from rebates it never received. GAAP requires bonuses obtained from suppliers for entering into multi-year contracts be applied to reduce expenses over the life of the contract.[115] Fine Host took the entire amount of such bonuses into income in the year the contract was signed.

If hiding expenses does not usually present as broad opportunities for earnings management as inflating revenues, the SEC's recent action against Arthur Andersen LLP, alleging complicity in the accounting fraud of its audit client Waste Management, Inc.,[116] reminds us of the very real possibilities that a properly motivated company may nevertheless discover. Waste Management's tenacious refusal to acknowledge its actual costs of operations resulted, after many years of artful concealment, in the largest restatement ever taken by a U.S. public company. It acknowledged a total of $1.43 billion in accounting irregularities, most involving the deferral "of current operating expenses to future periods in order to inflate its current period income."[117]

The company used diverse methods to evade recognition of period expenses, mostly in the more subjective aspects of its business. The capital assets of this sprawling waste disposal conglomerate included many thousands of garbage trucks and dumpsters, which it capitalized and then depreciated (expensed) over multi-year periods. Under GAAP, the company was required to base its depreciation schedules on its best estimate of the useful life of the assets. Seizing on the invitation for fraud presented by this inherently subjective standard, Waste Management arbitrarily increased the estimated useful life or salvage value of its trucks and dumpsters (thus decreasing depreciation expenses) as needed to remedy periodic earnings shortfalls.

Waste Management also capitalized costs of developing landfills to accept the solid waste it collected. These costs included interest paid to finance the projects. Rather than begin depreciating the interest associated with new landfills when

115. *See* CON 6, *supra* note 112, ¶¶ 145, 147.

116. SEC v. Arthur Andersen LLP, Accounting and Auditing Enforcement Release No. 1410, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,925, at 63,069 (June 19, 2001). Arthur Andersen, in one of the few recent instances in which the SEC has sanctioned a Big Five auditing firm (rather than targeting only individual accountants at the firm), settled this matter by consenting to the entry of an injunction against future violations of the anti-fraud provisions of the Exchange Act and payment of a $7 million penalty. *Id.* at 63,070; *see also* Arthur Andersen LLP, Accounting and Auditing Enforcement Release No. 1405, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,920, at 63,048, 63,049 (June 19, 2001).

117. *Arthur Andersen*, Enforcement Release No. 1410, 7 Fed. Sec. L. Rep. (CCH) at 63,071.

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_977 05/17/2002 08:43AM Plate # 0 pg 977 # 23



they were ready for use, as required by GAAP, Waste Management continued to capitalize (without amortizing) that expense indefinitely. It also capitalized the costs of obtaining permits to build or expand landfills, the balance for this item eventually reaching $500 million. Many of these projects, however, were abandoned. Under those circumstances, GAAP dictates that the asset (permit costs) be written off (expensed).[118] Waste Management failed to do this, sometimes lumping costs thrown off by failed projects together with costs from active projects for purposes of concealment.

A legal corollary of operating landfills is liability for the cost of environmental remediation. Under GAAP, Waste Management was required to periodically estimate its outstanding exposure for clean-up costs and establish reserves (liabilities) in that amount, to be drawn down as costs were incurred.[119] Waste Management, however, applied these reserves as a general "cookie jar" to cover expenses not connected to environmental remediation, thus distorting current period operating expenses. Further, when it acquired other businesses, Waste Management diverted amounts that should properly have been booked as goodwill to over-accrue remediation reserves. It would then apply these inflated reserves to cover expenses from projects with inadequate reserves, again resulting in the understatement of period expenses.

Waste Management also resolutely failed to properly accrue for estimated tax liabilities and for self-insurance expenses, did not recognize incurred but not reported claims, and arbitrarily discounted claims that were reported.[120] Finally, when its fraudulently deferred expenses had accumulated to a critical level, Waste Management netted $160 million in past errors and present period operating expenses against a one-time gain from the transfer of its interest in another company, with no disclosure of this accounting sleight-of-hand.

*Livent Corporation: The Asset Depreciation Shell Game.* As with booking bogus sales, hiding expenses is typically a game played against time. In the same way bad receivables cannot be disguised indefinitely, the real costs of running a business cannot be swept forever behind the financial furniture. The more sophisticated practitioners know this and seek no more than a respite from the law's disclosure requirements until some temporary shortfall can be resolved.

The Livent case,[121] however, demonstrates how long the day of reckoning may be postponed, even in cases involving blatant fraud. Over a period of almost a decade, Livent, a Canadian producer of such theatrical shows as *Ragtime* and *Phantom of the Opera*, cooked its books in grand style. To present a picture to Wall Street analysts of a company going from success to success, when Livent's theatrical productions were in fact box office failures, the company played a shell

118. FAS 5, *supra* note 67, ¶ 1.

119. *Id.* ¶¶ 8, 14.

120. *See also* SEC v. Healthcare Servs. Group, Inc., Accounting and Auditing Enforcement Release No. 842, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,357, at 63,369 (Oct. 16, 1996).

121. Livent Inc., Accounting and Auditing Enforcement Release No. 1095, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,602, at 63,012 (Jan. 13, 1999).

game with expenses so elaborate that management needed a separate, clandestine set of books to follow the real costs of the company's operations.[122]

In addition to simply failing to record period expenses, the company took advantage of the distinct accounting treatments afforded by GAAP to different types of theatrical production costs. Unlike the costs of a running production, which are typically treated as current period expenses, preproduction costs may be capitalized as an asset and amortized over the estimated life of the production.[123] The amortization period begins to run when the show opens. To delay the onset of the amortization period for its capitalized preproduction costs (and hence the time they began to act as a drag on earnings), Livent shifted millions of dollars of costs attributable to shows already in production to shows still in preproduction. Rather than accept the relatively short amortization period that applies to preproduction costs, moreover, Livent sometimes transferred such costs to its fixed asset accounts. For example, by misclassifying preproduction outlays as costs of theater construction, the amortization period could be stretched out to forty years.

Perhaps the most brazen example of Livent's disregard of the plain meaning of the term fixed asset involved its subsidization of one of its own shows. Faced with disappointing ticket sales for its Los Angeles production of *Ragtime*—as well as the likelihood that an unsuccessful Los Angeles run would foreclose the possibility of taking the production to Broadway—Livent contrived to artificially boost ticket sales by buying tickets through third parties. Naturally, it capitalized these expenditures to its fixed asset account.

*Livent* also illustrates that financial fraud may sometimes involve the overstatement of expenses.[124] The two individuals primarily responsible for the accounting fraud personally enriched themselves from company coffers through a kickback scheme utilizing two compliant third-party vendors. At the direction of the two officers, the vendors submitted invoices to Livent grossly overstating the services they had rendered to the company. Livent would pay the invoices, and the vendors, after pocketing an appropriate cut for their services, would then pass on the remainder to the two officers. Through this crude device, the two Livent officers siphoned approximately $7 million from the company. The kickbacks

122. *See also* SEC v. Chambers Dev. Co., Accounting and Auditing Enforcement Release No. 673, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,133, at 63,581 (May 9, 1995). Chambers Development, like Livent, reversed the proper financial reporting process by determining its results of operations in advance (as necessary to support its stock price), then working backward to bring its books and records into conformity with those results. Also like Livent, it did this primarily by fraudulently reclassifying amounts from expense to asset accounts.

123. *Cf.* FINANCIAL REPORTING BY BROADCASTERS, Statement of Financial Accounting Standards No. 63, ¶ 5 (Financial Accounting Standards Bd. 2000).

124. The circumstances under which companies look for means to accelerate expenses into the present to improve reported financial performance in future periods is considered in the discussion of the Sunbeam case, below. Also, Roger Lowenstein provides the example of Dura Pharmaceuticals, a drug company that avoided recognizing research and development (R&D) expenses by running them through a shell company. It recognized the costs of funding the shell as a one-time charge. Then, by having the shell company "hire" Dura to conduct R&D for it, Dura used the shell as a cookie jar of capital to cover what otherwise would have been period expenses for ongoing R&D. Roger Lowenstein, *You Want Earnings? We've Got 'Em*, WALL ST. J., Apr. 24, 1997, at C1.

were entered into the company's records as period expenses, rather than being appropriately disclosed on a line item for embezzlement. Apparently to reduce the profit and loss impact of this practice, the Livent officers caused the company to improperly capitalize some of these expenditures as preproduction costs.

*Improper Capitalization of Advertising Costs: Amre and America Online.* A comparison between two Commission actions involving similar accounting issues, one treated as financial fraud, the other as no worse than a violation of the reporting provisions, teaches that imprecise accounting standards in the hands of a clever practitioner can allow wide latitude for earnings management with limited legal consequences. Both *Amre, Inc.*[125] and *America Online, Inc.*[126] involved the improper capitalization of advertising costs. As a general rule, GAAP requires that advertising costs be expensed as incurred.[127] In this they differ from purchased intangibles, such as contract rights, which are normally capitalized and amortized over the useful life of the asset thus created.[128] Although Amre clearly and crudely ran afoul of this rule, America Online's (AOL's) more creative accounting treatment successfully evaded its application for several years.

Amre sold home siding and kitchen cabinets through direct mail and television advertising. When it received indications of interest from potential customers it would enter these leads in a lead bank to draw upon for sales calls. Rather than treating the costs of obtaining leads as a current period expense, Amre would capitalize them. The effect was to defer advertising expenses to later periods, increasing Amre's reported earnings in the short run.

On its face, this practice was not necessarily improper. Accounting practices concerning the capitalization of advertising costs varied widely at that time and there existed no comprehensive GAAP pronouncement on the issue.[129] Amre, however, was not content with mere aggressive accounting. To support the price of its NYSE-listed stock, Amre ventured into outright fraud by inflating the number of leads in its lead bank as necessary to meet earnings targets. When this

125. Amre, Inc., Accounting and Auditing Enforcement Release No. 356, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,823, at 63,038 (Mar. 2, 1992). *See also* SEC v. Levin, Accounting and Auditing Enforcement Release No. 357, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,824, at 63,045 (Mar. 3, 1992); SEC v. Conradt, Litig. Release No. 13,179, 50 SEC Docket 2032 (Mar. 3, 1992); Mac M. Martirossian, Accounting and Auditing Enforcement Release No. 394, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,853, at 63,092 (June 30, 1992); Edward Jan Smith, Accounting and Auditing Enforcement Release No. 554, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,014, at 63,389-46 (Apr. 26, 1994).

126. Am. Online, Inc., Accounting and Auditing Enforcement Release No. 1257, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,764, at 63,364 (May 15, 2000); SEC v. Am. Online, Inc., Litig. Release No. 16,552, 72 SEC Docket 1101 (May 15, 2000) (describing a related action for $3.5 million civil penalty).

127. Reporting on Advertising Costs, Statement of Position 93-7, ¶ 26 (American Inst. of Certified Pub. Accountants 1993) [hereinafter SOP 93-7].

128. *Amre*, Enforcement Release No. 356, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,043 n.14.

129. SOP 93-7 applies to financial statements for years beginning after June 15, 1994. SOP 93-7, *supra* note 127, ¶ 54. Previously, there was no authoritative accounting literature that applied specifically to the deferral of the costs of customer acquisition. *Id.* ¶ 19.

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_980 05/17/2002 08:43AM Plate # 0 pg 980 # 26



proved insufficient, Amre failed to recognize operating expenses, recorded phony inventory and booked revenue from sales prematurely. This conduct continued for approximately two years until the widening gap between financial fantasy and reality could no longer be papered over. There followed a series of SEC enforcement actions against the company and its officers for perpetrating the fraud and against Amre's auditors for failing promptly to catch it.[130]

AOL's approach to deferring advertising expenses was, by comparison, highly sophisticated. While struggling to achieve its present position as the Internet portal to the masses, AOL sent the computer disks allowing access to its service to millions of potential customers, defined as anyone with a mailbox. Rather than simply expensing its enormous costs of membership acquisition, AOL booked them as capital assets, dramatically improving its reported results. For 1996, for example, it transformed a loss of $175 million to a pretax profit of $62 million. This presumably enhanced the attractiveness of AOL's frequent equity offerings during a period when it was burning cash at a much high rate than could be provided from operations. Indeed, it is possible that AOL would not have been able to finance the aggressive play for market share that eventually succeeded so well had it not engaged in this form of earnings management. Finally, in the fall of 1996, AOL abruptly wrote off $385 million in capitalized membership acquisition costs and began to expense as incurred all such costs going forward. AOL thus eliminated any future drag to its earnings from the amortization of this asset.

AOL's accounting was criticized in the financial press as misleading but not illegal.[131] The SEC took the position it was both. In a settled action, the SEC charged AOL with violating the reporting and books and records provisions, but not with fraud.[132] The order analyzed in detail AOL's rationale for its accounting treatment and dismissed it as devoid of merit.[133]

Under the AICPA's SOP 93-7, *Reporting on Advertising Costs*, certain "direct response advertising costs" avoid the general rule that advertising costs should be expensed as incurred. The classic example of direct response advertising is the annual Montgomery Ward catalog of memory, with the order form at the back. A company that uses a form of solicitation that generates sales over an extended period can argue, under the general principle that revenue should be matched (recognized in the same period) with the expenses incurred to obtain it, that it should be able to spread out its solicitation costs over the same period as it made sales attributable to the solicitation. SOP 93-7 supports this approach, provided the company can present "persuasive evidence," based on "verifiable historical patterns of results for the entity" that the advertising will result in "probable eco-

130. *See Amre*, Enforcement Release No. 356, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,045; *see also supra* note 125.

131. *See*, *e.g.*, Bloomberg Business News, *Accounting Move Tags AOL with 'Timid' Label*, CHI. TRIB., Dec. 29, 1996, at C8; Jerry Knight, *Called to Account*, WASH. POST, Oct. 30, 1996, at C12; Allan Sloan, *Look Beyond the High-Tech Accounting to Measure America Online's Market Risk*, WASH. POST, Oct. 24, 1995, at D3.

132. Am. Online, Inc., Accounting and Auditing Enforcement Release No. 1257, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,764, at 63,364 (May 15, 2000).

133. *Id.* at 63,366-68.

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_981 05/17/2002 08:43AM Plate # 0 pg 981 # 27



nomic benefits to the company."[134] The circumstances under which this recoverability test can be satisfied are intended to be narrow.[135] Despite a sheen of objectivity, however, the quoted terminology is not necessarily determinate in application, particularly in the absence of interpretive guidance.

With SOP 93-7, AOL found a GAAP pronouncement drafted with greater concern for abstract symmetry of accounting policy than enforceability, and exploited it aggressively. AOL's position was that all of the costs of carpet-bombing the nation with computer disks could properly be capitalized under SOP 93-7 because AOL had sufficient revenue history to prove that its previous campaigns had produced a profitable membership base.[136] Despite carping in the press about the quality of AOL's earnings, no action was taken against the company until it abruptly wrote off $385 million in capitalized costs within weeks of filing an annual report that reported this as by far its largest asset.

The SEC's order found that AOL had failed to comply with SOP 93-7's requirement that the amortization of advertising expenses be tightly aligned with the revenue stream attributable to them.[137] Specifically objectionable was AOL's practice of taking a global view of the relationship between its costs of membership acquisition and the fees generated by the members acquired, rather than tying particular pools of advertising costs to the membership fees directly resulting from those costs. The crux of the order, however, was that AOL simply did not represent the type of business for which this accounting provision was intended.[138] In particular, "AOL was operating in a new, evolving, and unstable business sector, and thus could not provide the 'persuasive' historical evidence needed to reliably estimate the future net revenues it would obtain from its advertising expenditures."[139] The SEC rejected AOL's mathematical model for predicting the recoverability of its membership acquisition costs because it "assumed stability in customer retention rates over an extended period, as well as the maintenance of the company's gross profit margin percentage, which was based on the company's existing fee structure and costs of operation."[140]

The evidence adduced by the SEC in dismissing as fanciful AOL's net revenue projections was largely supplied by AOL itself, in the same public filings in which it reported the ballooning of this asset. In various periodic reports and offering documents, AOL admitted that it could not predict membership retention rates or be certain its operating margins had stabilized. Moreover, it admitted competition from other Internet service providers might require it to adopt new pricing programs and, indeed, had put its basic business model at issue. Taking AOL at

134. SOP 93-7, *supra* note 127, ¶ 37.
135. *Id.* ¶ 70.
136. AOL's logic was notably circular in that only through its creative application of SOP 93-7 could it report profits for any period.
137. *Am. Online, Inc.*, Enforcement Release No. 1257, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,366-68.
138. *Id.* at 63,368.
139. *Id.* at 63,365.
140. *Id.* at 63,366.

its word, the SEC held that "given its volatile business environment," AOL could not comply with the requirements of an accounting provision that required reliable predictions of future net revenues.[141]

AOL's admission that its biggest asset was valued on the basis of speculation about its future in a highly protean industry invited the conclusion that this asset represented nothing more than a form of goodwill, booked under circumstances not permitted by GAAP. On the other hand, AOL's disclosure made it difficult for regulators to contend that it had defrauded the market.[142] In short, AOL's practice of deferring enormous costs of membership acquisition, although disclosing information allowing analysts to discount the value of the resulting asset, allowed it to meet its objective of cosmetic enhancement of its financial statements during a critical period in its play for market dominance and limit its potential liability for securities fraud. Due to the SEC's order, however, the particular vehicle AOL chose to manage its earnings will provide less traction for other companies in similar circumstances.

## Balance Sheet Fraud

### Misstatement of Asset Values

The significance of earnings as a measure of corporate performance is discussed above. A company's earnings derive in large measure from the deployment of those economic resources reported on its balance sheet as assets.[143] Assets, "the scarce means that are useful for carrying out economic activities, such as consumption, production, and exchange,"[144] are the "lifeblood of a business enterprise."[145] They are the direct means of its preservation and growth. Hence, schemes to misrepresent the financial health of public companies often tamper with balance sheet as well as income statement items.

141. *Id*. at 63,367-68.

142. When AOL announced the write-off in October 1996, the stock price rose slightly. Thus it appears that its capitalized membership acquisition costs, despite the enormous size of this asset, was so heavily discounted that its write-off was not considered significant by the market.

143. GAAP assets are not synonymous with a company's "capital" in the broad sense of the term to mean all resources that can be applied to profit-making activity. *See* Fridson, *supra* note 10, at 25; Max Weber, The Theory of Social and Economic Organization 192 (A. M. Henderson & Talcott Parsons, trans., Oxford Univ. Press, 1947). For example, a company may have fully depreciated items of property, plant, and equipment that continue to have real economic value, or may have developed significant items of intellectual property that are not yet properly capitalizable under GAAP.

144. CON 6, *supra* note 112, ¶ 27.

145. *Id*. ¶ 15, which continues:

> Since resources or assets confer their benefits on an enterprise by being exchanged, used, or otherwise invested, changes in resources or assets are the purpose, the means, and the result of an enterprise's operations, and a business enterprise exists primarily to acquire, use, produce, and distribute resources. Through those activities it both provides goods or services to members of society and obtains cash and other assets with which it compensates those who provide it with resources, including its owners.

*Id*.

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_983 05/17/2002 08:43AM Plate # 0 pg 983 # 29



Sources of balance sheet misstatement run the gamut from a mere laxity in assessing the continued commercial value of aging equipment to the reporting of nonexistent bank deposits.[146] The most commonly misstated items are probably accounts receivable and inventory.[147] The notorious MiniScribe case[148] brought into the popular vernacular the phrase "shipping bricks" from that company's practice of creating fictitious inventory by loading its warehouses with boxes purporting to contain computer disk drives but actually weighted with the ubiquitous building material. Other extreme examples from recent SEC enforcement actions, which require little in the way of legal analysis, involve the painting of brass bars to look like gold,[149] the creation of fictitious inventory,[150] the double-

146. *See, e.g.*, Berkowitz v. Baron, 428 F. Supp. 1190 (S.D.N.Y. 1977); Gerald R. Hinshaw, Accounting and Auditing Enforcement Release No. 1147, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,654, at 63,168 (Aug. 2, 1999); Miguel A. Cabrera, Accounting and Auditing Enforcement Release No. 1107, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,614, at 63,058 (Feb. 10, 1999); SEC v. Vertucci, Litig. Release No. 16,069, 69 SEC Docket 0641 (Feb. 24, 1999); SEC v. Intercontinental Res., NA, Inc., Accounting and Auditing Enforcement Release No. 1084, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,598, at 63,862 (Sept. 30, 1998); SEC v. Zayed, Accounting and Auditing Enforcement Release No. 1081, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,595, at 63,857 (Sept. 24, 1998); SEC v. Simmons, Accounting and Auditing Enforcement Release No. 1016, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,531, at 63,720 (Mar. 19, 1998); SEC v. Peltz, Accounting and Auditing Enforcement Release No. 1013, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,528, at 63,716 (Mar. 3, 1998); SEC v. Hammer, Accounting and Auditing Enforcement Release No. 980, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,495, at 63,647 (Oct. 30, 1997); Diagnostek, Inc., Accounting and Auditing Enforcement Release No. 762, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,277, at 63,178 (Feb. 23, 1996); Am. Aircraft Corp., Accounting and Auditing Enforcement Release No. 760, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,275, at 63,175 (Feb. 16 1996); SEC v. Incendy, Accounting and Auditing Enforcement Release No. 656, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,116, at 63,549 (Mar. 14, 1995); *see also* Joseph T. Wells, *Ghost Goods: How to Spot Phantom Inventory*, J. ACCT., June 2001, at 33.

147. Joseph Sanfellipo, Accounting and Auditing Enforcement Release No. 1028, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,543, at 63,751-2 (Apr. 27, 1998); Jerry Stone, Accounting and Auditing Enforcement Release No. 1015, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,530, at 63,719 (Mar. 10, 1998); *Peltz*, Enforcement Release No. 1013, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,717; *Hammer*, Enforcement Release No. 980, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,647; SEC v. Montgomery, Accounting and Auditing Enforcement Release No. 940, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,455, at 63,558 (July 24, 1997); *Diagnostek, Inc.*, Enforcement Release No. 762, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,179; SEC v. Fries, Accounting and Auditing Enforcement Release No. 665, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,125, at 63,567 (Apr. 24, 1995); SEC v. Hansen, Accounting and Auditing Enforcement Release No. 654, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,114, at 63,547 (Mar. 13, 1995); Rodney Sparks, Accounting and Auditing Enforcement Release No. 315, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,784, at 63,376 (Sept. 9, 1991).

148. SEC v. Wiles, Accounting and Auditing Enforcement Release No. 308, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,777, at 63,356 (Aug. 14, 1991); Steven C. Wolfe, Sr., Accounting and Auditing Enforcement Release No. 344, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,811, at 63,024 (Dec. 10, 1991).

149. *Montgomery*, Enforcement Release No. 940, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,558.

150. Dorothea Bossio, Accounting and Auditing Enforcement Release No. 909, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,424, at 63,503 (Apr. 29, 1997); SEC v. Gold, Accounting and Auditing Enforcement Release No. 664, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,124, at 63,566 (Apr. 13, 1995).

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_984 05/17/2002 08:43AM Plate # 0 pg 984 # 30



booking of genuine inventory,[151] and the arbitrary doubling of the labor cost of producing inventory.[152]

Of course, any distinction between "income statement fraud" and "balance sheet fraud" will be imperfect. Due to the interactive nature of financial statements, almost any form of asset inflation will also be reflected on the company's income statement. For example, a company that carries obsolete inventory at an inflated valuation will report inaccurate earnings due to its failure to recognize, as an expense, the write down of that inventory. Indeed, many instances of balance sheet tampering by public companies are primarily directed at avoiding or postponing the disclosure of unfavorable earnings information.[153]

Certain financial frauds, however, are specifically directed at falsifying the company's balance sheet, with any effects on earnings being a secondary concern. Within the general category of phony or inflated asset cases fall instances in which the company is attempting to appear in compliance with net asset requirements in regulatory guidelines,[154] private debt covenants,[155] or Nasdaq or Exchange listing standards,[156] or to conceal the wasting or misappropriation of assets by company management.

*SEC v. Comparator Systems Corp.*[157] *Comparator Systems Corp.* provides an example of a balance sheet fraud with no component of earnings management. Comparator was a tiny Southern California company purportedly in the business of producing fingerprint identification technology. From 1993 through early 1996, Comparator common stock was thinly traded at a few cents a share on the Nasdaq SmallCap System. The company reported meager revenue during this period and, indeed, its primary product appears to have been its stock certificates; between July 1,

151. Charles W. Wallin, Accounting and Auditing Enforcement Release No. 774, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,289, at 63,222 (Apr. 19, 1996).

152. Alan Kappel, Accounting and Auditing Enforcement Release No. 552, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,012, at 63,389-34 (Apr. 22, 1994).

153. *See, e.g.*, Arden Franklin, Accounting and Auditing Enforcement Release No. 662, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,122, at 63,558 (Apr. 12, 1995); *Hansen*, Enforcement Release No. 654, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,546.

154. *See, e.g.*, SEC v. Ventana Corp., Accounting and Auditing Enforcement Release No. 714, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,229, at 63,083 (Sept. 21, 1995); Donald F. Withers, Accounting and Auditing Enforcement Release No. 582, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,042, at 63,392 (Aug. 17, 1994).

155. *See, e.g.*, SEC v. Ickovics, Litig. Release No. 16,309, 70 SEC Docket 2303 (D.D.C. Sept. 28, 1999).

156. *See, e.g.*, SEC v. Craig, Accounting and Auditing Enforcement Release No. 1108, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,615, at 63,063 (Feb. 10, 1999); *In re* Gunther Int'l Ltd., Exchange Act Release No. 37,073, 61 SEC Docket 2081 (Apr. 5, 1996); SEC v. Minkow, Accounting and Auditing Enforcement Release No. 269, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,738, at 63,306 (Aug. 15, 1990); SEC v. Comparator Sys. Corp., Accounting and Auditing Enforcement Release No. 786, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,300, at 63,266 (May 31, 1996).

157. *Comparator Sys. Corp.*, Enforcement Release No. 786, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,266; *see also* David Henry & Julie Schmit, *The Big Lie: How a Small Firm Took Wall Street on a Meteoric Rise and Fall*, USA TODAY, June 7, 1996, at B1; Greg Miller, *SEC Files Civil Lawsuit Against Comparator*, L.A. TIMES, June 1, 1996, at A1; Floyd Norris, *S.E.C. Charges Fraud in Case of Tiny Stock That Soared*, N.Y. TIMES, June 1, 1996, at C33.

1992 and May 1, 1996, Comparator sold at least 65 million shares of common stock in Regulation D and Regulation S offerings.[158] All the while, it maintained a Nasdaq listing for its stock by reporting net assets in excess of the $2 million minimum required under Nasdaq SmallCap rules.

Comparator might have gone on happily churning out stock certificates and the occasional press release had it not become a victim of its own sudden and unaccountable success. On three consecutive trading days in May 1996, Comparator stock broke the Nasdaq volume record, attaining, at its peak, a share price of approximately thirty times its historical level.[159] On that day, Comparator's market capitalization exceeded $1 billion. For a company with no recent revenues and, as it later emerged, a history of bad debts and unpaid salaries, this was a startling development indeed.[160]

Unfortunately for Comparator, the regulatory scrutiny that resulted from this episode proved to be the company's undoing. The SEC quickly halted trading in Comparator stock and soon after obtained a preliminary injunction against the company and its primary officers, based largely on evidence that most of the company's assets were of no value because "they embodied no future economic benefit, were recorded improperly, or did not exist."[161]

As is often the case in balance sheet frauds, the assets at issue were unorthodox, and therefore hard to value, and were acquired with the company's own stock.[162] These assets were described in Comparator's filings as patents and licenses, investments, accounts receivable, and prepaid fees. The patents and licenses, however, had either expired or passed irretrievably into the public domain for failure to pay required fees to the U.S. Patent and Trademark Office. The investments were interests in certain private companies not engaged in any particular business activity.[163] The account receivable was a claim against a former employee con-

158. Regulation D provides a safe harbor from the registration requirements of section 5 of the Securities Act of 1933 for "private offerings" meeting certain requirements. 17 C.F.R. § 230.506 (2001). Regulation S provides an exemption from the registration requirements for certain offshore sales of U.S. securities. *Id.* § 230.904 (2001).

159. The reasons for this remarkable performance by a previously obscure stock remain undetermined. Press accounts suggest that an investor frenzy was incited by individuals who touted Comparator stock through the Internet or by unscrupulous penny stockbrokers. Greg Miller & Don Lee, *Sifting Through Debris of Comparator Blowup Securities*, L.A. TIMES, June 8, 1996, at D1; Greg Miller & Tom Petruno, *For Investors, the Internet Has Promise, Perils*, L.A. TIMES, June 3, 1996, at A1.

160. Elliot Blair Smith et al., *The Comparator Story: A Life Divided*, ORANGE COUNTY REG., July 28, 1996, at K1.

161. Eli Buchalter, Accounting and Auditing Enforcement Release No. 818, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,333, at 63,316, 63,317 (Sept. 19, 1996).

162. *See also* SEC v. Madera Int'l, Inc., Accounting and Auditing Enforcement Release No. 1453, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,968, at 63,168 (Sept. 19, 2001); Joseph Salamon, Accounting and Auditing Enforcement Release No. 1207, [1999-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,714, at 63,265 (Nov. 10, 1999); James Bogner, Accounting and Auditing Enforcement Release No. 978, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,493, at 63,646 (Oct. 10, 1997); Dennis Klein, Accounting and Auditing Enforcement Release No. 937, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,452, at 63,548 (July 17, 1997); Frederick R. Grant, Accounting and Auditing Enforcement Release No. 876 [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,391, at 63,438 (Feb. 5, 1997).

163. In one case, Comparator had acquired most of the equity of the other company and hence, under GAAP, was required to consolidate its financial statements with those of its subsidiary, rather

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_986 05/17/2002 08:43AM Plate # 0 pg 986 # 32



cerning certain shares of Comparator stock the company claimed she had stolen.[164] The prepaid fees consisted of a stock bonus paid to Comparator officers, and a transfer of Comparator stock to a consultant as payment for future consulting services about business opportunities in Russia.

That these assets should not have found their way onto the balance sheet of a public company is, at bottom, a matter of their lack of economic utility. Among the fundamental characteristics of an asset is that "it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute . . . to future net cash inflows."[165] Expired patents, equity interests in dormant enterprises, and dubious claims against insolvent former employees have no such capacity.

From its complaint, the SEC viewed Comparator's patents and licenses as so clearly failing to comport with this basic principle that no further analysis was required. Comparator's $1.2 million investments in obscure private companies, if of any value when acquired, had now become so thoroughly impaired that their carrying values should have been written down to nothing.[166] Comparator's purported receivable from its sale of stock to a former employee was improperly recorded for two reasons. First, assuming that Comparator had an enforceable claim for payment—analogous to a stock subscription receivable—GAAP requires that such a claim be recorded as a reduction of shareholders equity, reflecting the dilutional effect of issuing shares in exchange for the hope of future payment, not as an asset.[167] Otherwise, companies could issue stock to the extent of the receivables they wished to record. Second, even if Comparator's claim had been properly recorded as a receivable, it was apparently uncollectible and, therefore, should have been written down to zero.[168] The advance payment in Comparator common stock to the consultant should, under GAAP, have been recorded as a reduction to shareholders' equity for the same reason as the employee receivable.[169] Finally, the prepaid fees to Comparator officers were in reality a form of employee compensation and should therefore have been recorded as a period expense.[170]

than report the amount of its investment as an asset on its balance sheet. CONSOLIDATED FINANCIAL STATEMENTS, Accounting Research Bulletin No. 51, ¶ 2 (American Inst. of Certified Pub. Accountants 1959).

164. The former employee claimed an entitlement to the shares and, in any event, was known to the company to be insolvent.

165. CON 6, *supra* note 112, ¶ 26.

166. The Financial Accounting Standards Board states that if the decline in the carrying value of an investment is judged to be other than temporary, the cost basis of the individual security shall be written down to its fair value and the amount of the write down shall be accounted for as a realized loss. ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, Statement of Financial Accounting Standards No. 115, ¶ 16 (Financial Accounting Standards Bd. 2001); *see also* SEC Staff Accounting Bulletin No. 59, 50 Fed. Reg. 37,346 (Sept. 13, 1985).

167. Eli Buchalter, Accounting and Auditing Enforcement Release No. 818, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,333, at 63,316, 63,320 (Sept. 19, 1996).

168. ACCOUNTING BY CREDITORS FOR IMPAIRMENT OF A LOAN, Statement of Financial Accounting Standards No. 114, ¶ 21 (Financial Accounting Standards Bd. 1993).

169. *Id.*

170. *See* CON 5, *supra* note 17, ¶ 86(b).

*Faking Regulatory Capital: First Pacific Bancorp.* Many phantom asset cases concern regulated entities, such as insurance companies and bank holding companies, that engage in financial subterfuge to conceal a failure to meet regulatory capital requirements. Those that are public companies may also, in the process, falsify the GAAP financial statements they file with the SEC.[171] The litigated opinion in the *Leonard Sands* matter illustrates the lengths to which management of such supposedly staid institutions will go to mislead their regulators.[172]

At the close of the 1980's, the Beverly Hills bank First Pacific Savings was threatened with seizure by federal banking authorities for failure to maintain adequate statutory capital. Its management responded by larding the bank's balance sheet with exotic assets obtained in exchange for stock of the bank's public parent, First Pacific Bancorp. These "assets" consisted primarily of certificates of deposit (CDs) of the National Bank of Liberia and certain contingent interests in U.S. low-income housing projects.

The Liberian CDs represented a particularly brazen attempt to spin gold from financial dross. In 1989, Liberia stood in default on obligations to various international lending agencies, and the government of President Samuel Kenyon Doe was struggling to contain a rebellion led by General Charles Taylor. Under these circumstances, desperate officials of the nation's central bank, the National Bank of Liberia, signed a joint venture agreement with "Dr." Mulc Raj Dass, an Indian national of colorful history,[173] providing that, if Dass could find anyone foolish enough to buy $20 million of the bank's CDs, $5 million would remain in his pocket. The agreement stipulated that the bank would issue the CDs only after receiving cash for them. The wily Dass, however, obtained possession of the CDs by convincing an errant Liberian bank official that payment was imminent. Dass then "sold" $3 million of the "unfunded" (and therefore worthless) CDs to First Pacific in exchange for preferred stock that would throw off no dividends unless

171. The accounting rules enforced by banking and insurance regulators apply only to companies under their oversight, and not all devices used by a company to inflate regulatory assets will also affect its GAAP balance sheet. Such devices may nevertheless violate the securities laws in other respects. In *SEC v. First Capital Holdings Corp.*, Accounting and Auditing Enforcement Release No. 657, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,117, at 63,550 (Mar. 17, 1995), for example, a public insurance company inaccurately reported its statutory capital in the footnote disclosure to its GAAP financial statements required by FASB Statement of Financial Accounting Standards No. 60, and failed to make appropriate MD&A disclosure that the company's reported statutory surplus did not meet regulatory requirements. The SEC charged that this conduct violated the anti-fraud, reporting and books and records provisions of the federal securities laws. *Id.*

172. SEC. v. Sands, Accounting and Auditing Enforcement Release No. 814, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,329, at 63,304 (Sept. 16, 1996); *see also* SEC v. Sands, Litig. Release No. 13,903, 55 SEC Docket (CCH) 1889 (Dec. 14, 1993); Arthur J. Dellinger, Jr., Accounting and Auditing Enforcement Release No. 511, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,970, at 63,330 (Dec. 7, 1993); Janice France, Accounting and Auditing Enforcement Release No. 509 [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,968, at 63,326 (Dec. 7, 1993).

173. Dass was arrested in 1986 by Scotland Yard for allegedly attempting to collateralize a loan with bogus Japanese government bonds from the World War II era, but avoided conviction. In 1989, Dass was arrested again, but not subsequently prosecuted, for attempting to relieve a Malaysian princess of $4 million through a confidence scheme. Subsequent to the events described in this article, Dass was convicted of perpetrating an "advance fee scam" in the United States and sentenced to federal prison.

First Pacific managed to lay the CDs off on someone else.[174] On the basis of this arrangement, First Pacific Bancorp recorded the Liberian CDs, at their full face value of $3 million as "interest bearing deposits in other banks."[175]

Within a year of this filing, the Doe government had been overthrown and Doe executed. Attempts by First Pacific to sell the CDs to other parties had failed and the bank had been seized by the banking regulators. In the ensuing SEC litigation, the court held that "[t]he booking of the CDs as assets was an apparent attempt to ignore the high probability that the CDs had no value and could not be collected."[176] In short, the bank's "purchase" of the Liberian CDs had been a mere trash for trash swap, contrived to fraudulently conceal the bank's bleak capital position from its regulators.

Further pumping up First Pacific's balance sheet were $5.6 million in remainder interests in low-income housing ventures financed by the U.S. Department of Housing and Urban Development (HUD). Designated "residual interest wrap notes," these assets were essentially unsecured contingent claims against partnerships that owned and operated tax shelter real estate projects. The wrap notes generated no cash during their terms, which could extend to forty years, instead accruing interest that would be paid only from an eventual distribution from equity. Their value was therefore highly speculative, requiring a determination of what value, if any, would remain in the properties after the HUD financing was extinguished, perhaps many years in the future,[177] and discounting that amount to present value. In the formula used to place a dollar value on these instruments, however, First Pacific relied on appraisals that failed to take into consideration the contingent nature of the instruments.

First Pacific paid for the wrap notes mainly with paper of dubious value. Although it contributed $766,000 in cash to the deal, the remainder of the $5.6 million purchase price was provided in the form of Bancorp preferred stock and contingent "success fees" (essentially equity kickers) on certain real estate ventures financed by First Pacific.

In litigation, the SEC successfully argued that the wrap notes were not worth what the bank claimed.[178] Under GAAP, when one "nonmonetary asset," in this case a wrap note, is swapped for another, here Bancorp preferred stock or "success fees," the value of the exchange is set by the asset of more clearly ascertainable value.[179] If the "fair value" of neither is reasonably determinable, "the recorded

174. What use Dass intended to make of the apparently worthless First Pacific stock is unknown.

175. *France*, Enforcement Release No. 509, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,328.

176. SEC v. Sands, 902 F. Supp. 1149, 1161 (C.D. Cal. 1995).

177. Most of the eleven properties involved were approximately half-way through the forty-year period that the owners were required, under their contract with HUD, to maintain the properties in order to retain their tax benefits.

178. The same issues were addressed in the settled administrative proceedings against two other former bank officers and the Bancorp's former auditors. *See supra* note 172.

179. The Financial Accounting Standards Board provides that the value of a "nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it," unless the value of the acquired asset is more clearly evident. ACCOUNTING FOR NONMONETARY TRANSACTIONS, Accounting Principles Board Opinion No. 29, ¶ 18 (Financial Accounting Standards

amount of the nonmonetary asset transferred . . . may be the only available measure of the transaction."[180] The wrap notes had been valued through a formula based on so little evidence that their actual value remained indeterminate. Similarly, the Bancorp preferred stock and "success fees" had no ascertainable value. Thus, under GAAP, First Pacific was thrown back on the book value of the nonmonetary assets it had given up to acquire the wrap notes as the "only available measure" of their value. Neither the preferred stock nor the success fees had ever been recorded as assets, however, leaving only the $766,000 cash component of the transaction to set the value of the assets acquired. This was therefore the value at which First Pacific should have carried the wrap notes, not the $5.6 million it reported in its filings.

Although this analysis may seem academic when applied to what was evidently another trash for trash swap, nonmonetary transactions sometimes have real economic substance that should be recognized. Therefore GAAP attempts to determine "fair value" through reference to analogous transactions with ascertainable cash values. The difficulty of determining what market-derived evidence is sufficient to provide reliable values is obvious. For this reason exchanges of nonmonetary assets will continue to provide a convenient vehicle for financial fraud unless carefully policed by auditors and regulators.[181]

## MISSTATEMENT OF LIABILITIES

Improper accounting for liabilities raises many of the same issues as that for expenses, discussed above, and so will be considered only briefly as a separate topic.[182] Deserving of specific attention, however, are several topics going to the forward-looking nature of liabilities—in contrast to, for example, operating expenses that are settled through payment in the period incurred. In addition, the case study of the *Sunbeam* litigation that concludes this Article addresses fraudulent misstatement of liabilities in the important context of the corporate restructuring.

Bd. 1973) [hereinafter APB Opinion No. 29]. Fair value "should be determined by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence." *Id.* ¶ 25.

180. *Id.* ¶ 26. APB Opinion No. 29 further states that "[f]air value should be regarded as not determinable within reasonable limits if major uncertainties exist about the realizability of the value that would be assigned to an asset received in a nonmonetary transaction accounted for at fair value." *Id.*

181. The First Pacific litigation also provides an example of balance sheet fraud used for the purpose of concealing the diversion of corporate assets. This did not involve the financial statements of First Pacific but rather those of a small Nevada corporation controlled by First Pacific chairman Leonard Sands. The Nevada company plowed money it had obtained from a blind pool offering into a stalled First Pacific offering, then misrepresented that transaction in its Commission filings. *Sands*, 902 F. Supp. at 1154; *see also* SEC v. Curry, Accounting and Auditing Enforcement Release No. 950, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,465, at 63,576 (Sept. 4, 1997) (alleging that illicit payments to the controller of the company and his brother were booked as purchases of inventory and equipment).

182. In many instances, a liability reported on a company's balance sheet will be reflected on its income statement by a corresponding expense, decreasing net income by that amount.

A liability is an unsatisfied economic obligation of a company sufficiently determinable that it should be reported as a claim upon the company's resources. The concept is broader than that of legal liability, also extending to "equitable and constructive obligations."[183] The garden-variety liability is the trade payable. As might be expected, therefore, many businesses struggling to present a false impression of financial health have contrived to shuffle trade payables off their books.[184] Other liabilities that have gone missing cover a wide range from unpaid taxes[185] to various costs of capital raising.[186] Methods of concealment have included destroying invoices, faking payment documentation, and misclassifying liabilities to asset accounts.[187]

As with other approaches to earnings management, the sophisticated abuses tend to cluster around the more subjective areas of accounting practice. Companies that face financial obligations that are both "probable" and "estimable" are required to establish liabilities reflecting the prospective losses.[188] This "best guess" standard presents latitude for abuse frequently exploited by businesses under financial stress. Many retailers have postponed truing up their reported results of operations by under-reserving for bad receivables or other impaired assets.[189] Banks and other financial institutions have sought to boost earnings or satisfy regulatory capital requirements by providing insufficient reserves for loan losses.-

183. CON 6, *supra* note 112, ¶ 35 n.22.

184. *See, e.g.*, SEC v. Ferrarini, Accounting and Auditing Enforcement Release No. 1008, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,523, at 63,710 (Jan. 29, 1998); Ngai King Tak, Accounting and Auditing Enforcement Release No. 946, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,461, at 63,567 (Aug. 28, 1997); Centuri, Inc., Accounting and Auditing Enforcement Release No. 775, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,290, at 63,228 (Apr. 19, 1996); SEC v. Rakoff, Accounting and Auditing Enforcement Release No. 240, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,709, at 63,253 (Aug. 17, 1989).

185. Arthur Andersen LLP, Accounting and Auditing Enforcement Release No. 1410, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,925, at 63,069 (June 19, 2001); Charles W. Wallin, Accounting and Auditing Enforcement Release No. 774, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,289, at 63,222 (Apr. 19, 1996); SEC v. Atkinson, Accounting and Auditing Enforcement Release No. 163, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,632, at 63,075 (Sept. 30, 1987).

186. *See, e.g.*, SEC v. Nat'l Bank of Ga., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,402, at 93,413 (Apr. 26, 1978) (alleging failure of bank to record borrowings from other banks as liabilities); Douglas P. Rosile, Accounting and Auditing Enforcement Release No. 641, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,101, at 63,522 (Jan. 19, 1995) (alleging failure to recognize as liabilities profit distributions due to limited partners); SEC v. McFliker, Accounting and Auditing Enforcement Release No. 174, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,643, at 63,086 (Dec. 21, 1987) (alleging purported sales contracts countervailing obligations to customers that caused the arrangements to be considered financing agreements).

187. *See, e.g., Tak*, Enforcement Release No. 946, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,568; *Wallin*, Enforcement Release No. 774, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,222; SEC v. Monus, Accounting and Auditing Enforcement Release No. 667, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,127, at 63,568 (May 3, 1995); and SEC v. Earthworm, Inc., Accounting and Auditing Enforcement Release No. 291, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,760, at 63,335 (Feb. 28, 1991).

188. FAS 5, *supra* note 67, ¶ 8.

189. *See, e.g.*, Greg Steven Kaplan, Accounting and Auditing Enforcement Release No. 844, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,359, at 63,375 (Oct. 21, 1996); *Atkinson*, Enforcement Release No. 163, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,075; SEC v. McMahen, Accounting and Auditing Enforcement Release No. 72, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,472, at 63,240 (Sept. 12, 1985).

This became a significant source of cases for the SEC and other regulators in the wake of the savings and loan crisis of the 1980s.[190] Other items against which companies have failed to adequately reserve include projected costs of environmental remediation,[191] self-insurance,[192] and legal judgments.[193]

Earnings management primarily concerns the timing of income in relation to points of reference established by reporting periods, analysts' expectations, and significant corporate events. When the misstatement of liabilities are the means of choice, companies most often push liabilities into later periods, hoping, like the Dickens character, that "something will turn up" to allow them to square their accounts at some future date. Some circumstances, however, will encourage precisely the opposite practice; in the same way that a company may overstate expenses—accepting a reduction to current period income to enhance future results—it may over-reserve for liabilities, creating a "cookie jar" that management can bleed into income at its discretion.[194]

Inflated reserves often follow unexpected profits that permit management to squirrel away income to remedy future lean periods without disappointing analysts' expectations in the short run, or a major corporate event that shifts market scrutiny from present to future results. A change in management, a corporate restructuring, or a major acquisition may cause analysts to see a present shortfall as a down payment on future improvements. In such cases, management will be tempted to throw everything possible into the company's "big bath," knowing that the market will largely disregard the company's present results.[195] The lack of objective precision to restructuring and acquisition reserves, based, as they are, on management's prediction of future developments, provides an element of opportunity to serve the motives for deceit just described.[196]

190. SEC v. Youmans, 543 F. Supp. 1292 (E.D. Tenn. 1982), *rev'd*, 729 F.2d 413 (6th Cir. 1984), *cert. denied*, 469 U.S. 1034; SEC v. Morris, Accounting and Auditing Enforcement Release No. 545, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,005, at 63,389-25 (Mar. 31, 1994); SEC v. Parigian, Accounting and Auditing Enforcement Release No. 257, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,726, at 63,288 (May 18, 1990).

191. *See also* Lee Pharms., Accounting and Auditing Enforcement Release No. 1023, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,538, at 63,739 (Apr. 9, 1998).

192. *See supra* notes 43-46 and accompanying text (discussing of the *Healthcare Services* case). Daniel C. Langford, Accounting and Auditing Enforcement Release No. 877, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,392, at 63,442 (Feb. 6, 1997).

193. George Christopher Bleier, Accounting and Auditing Enforcement Release No. 983, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,498, at 63,648 (Nov. 7, 1997).

194. Scott K. Barton, Exchange Act Release No. 44,500, 75 SEC Docket (CCH) 770 (July 2, 2001).

195. MICHAEL R. YOUNG, ACCOUNTING IRREGULARITIES AND FINANCIAL FRAUD 102 (2000); Floyd Norris, *The S.E.C. Tries to Make Companies Take Smaller Baths*, N.Y. TIMES, Nov. 26, 1999, at C1; Kelly, *Accountancy Body To Limit Liabilities Ruse*, LONDON TIMES, Sept. 17, 1998, at 10.

196. For a sharp-edged exposition of the abuses connected to restructuring reserves, see Walter P. Schuetze, Cookie Jar Reserves, Remarks at the Nineteenth Annual Ray Garrett, Jr., Corporate and Securities Law Institute (Apr. 22, 1999), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch276.htm; *see also* SEC v. W.R. Grace & Co., Accounting and Auditing Enforcement Release No. 1091, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,599F, at 63,867 (Dec. 22, 1998); Peter C. Ferraro, Accounting and Auditing Enforcement Release No. 804, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,319, at 63,286 (July 24, 1996); Ann Davis, *SEC Case Claims Profit 'Management' by Grace*, WALL ST. J., Apr. 7, 1999, at C1.

## Sunbeam: A Case Study in Financial Fraud

The much-publicized *Sunbeam* case illustrates not only the potential evils of "big bath" restructurings, but also a plethora of other devices used to distort reported financial performance, many of which were touched on above. Thus it provides a summary of the state of the art of earnings manipulation.

In July 1996, Sunbeam's board of directors hired Albert Dunlap, colloquially known as "Chainsaw Al," to revive the financially ailing company through an extensive downsizing. The intended end game appears to have been the quick sale of the company at a substantial multiple to earnings. Based on market optimism that Dunlap's team could improve the company's results, bolstered by strong earnings reports through most of Dunlap's tenure, Sunbeam stock quadrupled in price between July 1996 and March 1998. Sadly, however, it now appears that this transient success of market perception rested on cleverly manipulated earnings rather than a genuine turnaround of Sunbeam's performance.[197]

The program of earnings management began at year-end 1996, when management created a cushion for future periods by larding Sunbeam's balance sheet with $35 million in improper reserves and accruals. Sunbeam's overstatement of liabilities was dwarfed by its huge loss for the year (the result of a $337.6 million restructuring charge), but the subsequent release into income of the "cookie jar" reserves thus created would have a material effect on each quarter of 1997. First, Sunbeam slipped into its 1996 "big bath" an extra $18.7 million in liabilities—purportedly related to the restructuring—that either should not have been booked until a later period or should not have been booked at all. More crudely, Sunbeam recorded as 1996 expenses fees it had agreed to pay its advertising agency for future services, in contravention of GAAP "matching" requirements,[198] and inflated its reserves for liabilities related to other promotional activities. Sunbeam also booked litigation reserves that exceeded any reasonable estimate of its loss exposure,[199] and, finally, understated the cost basis of its inventory, thus increasing the margin to be realized upon its subsequent sale.

Throughout 1997, Sunbeam management doled out the contents of its cookie jar as needed to hit quarterly earnings targets and give the impression of a successful restructuring. In the first quarter, management offset improper restructuring reserves against various period expenses, inflated income through the sale of

197. The following description of Sunbeam's accounting practices is based primarily on the SEC's allegations in three filed enforcement actions and Sunbeam's restatement of its reported results of operations for the last quarter of 1996 through the first quarter of 1998. Sunbeam and the associated individuals named in enforcement actions have either settled the SEC's claims without admitting of denying their accuracy, or are contesting those claims in litigation. SEC v. Dunlap, Accounting and Auditing Enforcement Release No. 1395, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,910, at 63,035, 63,036-37 (May 15, 2001); Sunbeam Corp., Accounting and Auditing Enforcement Release No. 1393, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,908, at 63,023, 63,033 (May 15, 2001); David C. Fannin, Accounting and Auditing Enforcement Release No. 1394, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,909, at 63,033, 63,033 (May 15, 2001).

198. CON 5, *supra* note 17, ¶ 85.

199. FAS 5 requires that such reserves be for loss contingencies that are both probable and estimable. FAS 5, *supra* note 67, ¶ 8.

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_993 05/17/2002 08:43AM Plate # 0 pg 993 # 39



product with an artificially reduced cost basis, and ignored period advertising expenses it had fraudulently pulled into the previous year. This contributed materially to the company's bottom line for the quarter. Moreover, Sunbeam "sold" to a distributor $1.5 million in product Sunbeam agreed could be returned if not resold. As noted above, "contingent sales" do not support recognition of revenue under GAAP. Even if this transaction could be characterized as a "sale with a right of return," rather than a contingent sale, the revenue was still not proper. To recognize revenue on such sales, the seller must reasonably estimate future returns and reserve accordingly.[200] Sunbeam had no history of sales of this type, and hence no basis for estimating future returns.[201]

As a final measure, Sunbeam sold at a deep discount $19.6 million in excess and obsolete inventory.[202] This one-time boost to revenue, although not offensive to GAAP, should have been disclosed as an "infrequent event" in the "Management's Discussion and Analysis" section of Sunbeam's quarterly report.[203] Instead, the Company trumpeted its purported 10.3% increase in net sales over the same quarter of 1996 with no acknowledgment of the various nonrepeating items that had contributed to that result.[204]

In the following quarter, *most* of Sunbeam's income came from non-GAAP sources. First, $14.6 million in cookie jar reserves were bled into income. Sunbeam further supplemented earnings by inducing certain of its suppliers to provide $2.75 million in "rebates." Despite this designation, the payments were made in exchange for price, contract duration, and other concessions relating to Sunbeam's future purchases. Thus, they should have been treated as advance payments of price discounts and recorded as income at the time of the purchases to which the discounts related.[205]

Further, Sunbeam pulled sales out of later periods into the second quarter through another contingent sale to a distributor and by means of a "bill and hold" sale. Under the standard previously articulated by the Commission, a proper bill and hold sale must comply with various criteria, including:

> (1) The risks of ownership must have passed to the buyer; [and] . . .
> (3) The buyer, not the seller, must request that the transaction be on a bill and hold basis. The buyer must have a substantial business purpose for ordering the goods on a bill and hold basis.[206]

200. FAS 48, *supra* note 56, ¶ 6(f).

201. *Id.* ¶ 8(c).

202. Because of the offset against previously established reserves, a reader of the financial statements would not have been able to determine that these sales were at a negative margin.

203. 17 C.F.R. § 229.303(a)(3) (2001).

204. Moreover, in its Form 10-Q for the first quarter of 1997, Sunbeam touted the purported improvement to its gross margins without disclosing that this change reflected, in part, the release of excessive reserves and the recording of 1997 expenses in 1996.

205. CON 5, *supra* note 17, ¶ 83(a).

206. Stewart Parness, Accounting and Auditing Enforcement Release No. 108, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,508, at 63,357, 63,364 (Aug. 5, 1986). The Commission cautioned, however that "[i]n some circumstances, a transaction may meet all the factors listed above but not meet the requirements for revenue recognition." *Id.* at 63,365.

Other relevant facts include: "whether [the seller] has modified its normal billing and credit terms for this buyer" and "[t]he seller's past experiences with and pattern of bill and hold transactions."[207]

Sunbeam's bill and hold transactions did not meet these criteria. Sunbeam aggressively procured these sales by granting whatever price, credit, and other concessions were necessary to induce customers to write purchase orders early. Thus, it would be disingenuous to claim that the buyer had requested "the transaction be on a bill and hold basis."[208] It is also difficult to argue that the buyer had "a substantial business purpose for ordering the goods on a bill and hold basis," when its only motive was to obtain the various inducements offered by the seller.[209] Such an interpretation would substitute the seller's business purpose (to accelerate recognition of sales revenue) for the buyer's. Moreover, Sunbeam's customers accepted no additional risks of ownership as a result of the buy and hold structure of the transactions. Sunbeam paid all costs of insuring, storing, and shipping the product and apparently would have allowed the orders to be cancelled at any time. In short, these transactions were little more than projected orders tricked up to look like sales.

Even if Sunbeam's bill and hold sales met the *Parness* standard, they would have contributed substantially to Sunbeam's channel stuffing campaign. Under Regulation S-K, a company that accelerates material amounts of sales revenue must disclose this as a business practice and discuss its financial implications for future periods.[210] As one district court stated:

> Courts have held that allegations of omissions and misrepresentations regarding channel stuffing and the effects [on] competition are actionable. In *In re Lotus Development Corp. Sec. Lit.*, 875 F. Supp. 48 (D. Mass. 1995), the Court determined that plaintiff's factual allegations concerning inventory backlog supported the inference of misrepresentation as to the company's true financial status. In *In re Compaq Sec. Lit.*, 848 F. Supp. 1307, 1320 (S.D. Tex. 1993), the court upheld allegations of channel stuffing strikingly similar to those found here. Additionally, in *Compaq*, *supra*, the Court denied summary judgment where plaintiffs alleged that defendants' announcement of quarterly sales and earnings was materially inaccurate because management may have failed to properly account for the effects of dealer inventory overstock. 848 F. Supp. at 1320.[211]

207. *Id.* at 63,365.
208. *Id.* at 63,364.
209. *Id.*
210. 17 C.F.R. §§ 229.101(a)(1), 229.303(a)(3)(iii) (2001).
211. Harvey M. Jasper Ret. Trust v. Ivax Corp., 920 F. Supp. 1260, 1266-1267 (S.D. Fla. 1995); *see also* Cypress Bioscience Inc., Accounting and Auditing Enforcement Release No. 817, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,332, at 63,308, 63,311 ("In the MD&A narrative, de Soto failed to disclose Cypress' reliance upon volume discount/storage program revenue to make up for substantial shortfalls from the company's revenue goals for the third quarter of 1993."). Another court expressed skepticism of channel stuffing as a basis for fraud liability. Greebel v. FTP Software, Inc., 194 F.3d 185, 202-03 (1st Cir. 1999). It appears beyond doubt, however, that the undisclosed front-loading of sales revenue can grievously deceive investors, analysts, and lenders. The almost complete evaporation of Sunbeam's market capitalization when it became known that it had played timing games with its sales revenue provides a clear illustration of the perniciousness of this practice.

During the last two quarters of 1997, channel stuffing was no longer merely one of many means used by Sunbeam management to inflate income and conceal disappointing sales, but rather the primary method. Although Sunbeam also raided its balance sheet for restructuring and litigation reserves, booked income from supplier rebates that properly related to future periods, and avoided period advertising expenses by having booked them the previous year, the third and fourth quarters were largely characterized by frantic efforts to pull forward sales that would normally have occurred in later periods.[212] This included $32 million in fourth quarter bill and hold sales, some of which were, in substance, mere parking arrangements.[213]

Through early 1998, Sunbeam continued to present a picture of success to the investing public. In truth, the company's relentless channel stuffing had brought about a mounting sales shortfall, which even $35 million in new bill and hold sales could not close. Sunbeam had not only pulled revenue from 1998 into 1997, but also pushed certain expenses from 1997 into 1998. Both acted to impoverish 1998 earnings. The burden of past sins carried by Sunbeam, moreover, included the undisclosed dumping of excess and obsolete inventory in the first quarter of 1997, which negatively skewed comparisons to first quarter 1998 sales figures. Thus, with no acquirer yet in sight, management engaged in increasingly desperate efforts to stave off public exposure of Sunbeam's weakening financial condition. For example, management deleted from the company's computer system all records of pending returns of merchandise, artificially boosting Sunbeam's net sales for the first quarter and concealing the inadequacy of its reserves.[214]

In March and April 1998, Sunbeam acquired three other companies, apparently as the premise for another "big bath" restructuring. But this expedient was never implemented. Sunbeam's game against time had failed. After criticism of its sales practices began appearing in the press,[215] Sunbeam's board ordered an internal investigation. This led to the termination of Dunlap and various members of his management team, and the revision of Sunbeam's financial statements from the fourth quarter of 1996 though the first quarter of 1998. Sunbeam's stock, which had reached a high of fifty-two dollars per share in March 1998, now traded for

212. Filling out the grab bag of tools employed by Sunbeam to inflate income in the final quarter of 1997 was an $11 million sham sale of spare parts. A mere "agreement to agree," this transaction had no definite price term and transferred no economic risk to the buyer. Sunbeam Corp., Accounting and Auditing Enforcement Release No. 1393, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,908, at 63,023, 63,029 (May 15, 2001). Hence there was no colorable basis to treat it as a revenue transaction. CON 5, *supra* note 17, ¶ 83.

213. Sunbeam's 1998 Form 10-K disclosed that it had implemented an "early buy" program with respect to certain merchandise. The description of this program, however, fell far short of meaningful disclosure of the extent to which Sunbeam had accelerated sales revenue as needed to make its numbers. *Sunbeam Corp.*, Enforcement Release No. 1393, 7 Fed. Sec. L. Rep. (CCH) at 63,029-30.

214. This was, of course, a violation of the internal controls as well as the books and records provisions of the securities laws, as well as part of a scheme to defraud. *See* SEC v. Fukuhara, Accounting and Auditing Enforcement Release No. 1026, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,541, at 63,750 (Apr. 22, 1998).

215. The article that got the ball rolling was Jonathan R. Laing, *Dangerous Games: Did "Chainsaw Al" Dunlap Manufacture Sunbeam's Earnings Last Year?* BARRON'S, June 8, 1998, at 17.

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_996 05/17/2002 08:43AM Plate # 0 pg 996 # 42



less than a dollar. From peak to trough, the loss to investors was approximately $2.5 billion.

## CONCLUSION

Our public equity markets, for all of their virtues as an engine of economic accumulation, are marred by intrinsic conflicts of interest. Most notably, management does not always fully share the interests of investors in accurate financial disclosure. When these conflicts of interest cause a public company's reported results of operations to diverge from its actual performance, the liability of those responsible is often evaluated under legal standards of financial fraud. These standards are the final test of what the system will tolerate in terms of earnings management through creative accounting.

Fraud of every stripe occurs at the intersection of motive and opportunity. Management's motive to distort a company's financial results is routinely present in a world where it is judged by a few performance metrics, displayed at periodic intervals. It is heightened when financial rewards for managers are tied closely to short-term earnings targets. The brake on management misconduct provided by outside auditors is undermined by their knowledge they are retained at the sufferance of management. Requiring professionals to discipline the clients who pay their fees may place them under significant ethical stress. The more important the client, the greater will be the incentive to overlook improper conduct.

Opportunity for fraud is largely determined by the integrity of the company's financial reporting system and the nature of its business environment. The more limited and informal the company's internal controls, the more easily they are compromised. Thus, we see the relative prevalence of misconduct at small-cap companies. In addition, certain business environments are particularly hospitable to fraud. A company that sells its products or services to a few pliable customers, or to customers in countries with lax regulatory oversight, or through transactions with obscure, complex or unwritten terms will find wide latitude for abuse.

Opportunity for fraud is also fostered by the vagaries of financial reporting. No business enjoys perfect financial information. Particularly over the short term, measurements of commercial success are often less than precise and may involve a degree of subjectivity bordering on guesswork. Those metrics requiring predictions of future events, as required by accrual accounting, are unavoidably imprecise. Accounting and auditing standards recognize the lack of perfect information available to managers through, among other things, the acceptance of materiality thresholds. The play incorporated in our rules of financial disclosure, however, goes beyond commercial realism to allow, in some areas, unnecessary latitude to conform a company's financial statements to management's aspirations rather than its actual accomplishments. Permissive or imprecise standards undermine basic goals of transparency and enforceability, create perverse incentives to managers to engage in transactions of little economic utility, and add to the tools available to those inclined to commit fraud. Indeed, deceptive accounting routinely gravitates to those areas least subject to empirical confirmation, the permanent frontier of financial reporting.

Name /plr_tbl573_104837/tbl573_01_sauer/Mp_997 05/17/2002 08:43AM Plate # 0 pg 997 # 43



The confidence of the investing public will be maintained, and capital will find its most productive uses only if corporate financial disclosure is clear and reliable. Thus, the boundaries of acceptable accounting must be policed aggressively. Given the motives for deceit that will always exist, opportunity for fraud must be limited by the constant refining of our standards in the light of commercial reality. A fixed resolve to draw a line beyond which the law's tolerance will not extend remains essential to the integrity of our economic life. When those who would profit from fraud push the law, the law must push back.