
CHAPTER 1

The Income Statement—Revenues

Most lawyers represent businesses. Because the language of business is finance, it behooves lawyers to have a good working knowledge of the practical aspects of corporate finance.

There are three major financial documents: the income statement, the balance sheet, and the cash flow statement. Each is important, and Chapters 1 through 5 explain what to look for in each one of them.¹

Usually the best place to begin your analysis of financials for a business is with the income statement, sometimes called the profit and loss statement or statement of operations. The income statement shows the company's revenues and expenses for a specific period of time, which can be a year, a quarter, a month, a week, or other period.

Sidebar 1.1 International Financial Reporting Standards

Although this book is geared to U.S. accounting standards, some 100 countries are using international financial reporting standards ("IFRS"), and that number could easily climb to 150 by 2010. The U.S. Financial Accounting Standards Board ("FASB") and its counterpart, the International Accounting Standards Board ("IASB") have been at work for several years toward convergence of the two bodies of rules. As this occurs, there is some tension between detailed guidance, preferred by the shell-shocked U.S. accounting industry, versus principle based standards, preferred by the IFRS, which do not cover all possible scenarios. There is also some tension between the two systems in terms of rule content, although the rule-makers on both sides have tried to use that to advantage by crafting rules which capture the best of each system to most accurately reveal the underlying economic realities. In any event, given global competition, putting companies on a comparable accounting basis worldwide should aid investors in making global decisions and thus deploy capital more effectively.^{1, 2}

1. For an interesting article on this topic, see Tim Reason, *The Narrowing Gap: The Convergence of Foreign and Domestic Accounting Rules Could Catch Some U.S. Companies by Surprise*, CFO MAGAZINE, Dec. 2005, at 48–52.

2. The convergence of global accounting systems does not alleviate the need for separate accounting rules where required by local tax authorities. For instance, the tax authorities in the European Union member countries still require local generally accepted accounting principles ("GAAP") as their starting point.

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Table 1.1
Income Statement of Kellogg Company³

(\$ millions)	
Net sales ⁴	\$10,177.2
Cost of goods sold	5,611.6
Selling, general and administrative	<u>2,815.3</u>
Operating profit	\$1,750.3
Interest expense	\$300.3
Other income (expense), net	<u>(24.9)</u>
Earnings before income taxes	\$1,425.1
Income taxes	<u>444.7</u>
Net earnings	\$980.4

1.1 Overview

A good place to start your analysis of the income statement is at the revenue line. The income statement of Kellogg Company, the cereal company, is provided as an example at Table 1.1 above. In it, you will see that Kellogg uses the term “Sales” rather than “Revenues,” which is the way many companies refer to revenues when they are selling a product rather than a service.

First, check the sheer size of the company. (The term company includes not only corporations but also limited liability companies, limited liability partnerships, and limited liability limited partnerships.) Size is usually measured by revenues, except that the size of financial institutions is usually measured by assets. In 2005, the largest American company⁵ was ExxonMobil, with revenues of \$340 billion, followed by Wal-Mart and General Motors, with revenues of \$316 billion and \$192 billion, respectively. The largest American financial institution was Citigroup, with \$1.5 trillion in assets, followed by Bank of America Corp. and J.P. Morgan Chase & Co., with \$1.3 and \$1.2 billion in assets, respectively.⁶

At the other extreme, there are small, privately owned businesses, such as print shops, restaurants, bookstores, limousine services, and the like. Most companies fall between these extremes, and where they fall on the size spectrum

3. KELLOGG COMPANY 2005 ANNUAL REPORT.

4. The “Net” in “Net sales” usually means net of doubtful accounts, explained in Chapter 2, and net of any sales taxes.

5. *America’s Largest Corporations*, FORTUNE MAGAZINE, Special Issue, F-1 *et sequitur* (April 17, 2006). Indeed, ExxonMobil was the largest company in the world, followed by Wal-Mart and Royal Dutch Shell, with \$316 billion and \$307 billion in revenues, respectively.

6. Federal National Mortgage Company (“Fannie Mae”) reports on its website that as of October 31, 2005, it had some \$875 billion in net investments. However, on December 22, 2004, it announced that its previously issued financial statements should not be relied on in light of the determination by the U.S. Securities and Exchange Commission’s determination that its financial statements were not prepared in accordance with generally accepted accounting principles (GAAP). It was not included in the Fortune 500 published on 18 April 2005.

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provides an indication of the resources that each has at its command. To be sure, size alone (as measured by revenue) is not the whole financial story, for, as we will see, there are some very big companies that are doing poorly, and some small companies doing extraordinarily well. Yet at the first cut, it is useful to make note of the size of the company. As of year-end 2005, a company with revenues of \$21.3 billion or more was in the Fortune 100, which means that it was one of the one hundred largest corporations in the United States. If it had revenues between \$4.0 billion and \$21.3 billion, then it was in the Fortune 101-500.

The business community sometimes classifies companies by the market value of their outstanding stock. This can be measured by the market value per share times the number of shares outstanding. The total market value of the outstanding stock is often referred to as a company's market capitalization or simply as its market cap. As of March 17, 2006, the company with the largest market cap⁷ in the United States was ExxonMobil, with a market cap of \$372 billion, followed by General Electric, Microsoft, Citigroup, and Bank of America, with market caps of \$360 billion, \$284 billion, \$236 billion, and \$217 billion, respectively.⁸ Capitalization categories are defined in different ways. The Investment Company Institute (an association of investment companies) classifies large-cap companies as having a market value of \$5 billion or more, mid-cap companies having a market value of \$1 billion to \$5 billion, and small-cap companies having a market value of less than \$1 billion.⁹

After noting the size of the company, it is usually useful to check the rate of growth. On average, U.S. companies during the five years, 2001-2005, grew about 2.6% a year, barely ahead of inflation, although the rate of growth and the spread above inflation increased toward the end of this period.¹⁰ Some companies, of course, grow more rapidly. If a company is not growing at least by the inflation rate, then it is shrinking in real terms, which is generally, although not always, a bad sign.

Even if a company is growing nicely, there are two possibilities worth asking about, and they are not usually disclosed in the financials (although in the case of publicly held companies in the U.S., it may be necessary to discuss these in the management discussion and analysis ["MD&A"]). First, if the revenues have grown by, say 20%, it may be that the company sold the same number of units but was able to raise prices by 20%. Alternately, perhaps prices were unchanged but it sold 20% more units. Second, perhaps the company sold the same number of units but sold them all overseas and the dollar dropped against the

7. Market capitalization is measured by the number of shares outstanding multiplied by the market value per share.

8. *America's Largest Corporations*, FORTUNE MAGAZINE, Special Issue, F-1 *et sequitur* (April 17, 2006).

9. There are other ways to classify capitalization sizes. For instance some brokerage firms use the following: Mega cap is \$200 billion and higher; Big/Large cap is \$10-200 billion; Mid Cap is \$2-10 billion; Small Cap is \$300 million to \$2 billion; Micro Cap is \$50-300 million; and Nano Cap is under \$50 million.

10. *Current Estimates and Percent Change of the GNP*, ANNUAL REVISION OF THE NATIONAL INCOME AND PRODUCT ACCOUNTS U.S. Dept of Commerce; Bureau of Economic Analysis 2006.

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relevant foreign currencies with the result that the revenues, when translated into dollars, were worth more. Conversely, perhaps the company sold twice the same number of units overseas but the foreign currency(ies) fell against the dollar, making them worth less when translated into dollars.

Although not strictly part of the financials, particularly for a younger company it is often useful, especially in the context of due diligence being conducted in connection with an offering registered under the Securities Act of 1933, to get a sense of how much room for growth there is in the company's business. For instance, when Nanosys, a start-up nano-technology company, filed to go public in 2004,¹¹ it had negligible revenues, a loss of \$9 million in its most recent year, and did not expect to have a product to bring to market for at least two years, if ever. Nonetheless the market cap put on the company was expected to be in the hundreds of millions because Nanosys had a very strong board of directors and management team, contractual relations with Intel, Matsushita Electric, and other leading companies, and was working to develop nano-based systems with applications in electronics, energy, defense, health care, and information technology, potentially a multibillion-dollar market, if it succeeded.

That, then, spurs a follow-up question. Even if the potential market is big, can the issuer sustain any advantage it might have therein? In the case of Nanosys, that advantage might be in the form of patents, trade secrets, other intellectual property, or key people. If the latter, then one would want to see tight noncompete and nondisclosure agreements, and the human resource component of the company would have a particularly important link to the strategy. For this information, one would have to look outside the financial statements.

In other cases there might be another source of sustainable advantage, such as superior management talent, lower costs (due to experience curve effects, lower cost sources of supply, or economies of scale), better distribution channels, contracts with key customers or suppliers, or successful differentiation. In the absence of such an advantage, the revenue growth might be temporary, or, even if revenues grow, competition might enter (or respond, if already in the market) in a way that results in low returns.

Returning to the revenue line, there are other matters to probe. First, there are some technical accounting matters that merit attention. Lawyers are not trained as accountants and are not expected to function as accountants. Nonetheless, it is worth noting that approximately 50% of all securities fraud cases involve revenue recognition-i.e., the incorrect and typically premature recording of revenue.¹² This is most likely to be an issue if the company is young

11. Nanosys, Inc., filed a Registration Statement on Form S-1 with the Securities and Exchange Commission on April 22, 2004 and later pulled the offering before it was priced or consummated.

12. See SEC Staff Accounting Bulletin No. 101-Revenue Recognition and Financial Statements, 3 Dec. 1999, in which the SEC cites the March 1999 report entitled *Fraudulent Financial Reporting: 1987-1997 An Analysis of U.S. Public Companies*, sponsored by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, which indicated that over half of financial reporting frauds in the study involved overstating revenue.

and growing rapidly, as its stock price, whether in the public or private markets, is particularly likely to be geared to its growth rate rather than its earnings. Hence, a “heads up” concerning the problems that may be lurking will help a lawyer advise his or her client in many situations, such as negotiating or documenting an acquisition or financing.

1.2 The GAAP Rule and the SEC’s SAB No. 101

The principle¹³ under U.S. generally accepted accounting principles (“GAAP”) is that revenue should only be recognized when the earning process is complete and an exchange has taken place. There are numerous accounting rules that have been adopted over the years to apply the foregoing general principle to particular fact patterns, such as accounting for franchise fee revenue,¹⁴ transactions involving real estate, and rights of return.¹⁵ For a general orientation with regard to GAAP, see Sidebar 1.2.

Sidebar 1.2 Orientation Concerning GAAP and SFAS

The term GAAP refers to generally accepted accounting principles. This is a generic term and includes what might be thought of as the common law of accounting as well as some accounting rules that might be analogized to statutory law. The generic part pertains to what belongs on a balance sheet and in an income statement, their configuration, and the like.

The Securities Exchange Act of 1934 granted the Securities and Exchange Commission (SEC) authority regarding the accounting rules. In 1939, the SEC delegated that authority to the Commission on Accounting Procedure (“CAP”), which consisted exclusively of accountants. In 1959, the CAP was succeeded by the Accounting Principles Board (“APB”), which included not only professional CPAs but also representatives from industry, academia, and government. Its pronouncements were known as Accounting Principles Bulletins, or APBs. In 1973, the Financial Accounting Standards Board (FASB) replaced the APB. The FASB’s major pronouncements, of which

(continued)

13. Codification of Accounting Standards and Procedures, Statement of Financial Accounting Concept No. 5, Recognition and Measurement in Financial Statements of Business Enterprises Para. 83 (American Institute Of Certified Public Accountants, Financial Accounting Standards Board, 1984).

14. FAS-45-Accounting for Franchise Fee Revenue.

15. SFAS 48-Revenue Recognition When a Right of Return Exists provides that revenue should not be booked until:

1. The price is substantially fixed or determinable;
2. The seller has received full payment or the buyer is indebted to the seller and the indebtedness is not contingent on the resale of the goods or any obligation of the seller to help the buyer;
3. The buyer has economic substance and is not a straw, front, or conduit existing for the benefit of the seller;
4. Physical destruction, damage, or theft of the goods would not change the buyer’s obligation to the seller;
5. No significant obligations exist for the seller to help the buyer resell the merchandise; and a reasonable effort can be made of the amount of future returns.

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Sidebar 1.2 (*continued*)

there have been 154 as of February 2006, are known as Statements of Financial Accounting Standards (SFAS) or Financial Accounting Standards Bulletins (“FASB”), which apply both to publicly owned and privately owned companies, as did the SFAS’s predecessors.¹⁶

The above is not to be confused with GAAS and the SAS. GAAS is the acronym for generally accepted auditing standards (for example, if you are auditing inventory, you must observe a specified portion being counted, and so on). The Auditing Standards Board, a committee of the American Institute of CPAs, has adopted Statements of Auditing Standards (“SAS”), which, like the FASB’s specific rules, are pronouncements regarding auditing. The SASs thus became part of GAAS.

Because there is no single GAAP rule on revenue recognition (the rules in the area having evolved in a way analogous to common law), and because it believed that companies had been pushing the envelope hard on this point, the Securities and Exchange Commission (“SEC”) on December 3, 1999 issued its Staff Accounting Bulletin (“SAB”) No. 101, which went into effect in the fourth quarter of 2000, after two delays resulting from corporate complaints. Although SAB No. 101 applies only to publicly owned companies (i.e., companies required to file annual and quarterly reports with the SEC), privately owned companies might find it useful, for it essentially codifies the GAAP rules.¹⁷

Under SAB No. 101, revenue should not be recognized until it is “realized or realizable and earned,” which, it provides, generally has occurred when:

- persuasive evidence of an arrangement exists;
- delivery has occurred or services have been rendered;
- the seller’s price to the buyer is fixed or determinable; and
- collectability is reasonably assured.

Lawyers should be particularly vigilant for revenue recognition problems when management has an incentive to maximize the company’s share price, for example, because of stock option timing price. Sections 1.3 through 1.12 describe the more common revenue recognition problem fact patterns.

1.3 Gross-ups of Revenue

An obvious revenue recognition issue is illustrated by Priceline.com, the company made famous by the ads about “naming your own price” for airline tickets, hotel rooms, car rentals, and other items. Priceline books as revenue the full amount customers paid for such items, even though the vast majority of what customers pay (about 72%) goes to the airlines, hotel, or other vendors. For

16. There are also Statements of Accounting Concepts, of which there have been seven, FASB Interpretations, of which there have been 47, and FASB Technical Bulletins, of which there have been 50, from 1973 until 2006.

17. The reader might also want to refer to *Audit Issues in Revenue Recognition*, American Institute of Certified Public Accountants, 1999.

TABLE 1.2
Priceline.com
Summary of 2005 Income Statement
 (\$ million)

Revenue	914
Cost of Revenue	716
Gross Profit	198
Advertising, Selling, G&A, and Other Overhead Expenses	99
Operating Profit	99

Source: Priceline.com 2005 10-K Report

instance, as shown in Table 1.2, in 2005 Priceline booked \$936 million in revenues, which included \$716 million paid to the airlines, hotels, car rental companies, and others, which traditional travel agencies call “gross bookings,” not revenues.

In terms of operating profit or loss, whether Priceline books the full amount paid by customers as revenue makes no difference. That is because, to the extent that the revenues are grossed up by including the full amount paid to the airline or other vendor, so are the expenses. Priceline’s reason for including the full amount is the hypothesis that revenue growth still drives stock prices.

Priceline justifies this practice on the premise that it takes the full risk of ownership as the “merchant of record” and that it can determine the size of the spread (i.e., the difference between what customers pay Priceline and what Priceline pays its vendors), in contrast to travel agencies, which operate on a fixed commission. As of 2005 the SEC has accepted this line of reasoning, although the practice has been subject to criticism on Wall Street and in the press.¹⁸

1.4 Right to Return

Assuming there is no gross-up of the revenue, in the plain vanilla situations, such as where a customer walks into a store, buys a book for cash, and walks out, revenue recognition is not a problem. However, factual situations become more complex, and issues arise. For example, a publisher may record sales to a bookstore only when the bookstore has ordered the books and the publisher has shipped them.¹⁹ Furthermore, if the bookstore has a contractual right to return the books if it has not sold them in, say, 60 days, then the publisher may not

18. Jeremy Kahn, *Presto Chango! Sales Are Huge!*, FORTUNE MAGAZINE, 90 (Mar. 20, 2000).

19. For more on the recognition of revenue when the buyer has a right to return merchandise, see Financial Accounting Standard 48-*Revenue Recognition When a Right to Return Exists*.

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book the sale until the 60 days have lapsed. However, if experience shows that on average only 20% of the books are returned, then the publisher may book the sale for 80% of the books at the time of shipment and for the other 20% after the 60 days have lapsed. Sometimes there are questions of fact as to whether the seller has a legal obligation to take the goods back. Delphi Corp., the auto parts maker that was spun off from General Motors announced in early 2005²⁰ that two of its senior executives, including its vice chairman and chief financial officer, were ousted after a finding by its board of directors that, among other things, the Company had recorded sales of inventory to outside companies notwithstanding an agreement by the Company to buy back those same assets at a later date.

Knowing when to book sales may be easy for a publisher with a long track record, but it can be very difficult for a company built around a new product. The problem can also be complicated if there is a post-delivery service contract or bundling arrangement, raising the question of whether part of the payment for the product was really pre-payment for future services, such as described in Sidebar 1.3, which describes a typical revenue recognition problem.

Sidebar 1.3 An Example of Incorrect Revenue Recognition

Companies of all sizes are prone to engaging in revenue recognition shenanigans. In what was at the time the largest civil penalty against a public company in the United States for financial reporting violations, in 2002 Xerox Corporation settled an action brought by the SEC by, inter alia, agreeing to restate its 1997-2000 financials and paying a \$10 million penalty.²¹ Xerox admitted to overstating its 1997 through 2000 revenues by \$3 billion (its total revenues in 2000 were \$18 billion²²) and its pre-tax profit by \$1.5 billion. It used what it called "accounting actions" and "accounting opportunities" to meet or exceed Wall Street expectations, mostly by accelerating the recognition of equipment revenue at the expense of future periods.

Although seven different "accounting actions" were used, the primary one involved Xerox's accounting treatment of equipment leased to customers. Under many of Xerox's leasing arrangements there were three components of revenue: (1) the value of the "box"-i.e., the equipment being leased, (2) the revenue paid to Xerox for servicing the box during the life of the lease, and (3) the interest embedded in the lease. Under GAAP, if a company leases equipment to a customer under a capital lease²³ and concurrently enters into a service agreement with respect to the equipment, then the lessor should book the sale at the time the lease is entered into. At that point it books its profit, if any, on the gain from the sale (in this case of the "box"). As interest on the financing element of the lease accrues, the company should book the interest as revenue over the life of the lease. As the company earns service revenue under the service element of the agreement over the life of the lease, it should book the revenue.

20. Karen Lundegaard, *Delphi Discloses Accounting Problems*, THE WALL STREET JOURNAL, A-3 (March 7, 2005).

21. See Footnotes 9 and 10.

22. XEROX CORPORATION 2000 ANNUAL REPORT.

23. To learn about capital leases and how they differ from operating leases, see Section 4.2(c).

Bundling the sale, financing, and service elements of the transaction is fine so long as the company unbundles them for purposes of revenue recognition. However, Xerox did not do so.²⁴ Rather, Xerox allocated a disproportionate share of the revenue to the sale component of the transaction, thus accelerating into the current period revenue more correctly allocable to the financing and/or service components of the transaction.

For example, if Xerox were offering to sell a piece of equipment for \$200,000 but the customer wanted instead to lease it for five years at \$55,000 per year, then at the time the lease is entered into, the company should book the sale for \$200,000, as though the customer had borrowed from a bank and used the proceeds to purchase the equipment from Xerox. Because the payments to Xerox total \$275,000 (five years of payments at \$55,000 per year), \$75,000 represents interest payments, and \$200,000 represents the sale of the equipment. As the customer makes payments, the sums are allocated first to interest on the unpaid balance. As the balance declines, the portion of each payment deemed to be interest declines, and the portion of the payment deemed to be principal payments increases, just as with a home mortgage. Over the life of the leaser, interest payments would total \$75,000 and principal payments would total \$200,000. Similarly, revenues under the service contract ought to have been booked as though the equipment had been sold to the customer by an unrelated third party and were simply being serviced by Xerox, as explained in Section 1.12.

Xerox, however, during the period in question, wanting to make current revenues (and profits) look good, was willing to rob the future to enhance the present. To shift revenue to the current period, using a term it called the “return-on-equity” method, Xerox shifted revenue to the equipment that ought to have been allocated to interest earned in future periods, i.e., the financing. Similarly, in a game it termed “margin normalization,” it allocated to the sale of equipment the revenue it anticipated generating under the service agreements (see the discussion of Related Service Agreements at Section 1.9). In addition to the violations of GAAP, by failing to discuss the foregoing in its Management Discussion and Analysis (MD&A), it likely violated the SEC’s MD&A rules.

1.5 Channel-Stuffing

Over the years a large number of companies in a variety of industries, from soft drinks to breakfast cereals and from laptops to video conferencing equipment, have inflated their financial results by shipping more goods than customers want or need.

24. Information on this subject is derived from the following sources: (1) SEC Release 2002-52 *Xerox Settles Enforcement Action Charging Company with Fraud*, (April 11, 2002), re: Xerox agrees to pay a \$10 million fine, at the time the largest financial fraud penalty ever against a public company, (2) SEC Litigation Release No. 18174, *Accounting and Auditing Enforcement Release No. 1796*, June 5, 2003, re: six former senior executives of Xerox settle with the SEC and agree to pay over \$22 million in penalties, disgorgement and interest, and (3) Xerox Corporation 2001 10-K/A, filed January 27, 2003, replacing and amending the 2001 Annual Report, re: Note 2 regarding the 2000 and 1999 Financial Statements.

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This practice, known as channel-stuffing, sales loading, trade loading, or simply loading, is often accompanied by a guarantee that the customer will get the benefit of any future price reductions, by promises of rebates, or by promises that the distributor or other customer may return the goods or need not pay for the goods until they are sold.

If shipment has occurred, then the key questions are whether the customer has a right to return the goods, whether any incentives (such as rebates or upgrades) have been properly accounted for, and whether the allowance for doubtful accounts is adequate. A red flag for this activity is accounts receivable growth in excess of revenue growth.²⁵ (For more on the latter point, see Section 3.1(b).)

1.6 Bill and Hold

Closely related to channel stuffing is bill and hold, a practice by which the seller has not yet shipped the goods but books the revenues, on the grounds that the customer has agreed to take the goods but wants the vendor to hold off on shipping them. This has been a problem area, and in SAB 101 the SEC set forth criteria that in its view must be met in order to recognize revenue before delivery to the customer has occurred,²⁶ including:

1. the risk of ownership must have passed to the buyer;
2. the buyer rather than the seller must have requested that the transaction be on a bill and hold basis;
3. there must be a fixed delivery schedule;
4. the goods must have been segregated from the seller's inventory and not be available for filling other orders; and
5. the goods must be ready for shipment.

1.7 Prepayments

Similarly, magazine publishers, airlines, cruise lines, and other companies that collect payment in advance should not book the sales until the goods or services have been rendered. For instance, if Time Warner sells an annual subscription to Time Magazine, a weekly, for \$26, it should book revenue of \$.50 a week as it ships the magazines throughout the year. Until then the cash it collected (an asset) is offset by a liability, representing the obligation to deliver the magazines.

25. This can be determined by comparing the rate of increase in accounts receivable on the balance sheet with the rate of growth in revenues on the income statement.

26. These criteria, sometimes referred to as the Stewart Parness criteria (in reference to SEC Release No. 108, 5 Aug. 1986), are set forth in SAB 101, Paragraph 3.

SAB No. 101 also impacts retailers who have booked payments under lay-away plans as received, because the SEC's position is that revenue should not be booked until the goods have been delivered to the customer.²⁷

1.8 Upgrades

The matter is further complicated when there is a potential upgrade involved. To illustrate, consider a vendor of network cables that sells cables to an electronics retailer. In the contract the retailer has the right to return the cables any time within four months. At the time of the initial sale the vendor will have to estimate the number of cables that will be returned and treat that percentage as doubtful accounts, thus deferring the revenue recognition on that portion until the four months have elapsed.

Suppose the retailer instead has a right to exchange the cables if an upgraded model is developed by the vendor within the next four months. If within the four months an upgrade becomes available and the customer opts to exchange the cables, then the vendor will have to (1) increase its inventory (but at the lower of cost or market) and decrease its accounts receivable to reflect the return of the unsold cables and (2) decrease its inventory and increase its accounts receivable to reflect the sale of the new cables. Also, its income statement will have to be revised to conform to any incremental purchase price and the incremental costs associated with the new cables. Such revisions must reflect the difference (if any) that the retailer will pay for the new product as well as an allowance for the return of the outmoded cables.

1.9 Related Service Agreements

Further, if there is a related service agreement, then allocation of revenue may be an issue. For example, if the contract is for the sale of a computer system plus three years of service, with payments of \$125 million at the time of installation and \$25 million a year for each of the three years of service, then ostensibly the vendor is entitled to book only the \$125 million at the time of installation, and \$25 million per year for the length of the service contract. However, if on an unbundled basis, the system sells for \$80 million and the service contracts are priced at \$40 million a year, then the seller probably ought to book only \$80 million in revenue at the time of installation. (Sidebar 1.3 further illustrates this point with reference to a problem Xerox encountered.)

27. See SAB. No. 101 and Andrew Osterland, *Hard Lessons*, CFO MAGAZINE Sept. 2000: 72–80.

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1.10 Sale of Franchises

Another area where there is room for aggressively booking the revenues involves the sale of franchises. One normally thinks of the major revenue producing activity of franchisers being the collection of royalties from franchisees. However, if the franchiser collects a front-end fee (usually bearing a name such as area development right), perhaps in return for exclusive rights to a territory, then franchisers may book the fee as revenue. This practice can make the growth rate in the early years look spectacular. However, in return for a high front-end fee the franchiser might accept low royalties for the life of the franchise agreement. Then, once the market penetration has been completed and the rate of signing up new franchisees declines, the franchiser's growth rate in revenues and earnings drops.²⁸

1.11 Large Projects

There is one category of circumstances in which revenue may be recognized before goods are delivered or services are rendered in full. Companies may account for large items or projects by using the completed-contract method, which recognizes revenue only on the completion or substantial completion of the contract, i.e., the remaining costs are insignificant.²⁹ When contracts are for large items, or projects, where the revenue work spans several years, the GAAP rules permit companies to book revenues before the entire project is completed, although this is a thorny area in practice.

This progressive, or fast-track, billing is known as the percentage of completion method and occurs in large, long-term construction projects, such as tunnels, subway systems, hotels, pipelines, office buildings, bridges and ships, and the design and building of unique, expensive products or systems such as space stations. The applicable GAAP rule is that revenue may be booked based on the percent of the project that has been completed provided (1) the percentage of the work in fact completed can be reasonably estimated, (2) the company is likely to complete the contract, and (3) there is no important uncertainty about the contract. Any expected losses must be recognized immediately under the percentage of completion method. In practice the use of this method

28. This happened at Boston Chicken, which later changed its name to Boston Markets and went into bankruptcy proceedings before being acquired in 1999 by McDonalds, primarily for the real estate assets. However, the classic case involved Jiffy Lube International, a Baltimore-based franchiser of quick oil changes. During its growth phase in the mid 1980s, its stock price jumped from \$78 per share in 1986 to \$250 in 1987. This price run-up was due to reported revenue growth, yet much of the growth was due to the collection of one-time front-end fees from new franchisees. When the growth from this source tapered off and investors looked at Jiffy Lube's value based only on royalty revenues, the stock price fell to \$3.50 a share in 1990 before it was mercifully acquired by Penzoil, its major vendor. See also Howard M. Schilit, *Financial Shenanigans*, 46-47 (1993).

29. *Accounting Research Bulletin No. 45, Paragraph 9*. See also JAN R. WILLIAMS and JOSEPH V. CARCELLO, *MILLER GAAP GUIDE 2004*. (New York: Aspen Law and Business, 2004) 30.02.

Table 1.3
Percentage of Completion Accounting/Contract Canceled

Contract price	\$5 billion				
Estimated costs	\$4 billion				
Estimated profit	\$1 billion				
Year	1	2	3	4	5
Percent completed	20%	20%	20%	0	0
Revenues booked	\$1B	\$1B	\$1B	0	0
Expenses booked	\$0.8B	\$0.8B	\$0.8B	0	0
Profit booked	\$0.2B	\$0.2B	\$0.2B	0	0

requires the use of assumptions and estimates regarding such factors as contract options, change orders, price-adjustment clauses, subcontractor performance patterns, asset utilization, and labor contracts.³⁰

When the use of the percent completion test is appropriate, the company records that portion of the revenues, expenses, and profit that corresponds to the portion of the contract life that elapsed during the year (or other period). For instance, if a company has a contract with the Department of Defense to deliver armaments in five years for \$5 billion and it expects that the related expenses will be \$4 billion, then it might (if the above tests are met) be appropriate to use the percent completion test rather than waiting and booking the full \$5 billion in revenues, \$4 billion in expenses, and \$1 billion in profit when the armaments are delivered. Table 1.3 summarizes the way this is typically accounted for through Year 3.

It becomes more complex if, for example, a new administration changes national defense policy and cancels the contract just before the end of Year 3, which may complicate the issue of what the company will receive.

Another problem with the percent completion test is that it necessitates estimates of future expenses and thus lends itself to distortion of such estimates to manage the timing of the booking of profits. The result can be a front-end loading of revenues and a deferral of expenses.

Biotech companies, semiconductor equipment manufacturers, telecommunications companies, and companies in other industries where long term contracts are the norm may be among the most heavily impacted by SAB No. 101. The big issue for biotech companies, for instance, is the treatment of up-front fees and milestone payments they receive for research projects. A common practice prior to SAB No. 101 was to recognize the payments as revenue when received. However, the SEC's position is that under SAB No. 101 the revenue must be recognized over the life of the contracts. Although this may make it difficult for some such companies to meet financing hurdles, it shouldn't, because

³⁰ For a good example of this, see Boeing's 2004 Annual Report, and in particular the MD&A and the notes to the financials regarding its Integrated Defense System segment, which accounts for slightly over half its revenues and operating profits.

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the accounting treatment has no bearing on the company's cash position, which ultimately is what lenders ought to be concerned about.

For semiconductor equipment manufacturers, a key issue arises because title usually passes when the equipment is shipped to the customer, yet the customer usually has a right to return the equipment if it doesn't work properly once installed. SAB 101 guidelines provide that recognition of the revenue should be deferred until the equipment is accepted by the customer.

1.12 Related Party Transactions

If revenues are booked for sales made to related parties, both GAAP and the SEC require disclosure.³¹ This pertains not only to revenues but also to costs and other transactions, such as the purchase of services, leases, and borrowings, whether income statement or balance sheet items.

GAAP permits the recording of the transaction on the same basis as if the parties were not related unless the substance of the transaction is not arm's length.³² Under GAAP a related party includes, but may not be limited to, (1) management and their immediate families, (2) principal owners and their immediate families, (3) investments accounted for by the equity method, (4) beneficial employee trusts managed by management of the company and (5) any other party who or which has such control or influence that an arm's length transaction might not be achieved.³³

GAAP requires³⁴ disclosure of:

1. the nature of the relationship(s) involved;
2. a description of the transaction(s);
3. the dollar amount(s) of the transaction(s);
4. the amount(s) due from or to the related parties; and
5. information regarding the income tax implications.

The SEC rules, which have a \$60,000 threshold, differ slightly from GAAP in their definition of related party and in the information required to be disclosed. The SEC defines a related party as a director (or nominee for election) or executive officer, a holder of 5% or more of any class of shares, and any member of the immediate family of any of the foregoing.³⁵

The amount of detail disclosed must be sufficient for the user of the financials to be able to understand the transaction (or any currently proposed transaction) and its impact on the company's performance. Consequently, the degree of detail will vary depending upon the nature and circumstances of the trans-

31. *Related Party Disclosures*, Financial Accounting Standards Board No. 1, Mar. 1982; and *Certain Relationships and Related Transactions*, Regulation S-K Item 404, 17 CFR 229.404

32. *Related Party Disclosures*, Financial Accounting Standards Board No., 1 Mar. 1982

33. *Related Party Disclosures*, Financial Accounting Standards Board No. 57, 1 Mar. 1982: Para. 1.

34. Financial Accounting Standards Board No. 57, 1 Mar. 1982.

35. *Certain Relationships and Related Transactions*, Regulation S-K, Item 404(a), 17 CFR 229.404(a).

action and the relationship between or among the parties. Subject to some further requirements and refinements, the SEC requires disclosure of:

1. a description of the transaction;
2. name of the person and the person's relationship to the company;
3. the nature of the person's interest;
4. the amount of the transaction(s); and
5. where applicable, the amount of such person's interest in the transaction.³⁶

1.13 Management Discussion and Analysis Considerations

Sometimes revenue recognition can create a Management Discussion and Analysis problem for a company even if it does not create a GAAP problem. For instance, one publicly owned company was a vendor to J.C. Penney and shipped women's garments to Penney, giving the latter the right to return any garments not sold by January 31. After that deadline Penney insisted that some of the garments be taken back. Even though it was not obligated to do so, the vendor was compelled to accept the returns because Penney was a major customer and it risked losing Penney business if it did not do so. The problem was that between January 31 and the date of the return of the goods, it had filed its annual report and 10-K, and the MD&A was silent with respect to the possibility that the Company might be compelled to accept the returns even though Penney had raised the issue and discussions were taking place. After the Company disclosed that it was taking goods back, its stock price dropped, resulting in a securities class action. Thus any lawyer preparing or reviewing an MD&A ought to ask probing questions about subsequent events, including revenue recognition and returns, not only with respect to the accounting period being reported but also between the end of the latest accounting period and the date of the MD&A filing.

1.14 Interpretation of the Revenue Line

In addition to the GAAP-related questions about revenue recognition, there are qualitative and analytical areas to probe. First, it is useful to check the company's growth rate, that is, how its revenues compare with the previous year or other period. At the risk of over-generalizing, a baseline for growth rate is that a U.S. company should grow annually at the inflation rate plus the U.S. population growth rate. On average across the economy, if a company is growing at that rate, it is holding even. If it is growing faster, it is outperforming the economy, and if it is growing less rapidly, it is under-performing the economy and losing ground. The rate of growth also sets a baseline of expectations concerning the rate at which expenses are growing.

³⁶. *Ibid.*

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Further, one should look back several years, at least through a business cycle. This is particularly important if the company is in a cyclical business, such as steel, housing, and autos, as contrasted with a noncyclical, recession-proof business such as food processing, personal care products, and medical supplies. Sidebar 1.4 illustrates this by comparing Ford with Johnson & Johnson. Notice how much more steady J&J's revenue growth (Line 6) is relative to Ford's (Line 2) and, even more dramatically, how much steadier J&J's earnings growth (Line 8) is relative to Ford's (Line 4). If the business is cyclical, one ought to determine where the company is in the business cycle and interpret the financials accordingly, as explained more fully in Chapter 6.

Sidebar 1.4 Comparison of Sales and Earnings Patterns for a Cyclical and a Noncyclical Company

Autos, chemicals, steel, airlines, and some other industries are cyclical because in recessions and periods of high interest rates buyers often defer or forego their purchases. By contrast, some companies' products, notably foods, medical products, and personal care items, are noncyclical, as people buy them despite the state of the economy. Ford Motor Company provides an example of the former. Johnson & Johnson, a maker of a broad range of health care and hygiene products and toiletries, is an example of the latter, as shown in Table 1.4.

Table 1.4
Cyclical versus Noncyclical Earnings

	Year									
	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04
(\$ billion except growth rates)										
Cyclical: Ford										
1. Revenue	137.1	147	153.6	144.4	162.6	170.6	161.3	163.1	165.1	171.7
2. Revenue Growth	6.8%	7.2%	4.5%	-6.0%	12.6%	4.9%	5.5%	1.1%	1.2%	4.0%
3. Earnings	4.1	4.4	6.7	6.1	7.2	3.5	-5.5	0.2	0.9	3.5
4. Earnings Growth	-22.0%	7.4%	49.6%	-8.0%	18.3%	-52.1%	-257.3%	-104.1%	313.1%	281.9%
Noncyclical: Johnson & Johnson										
5. Revenue	18.9	21.8	22.8	23.8	27.4	29.2	32.3	36.3	41.9	47.3
6. Revenue Growth	19.7%	15.0%	4.9%	4.3%	14.9%	6.6%	10.8%	12.3%	15.3%	13.1%
7. Earnings	2.4	2.9	3.3	3.7	4.3	5	5.7	6.6	7.2	8.5
8. Earnings Growth	23.1%	21.8%	14.9%	12.2%	15.1%	15.9%	14.4%	16.4%	9.1%	18.2%

Sources: Company Annual Reports and SEC

Notice how much more regular Johnson & Johnson's sales and earnings are than Ford's. Notice also that the percentage changes in Ford's earnings are greater than the percentage changes in its sales. To a large extent, this reflects the impact of operating leverage discussed in Chapter 6.

1.15 Strategic Context

The revenue line also invites questions about the company's strategy. First, how diversified is it? By and large, the less diversified it is, the more risky it is, although that does not necessarily mean that diversification is always good.

Second, the financials ought to be read in light of the context in which the company operates. It is often useful to know how far afield the company competes geographically. This is usually a function of transportation costs, although

Table 1.5
Ford vs. Johnson & Johnson Percent Revenue Growth

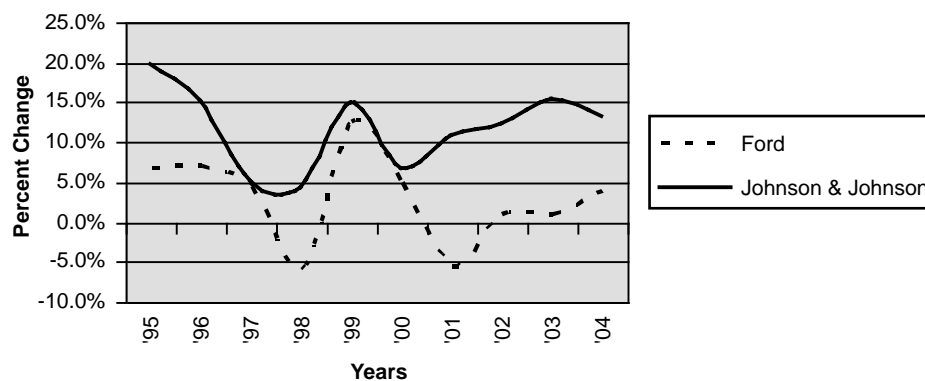
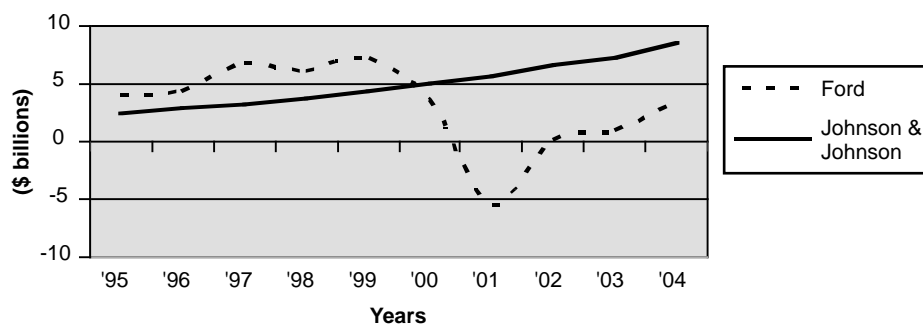


Table 1.6
Ford vs. Johnson & Johnson Earnings



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at times government policies (such as trade barriers), spoilage, or convenience factors, determine the geographic scope of competition. At one extreme, diamonds and computer chips are so light and compact that the transportation costs are negligible relative to their value, with the result that they have become international businesses. By contrast, the cement, can, and pet grooming businesses are generally local due to the high costs of transportation; the weight or bulk of these products, or the travel costs and time associated with shopping outside the local area, are high relative to their value.

Further, it is often useful to get a read on a company's strength relative to its competitors. This is not evident in the financial statements alone but can be assessed by checking other sources (such as analysts' reports or the trade press), physically comparing the products, asking experts with intimate knowledge of the products, and other ways. In addition to sheer size, it can be useful to assess the comparative financial performance, growth rates, product quality, management reputation, and, if possible, comparative costs of the company and its competitors.

However, before we get ahead of ourselves, the expenses merit attention. This will be the topic of our next chapter.

Implications for Counsel

1. Slightly over half of all securities fraud cases involve revenue recognition, so it's worth focusing on this number when reviewing disclosure documents, conducting due diligence, negotiating acquisition agreements, and in securities litigation.
2. The facts involving revenue recognition can be highly complex.
3. The SEC has weighed in with SAB 101, which is well worth reading.
4. In a wide range of situations counsel should be vigilant with respect to revenue recognition, whether it involves an MD&A, obtaining representations from a seller in an acquisition, a securities offering, or other contexts.