Financial Warnings

Overstated Revenue

"Boosting the Top-Line"

Premature Revenue Recognition

Fictitious Revenue Recognition

Early Warnings Checklist

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When Should Revenue be Recognized?

The following revenue recognition practices for software sales were taken from the accounting policy notes of selected software companies.

How do the revenue recognition practices differ?

Which company's practice is more aggressive and which is more conservative?

Should revenue be recognized in each instance?

Autodesk

Revenue from sales to distributors and dealers is recognized when the products are shipped.

BMC Software

Revenue from the licensing of software is recognized upon the receipt and acceptance of a signed contract or order.

Computer Associates

Product license fee revenue is recognized after both acceptance by the client and delivery of the product.

Group 1 Software

Perpetual licenses of software products are granted under a standard license agreement. Revenue from such agreements is generally recognized upon execution of a binding perpetual agreement. Shipment of the product follows immediately upon such execution, and, in certain instances, precedes it.

Guidelines for Revenue Recognition

Revenues are recognized when the following conditions are met:

- The revenues are earned
    - The entity has completed what it must do to be entitled to benefits represented by the revenue
    - An exchange transaction has taken place - an exchange of rights and privileges
- The revenues are either realized through collection or realizable through an enforceable claim for collection

A Closer Look: Basic Principles of Revenue Recognition

Any firm providing goods and services should recognize revenue by applying the following five steps:

Step 1: Identify the contract with a customer
Step 2: Identify the separate performance obligations in the contract
Step 3: Determine the transaction price
Step 4: Allocate the transaction price to the separate performance obligations in the contract
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Contract – Agreement between two or more parties that creates enforceable rights and obligations.

Customer – Party that has contracted to obtain goods or services that are the output of an entity's ordinary activities.

Satisfying a performance obligation – control of a good or service is transferred to the customer. Performance might be delivery of the good or service, or the passage of time, in the event of a warranty obligation.

Consider example:
Contract is for sale of MRI machine for $1.2 million. Included in the purchase price are the following performance obligations:

• Software tailoring to specific application
• Delivery of MRI machine
• Installation and testing of MRI machine
• Training on use of MRI machine
• Three years of technical and warranty support

Other Information:
• 20% non-refundable deposit with contract
• Software tailoring to require 80 hrs, valued @ $120/hr=$9,600
• Training requires 120 hrs, valued @ $120/hr = $14,400
• Technical support and warranty behind normal product performance for 3 years is valued @ $200,000

Revenue Recognition Abuses
A Contract or a Consignment?
PerSeptive BioSystems, Inc.

Company's Stated Revenue Recognition Policy . . .

The Company recognizes revenue from product sales upon shipment from the Company's warehouse.

Company's Actual Revenue Recognition Policy, as Described in The Wall Street Journal . . .

Not long ago, a $50,000 lab instrument made by PerSeptive BioSystems, Inc. for purifying and analyzing biotechnology products showed up on the loading dock of Imclone Systems, Inc. a Somerville, N.J., biotech company. "It was like parking a Mercedes in my driveway and leaving the key," says John A. Gilly, a vice president at Imclone, which hadn't order the machine.

Along with the machine came an offer from PerSeptive salesman: pay nothing for it now and return it later if you don't like it. Dr. Gilly, who sent the machine back, says it was offered "on a 90-day free trial, like the book of the Month Club."

When PerSeptive went public two years ago, many investors saw it as a good bet: While other biotech stocks might rise and fall with the fortunes of costly clinical trials, PerSeptive would prosper by selling tools to the whole industry. Today, however, PerSeptive is faced with troublesome questions. One centers on soaring receivables and inventories, burdening the balance sheet as a result of aggressive sales tactics.

Revenue Recognition Abuses
Is There a Contract?
Digital Lightwave, Inc.

From SEC Enforcement Action No. 1243 . . .

During the last four days of the second quarter, Digital improperly recorded revenue on shipments of units to Ameritech Corp. ("Ameritech") and Teleport Communications Group ("TCG"). The Ameritech shipment consisted of seven (7) units which was recorded as revenue totaling $246,750--approximately 4.6% of Digital's revenues for that quarter.

At the time Digital recorded the revenue for these units, this was not a real order. This is evidenced by a written agreement between Digital and Ameritech which provided that Ameritech would only obligate itself to purchase a unit through a written purchase order ("PO").

These units were in fact not shipped to Ameritech because Digital never received a commitment from Ameritech to purchase them. Instead, the units were shipped and placed with a Digital salesperson.

Ameritech did not submit POs to Digital committing itself to purchase the units until well after the close of the quarter. Further, invoices for these units were not issued by Digital until after the company received the POs.

Revenue Recognition Abuses

Has Performance Obligation been Fulfilled?

American Software

From the notes. . .

> **Revenue Recognition**
> Upon entering into a licensing agreement for standard proprietary software, the Company recognizes eighty percent (80%) of the licensing fee upon delivery of the software documentation (system and user manuals), ten percent (10%) upon delivery of the software (computer tapes with source code), and ten percent (10%) upon installation.

It is particularly noteworthy that the company actually recognized the vast majority of its software revenue prior to the actual delivery of the software.

Installation and customer acceptance came even later.

Revenue Recognition Abuses

Cylink Corp.

From SEC Enforcement Release No. 1313 . . .

Cylink's problems began when the Company's then-Chief Financial Officer ("CFO") fraudulently directed that Cylink recognize revenue on transactions in the fourth quarter.

Cylink recognized $3.7 million in revenue on product it stored in a third-party warehouse relating to an order from a small international distributor.

The transaction was contingent on the distributor's ability to obtain a letter of credit. When the distributor failed to obtain a letter of credit prior to the end of the year, former Cylink executives decided to store the product in the warehouse.

Cylink's former CFO also directed that Cylink falsify its internal records to reflect open credit, rather than letter of credit, as the payment terms.

Finally, the former CFO directed that Cylink recognize revenue on the transaction even though Cylink did not release the product to the distributor but rather maintained control of the product in the warehouse pending receipt of a letter of credit.

Revenue Recognition Abuses

Informix Corp.

From SEC Enforcement Action #1215 . . .

Former sales personnel, managers, and others at the Company used a variety of written and oral side agreements with customers as a means to inflate revenues and earnings. The terms of the side agreements varied and included provisions

- Allowing resellers to return and to receive a refund or credit for unsold licenses;
- Committing the Company to use its own sales force to find customers for resellers;
- Offering to assign future end-user orders to resellers;
- Committing the Company to purchase computer hardware or services from customers under terms that effectively refunded all, or a substantial portion, of the license fees paid by the customer;
- Paying fictitious consulting or other fees to customers to be repaid to the Company as license fees.

Revenue Recognition
and the Case Against General Electric

FOR IMMEDIATE RELEASE

SEC CHARGES GENERAL ELECTRIC WITH ACCOUNTING FRAUD

GE Agrees to Pay $50 Million to Settle SEC's Charges

Washington, D.C., – The Securities and Exchange Commission today filed civil fraud and other charges against General Electric Company (GE), alleging that it misled investors by reporting materially false and misleading results in its financial statements.

The SEC alleges that GE used improper accounting methods to increase its reported earnings or revenues and avoid reporting negative financial results. GE has agreed to pay a $50 million penalty to settle the SEC's charges.

"GE bent the accounting rules beyond the breaking point," said Robert Khuzami, Director of the SEC's Division of Enforcement. "Overly aggressive accounting can distort a company's true financial condition and mislead investors."

David P. Bergers, Director of the SEC's Boston Regional Office, added, "Every accounting decision at a company should be driven by a desire to get it right, not to achieve a particular business objective. GE misapplied the accounting rules to cast its financial results in a better light."

The SEC uncovered the accounting violations in a risk-based investigation of GE's accounting practices. In a risk-based investigation, the SEC identifies a potential risk in an industry or at a particular issuer and develops an investigative plan to test whether the problem actually exists. In this case, the SEC identified the potential misuse of hedge accounting as a possible risk area. The SEC's investigation ultimately uncovered four separate accounting violations.

Without admitting or denying the SEC's allegations, GE agreed to the financial penalty and consented to the entry of an order permanently enjoining it from violating the antifraud, reporting, record-keeping and internal controls provisions of the federal securities laws. The SEC took into account the remedial acts taken by GE and its audit committee during the investigation, including improvements to its internal audit and controllership operations. The charges announced today conclude the SEC's investigation with respect to the company.

The Case against GE

Excerpts from the SEC civil action against General Electric, focused on a single transaction, the recognition of revenue from the sale of locomotives follow.

On the surface, GE appeared to have a sale. GE had an order, had executed delivery and the sale was collectible. Why did the SEC insist that the revenue should not have been recognized?

UNITED STATES DISTRICT COURT
DISTRICT OF CONNECTICUT

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff,

v.

GENERAL ELECTRIC COMPANY,

Defendant.

III. Improper Recognition of Revenue from Locomotive "Bridge Financing" Transactions

In the fourth quarters of two consecutive fiscal years, GE improperly recorded revenue of $223 million and $158 million respectively for locomotives purportedly sold to financial institutions with the understanding that the financial institutions would resell the locomotives to GE's railroad customers in the first quarters of the subsequent fiscal years. The six transactions were not true sales and did not qualify for revenue recognition under GAAP. GE personnel at the business level orchestrated these transactions in order to improperly accelerate revenue recognition. A member of GE's corporate accounting group approved the accounting for these transactions despite learning that GE maintained significant obligations that: (1) suggested that the risks of ownership for the locomotives had not passed and (2) should have precluded revenue recognition under GAAP.

A. The "Bridge Financing" Transactions

Certain business personnel in GE's Transportation Systems unit ("GETS"), assisted by members of GE's Capital Markets group, explained to a senior accountant in GE's corporate accounting group that GETS expected to sell a significant number of locomotives to railroad end users in the fourth quarter of the current year, but that the railroads might ask to delay those purchases until the first quarter of the subsequent year. The business team proposed that GE resolve this issue by selling the locomotives to "financial intermediaries" in the fourth quarter and having the financial intermediaries then resell the locomotives to the railroads in the ensuing first quarter.

The proposed structure was very similar to a financing arrangement. Under it, the financial intermediaries would profit not by selling the locomotives to the railroads at a higher price, but by charging GE certain fees. In most of the transactions that resulted, these fees were based on (1) an upfront commitment fee paid by GE to the financial intermediaries and (2) a London Interbank Offered Rate (LIBOR)-based interest charge on GE for each day between the "purchase" of the locomotives from GE and the subsequent sale of the locomotives to the end user railroads.

The details of the transaction held that GE would store the locomotives on GE property until they were delivered to the railroad end users. At the time, the senior accountant was aware that while on GE's property, GE would be required to (a) run the locomotives in idle to prevent damage from the cold; (b) fuel and monitor the idling locomotives; and (c) provide security to the locomotives.

Other terms of the agreement held that, (1) If the railroads did not timely pay the financial intermediaries, GE was obligated under its agreements to pay the financial intermediaries a penalty fee calculated as a percentage (from 5-7.5% per annum) of the outstanding balance from the day the railroads' payment was due until it had been paid in full. (2) GE had agreed to indemnify one of the railroad end users for the possible tax consequences of the transaction that could result to the railroad after it purchased the locomotives from the financial intermediary. If the indemnification provision were triggered, the cost to GE would be anywhere between $2 to 4 million. In addition, the business team also told the senior accountant that the financial intermediaries were responsible for the costs of storing and insuring the locomotives while the intermediaries owned the locomotives.

Notwithstanding their awareness of these terms of these rail transactions, members of the corporate accounting group permitted GE to recognize the revenue and income on these deals in the fourth quarter. These transactions accounted for 131 of the 191 locomotives purportedly sold by GETS in the fourth quarter.

Gain on Sale: Should It Be Recognized?

Comcast Cable Communications Corp.

Observations?

From the Income Statement (Q/E, $millions)	Current Yr	Prior Yr
Service income	$1,126.2	$ 965.9
Costs and expenses:		
Operating	415.7	417.0
Selling, general and administrative	227.3	225.4
Depreciation and amortization	666.7	495.3
	1,309.7	1,137.7
Operating loss	(183.5)	(171.8)
Other income (expense):		
Interest expense	(132.8)	(124.1)
Interest (expense) income on notes to/from affiliates	(17.4)	.9
Investment (expense) income	(79.0)	35.5
Equity in net losses of affiliates	(2.8)	--
Other income (expense)	1,198.0	(.3)
	966.0	(88.0)
Income (loss) before income taxes, extraordinary items and cumulative effect of accounting change	782.5	(259.8)
Income tax (expense) benefit	(355.2)	65.4
Income (loss) before extraordinary items and cumulative effect of accounting change	427.3	(194.4)
Extraordinary items	--	(.9)
Cumulative effect of accounting change	(61.3)	--
Net income (loss)	$ 366.0	$ (195.3)

From the Comcast notes . . .

Other Income (Expense)

In connection with our cable systems exchange with Adelphia pursuant to which we received cable communications systems serving approximately 445,000 subscribers from Adelphia in exchange for certain of our cable communications systems serving approximately 440,000 subscribers, we recorded a pre-tax gain of $1.199 billion, representing the difference between the estimated fair value as of the closing date of the transaction and our cost basis in the systems exchanged.

From the Adelphia Communications Corp. notes . . .

Gain on Cable Systems Swap

Adelphia swapped certain cable systems for certain cable systems owned by Comcast. The result of this transaction was a gain of $519.2 million. (As an aside: Adelphia pretax income with the gain: $265.3 million; pretax (loss) without the gain ($253.9 million)).

Comcast/Adelphia
Nonmonetary Exchange of Similar Assets

Similar assets are those that are used for the same general purpose, are of the same general type, and are employed in the same line of business. It is not necessary to exchange identical assets. The treatment described applies to those assets that are exchanged as a result of technological advancement as well as to those that are exchange as a result of wearing out (trade-ins). The general rule involving the exchange of similar assets involving a gain is to value the transaction at the book value of the asset given up. In this situation, the gain is deferred over the life of the new asset by allowing a lower amount of annual depreciation.

Gain on Sale: Curious Financial Statement Presentation

IBM Is Resolute On Accounting Cited by SEC
The Wall Street Journal
By Mark Maremont and William M. Bulkeley
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Many companies simply cave in after the Securities and Exchange Commission questions their accounting methods.

But International Business Machines Corp. has faced such questions and prefers to stick by its own interpretation.

An accounting treatment used by Big Blue to reduce its reported operating costs has previously been the subject of concern at the SEC. But so far -- despite special wording in an SEC accounting advisory intended to tighten the rules governing the practice -- IBM insists that it is operating within the letter of accepted industry practices and standing by the treatment it prefers, which recently cost the company dearly in the stock market.

IBM was criticized for using gains from selling assets to offset ordinary expenses, rather than listing the gains separately as nonoperating income or in some other category. IBM says that is consistent with its past practice and meets accounting guidelines. The SEC hasn't asked IBM to change its reports, according to people familiar with the matter.

SEC accountants summoned IBM executives to Washington and asked them why Big Blue that year included $2.7 billion in gains from the sale of its Global Network business to AT&T Corp. as part of the "sales, general and administrative," or SG&A, expense category in its financial statements.

Some SEC staffers argued that Big Blue should have separately reported the asset gains to ensure that investors understood their impact, people familiar with the matter say. In addition, SEC accountants were perturbed that IBM in some public statements was implying that its operating costs were down because of tight expense controls. In fact, reported expenses actually declined in large part because the asset-sales gains were used as offsets, the people say.

SG&A, also known as corporate overhead, typically includes such ordinary expenses as salaries, advertising, rent and travel costs. Analysts often use it to measure a company's efficiency.

The issue died down for a while but came to public notice again two weeks ago, when IBM's stock was hammered after it was revealed that the company managed to beat analysts' earnings expectations by completing an asset sale for a gain of $300 million, or nine cents a share. The gain came from selling its optical transceiver business to JDS Uniphase Corp. on the last business day of the year.

As done earlier, the company used the gain to offset its SG&A costs. IBM didn't disclose the impact of the sale when it reported its fourth-quarter earnings in a January news release. In the news release, Chairman Louis Gerstner said, "We also once again demonstrated exceptional management of our cost and expense structure." However, without the sale, SG&A expenses would have risen.

IBM spokesman Rob Wilson says IBM clearly disclosed the impact of all major gains from the asset sales, including the AT&T deal, in news releases and footnotes to its financial statements that were filed with the SEC. The company hasn't yet filed its annual report for the most-recent year and promises more extensive disclosure than usual about such asset sales and other items included in its SG&A.

Although the SEC didn't ask for any reclassifications after the meetings, the agency's accountants delayed the release of SEC Staff Accounting Bulletin 101 while they attempted to tighten the rules governing asset-sale accounting, according to people familiar with the matter. When the accounting guideline was released, it contained a footnote specifying that gains or losses from asset sales should be reported in "other general expenses," a separate category from SG&A, and reminded companies that material amounts needed to be disclosed separately.

Internally, SEC staffers referred to the provision as "the IBM footnote," according to people familiar with the matter.

Reached late yesterday evening, Lynn Turner, who was the SEC's chief accountant when SAB 101 was written, said the accounting bulletin "unequivocally does not permit inclusion of gains on sales from assets in SG&A. Rather, it has to be included in the `other income and expense' line item."

Such accounting bulletins are merely advisory and represent the SEC staff's interpretation of accounting rules. However, most companies follow the SEC's guidance, to avoid the risk that they will be forced to restate or reclassify their results.

IBM declined to comment on any meetings with the SEC. Mr. Wilson, the IBM spokesman, says the company has historically included gains and losses from asset sales, licensing of intellectual property and real-estate sales under the SG&A line. He says IBM considers such gains as a normal, ongoing part of doing business and believes they properly belong in that category.

Asked about the view that the SAB 101 footnote forbids companies from booking asset-sale gains in SG&A, Mr. Wilson says that IBM is correctly following SAB 101. He says the footnote in the SEC bulletin on asset sales refers to a more comprehensive SEC rule, known as Regulation S-X. That regulation requires companies to list SG&A separately from "other general expenses" that are "not normally included" in SG&A. However, Mr. Wilson says IBM "normally" includes these sources of income in SG&A, so it meets the standards.

Charles Mulford, an accounting professor at Georgia Institute of Technology, Atlanta, says IBM is relying on a "play on words" that bypasses the intent of Regulation S-X. He interprets the word "normally" as meaning items that most companies would include in SG&A, not items that a particular company defines as its normal practice.

He adds that IBM's inclusion of asset-sale gains in SG&A "at best is misleading." By doing so, he says, the company "is implying it is controlling expenses more than it is." Prof. Mulford says his reading of SAB 101 indicates the SEC's staff was clearly telling companies to include gains or losses from the sale of assets in a different category from SG&A.

Case Assignment
Trading Cards, Inc.
(Topps, Inc.)

Trading Cards, Inc. is a marketer of collectible trading cards featuring sports figures, television and movie characters. It also produces and distributes bubble gum and other candy products.

The company sells its trading card products to wholesalers, retailers and hobby dealers. Shipments to wholesalers and retailers, which represent 70% of the company's sales, have the right to return unsold cards.

Excerpts from the company's financial statements for the years ended 2013 and 2014 are provided below. Also provided are selected financial statistics from the company's quarterly reports for several quarters through September, 2015, the third quarter of the fiscal year ended December 2015.

Required:

1. How and when does the company recognize revenue? How are returns handled? What might go wrong with this approach?

2. How do you think the company can be expected to perform in future quarters and years? More specifically, what are your expectations for earnings performance in the quarter and year ended December 2015?

3. After the release of earnings information for the quarter ended September 2015, management of the Company was asked about whether it was concerned about higher than normal returns. Their response was,

   ". . . No, . . . the Company still gets paid every 21 days . . . receivables appear to be rising only because the Company has been shipping nearly 50% of its cards in the final few weeks of each quarter, leaving huge receivable so the books at quarter's end . . . the Company changed its shipping schedules in the past year . . .The increased receivables are really just an accident of bookkeeping."

   What is your reaction to this response from management? Where might you find information to assuage your concerns?

Trading Cards, Inc.
Annual Financial Information
($ amounts in thousands)

From the income statement (000's). . .

	2014	2013
Net sales	$303,187	$290,006
Cost of sales	162,884	149,309
Gross profit on sales	140,303	140,697
Royalties and other income	5,459	5,669
Selling, general & administrative expenses	54,600	50,569
Income from operations	91,162	95,797

From the balance sheet (000's) . . .

Cash	$10,851	$7,660
Accounts receivable trade, less allowance for doubtful accounts of $500 in 2014 and 2013	35,081	21,621
Inventories	37,756	31,709
Accounts payable	34,621	29,770
Accrued expenses and other liabilities	35,809	30,211

Trading Cards, Inc.
Selected Footnote Information

Note 1 - Summary of Significant Accounting Policies.

- Sales revenue is recognized upon shipment of product to resellers.
- Estimated losses expected in connection with sales returns are accrued in the period in which the related sales are recorded.

Note 3 - Accrued Expenses and Other Liabilities (000's).

	2014	2013
Royalties	$ 19,547	$ 16,487
Employee compensation	6,715	3,249
Allowance for estimated losses on sales returns	8,375	8,818
Other	1,172	1,657
Total	$ 35,809	$ 30,211

Trading Cards, Inc.
(Topps Co., Inc.)
Quarterly Financial Information
($ amounts in thousands)

Q/E:	9/15	6/15	3/15	12/14	9/14	6/14	3/14	12/13
Sales	$62,609	$83,758	$76,433	$84,684	$74,091	$76,272	$68,134	$67,532
C G Sld	34,185	44,828	41,833	49,941	40,028	40,877	32,038	35,512
G Prft	28,424	38,930	34,600	34,743	34,063	35,395	36,096	32,020
Op Exp	10,834	12,810	14,491	16,679	11,738	11,601	14,582	12,152
Op Prft	$17,590	$26,120	$20,109	$18,064	$22,325	$23,794	$21,514	$19,868
Gr Mrgin	45.4%	46.5%	45.3%	41.0%	46.0%	46.4%	53.0%	47.4%
Op Mrgin	28.1%	31.1%	26.3%	21.3%	30.1%	31.2%	31.6%	29.4%
A/R:	$33,632	$52,716	$44,838	$35,081	$33,660	$38,124	$15,153	$21,621
A/R Days	48	57	53	37	41	45	20	28
Allw for Dtfl Acts	$500	$500	$500	$500	$500	$500	$500	$500
Invntry	$43,915	$35,688	$34,452	$37,756	$33,540	$29,009	$30,830	$31,709
Inv. Days	116	72	74	68	75	64	87	80

Note: during all quarters presented, the allowance for estimated losses on sales returns hovered around $8,500.

Post-Case Item
Trading Cards, Inc.
Corporate Announcement
Before Release of Quarterly and Annual Results
for the Fourth Quarter Ending December, 2015

Trading Cards, Inc. today announced that shipments of sports cards during the fourth quarter ending December 2015 will be significantly lower than the Company anticipated. As a result of lower shipments as well as the Company's decision to increase provisions for obsolescence and returns, the Company will report a net loss for its fourth quarter.

A Post-Mortem
Possible Success with a Business Model Change

Topps Takes Trading-Card Game, Runs With It

Combining Fantasy Sports and Card Collecting, Attax Proves a Success for Company Taken Private by Eisner, Other Investors

By Gregory Zuckerman, The Wall Street Journal

Michael Eisner may no longer be a power broker in Hollywood but he's become a player in schoolyards around the globe.

His winning ticket is Attax, a sports-card game created by Topps Inc., the trading cards and candy company bought three years ago by Mr. Eisner's investment company and other investors, not long after he left Walt Disney Co. as its chief executive.

Attax combines a once-popular kids' pastime—collecting baseball and other sports cards—with a present-day "fantasy" games twist. Kids can build teams and compete against each other. Since their launch, Attax cards, have sold over 100 million packs and now account for about 25% of revenue and profits, Topps says, adding that it's one of the most successful products in the company's 72-year history.

The company is gearing up for a big test for Attax in the U.S.: a nationwide rollout of baseball cards for major-league baseball.

The Attax success stands out among some recent disappointments from the 68-year-old Mr. Eisner. During the five years since he relinquished the reins at Disney after a 21-year tenure there, his track record has been mixed. Last year, Mr. Eisner pulled the plug on his infrequently aired CNBC talk show. A book about Mr. Eisner's summer-camp experience didn't leave a mark. A Web series by his online movie studio had some success, and an animated television show that Mr. Eisner currently produces about a traveling dentist has gained respectable ratings, though critics have been harsher, with one saying it is "like pulling teeth."

Mr. Eisner's buyout of Topps, through his investment company Tornante Co., seemed like another long shot. Sales had slipped in the years before the purchase, as some kids shifted to videogames and other diversions, like Pokémon. Many adult collectors also moved on. When the economic downturn hit, Mr. Eisner says he worried that sales could fall as weekly allowances shriveled.

But in a nondescript office in a small town 45 miles north-west of London, several years ago, a 26-year-old Topps employee was tinkering with a revamped sports card, one that aimed to capitalize on the success of fantasy sports games enjoyed by many adults, the company says. The Attax game was born. (Topps won't disclose the name of the creator, fearing that the employee might be wooed away by a rival, says a spokesman.)

Mr. Eisner at first wasn't convinced he had a winner on his hands. But when the new soccer cards, called Match Attax, were introduced in England, they were an instant hit. Mr. Eisner pushed Topps to purchase the rights to manufacture cards for soccer leagues in Germany.

Last year, Topps tested its baseball cards in the New York market. By the end of the summer, the cards—sold in packs of six for $1.49, as well as larger $4.99 "starter packs"— had sold out of most stores, sending some parents and children on desperate searches.

To introduce the game, Topps set up demonstrations at minor-league stadiums and Little League parks in the New York area, a tactic it plans to expand this summer.

"I spend about $20 a week on packs of cards," says Shanren Brienen, a 13-year-old in Orlando, Fla. who plays Attax about 10 hours a week with friends and cuts his parents' grass to raise money to support his hobby.

Like traditional baseball cards, the Attax line features glossy player pictures. But rather than list dozens of statistics on the back, the new baseball cards have just three ratings for each player's ability at pitching and batting. In games, one player puts out a pitcher, face up, and another a batter, face down. The first player then decides which of several pitches to throw. If the rating for that pitch bests the batter's rating for those types of pitches a strikeout results; if not, it's a home run for the player with the batter card.

The cards include both current stars and legends of the past. Player one might place a face-up card of fire-balling San Francisco Giants' pitcher Tim Lincecum, calling out a fastball, to take advantage of his high 97 rating for that pitch. The rival would then turn his card over; if it turns out that his hitter has a mediocre fastball rating that is below 97, it's an out; but if the batter turns out to be Babe Ruth, who has a 99 fastball rating, it's a home run.

Though strategy is involved in the game—a player might choose to have Mr. Lincecum throw a change up, to surprise an opponent expecting a fastball—even young children can catch on quickly.

"It's a very simple game," says Mr. Eisner, who argues that the card industry lost its way catering to collectors and not kids.

Fads come and go, of course, especially among fickle youth. And some children call the baseball Attax cards too simple, because each at-bat can result in just two outcomes, a home run or an out. That would make the excitement harder to sustain.

Teachers tend to dislike schoolyard crazes, too, and Attax is no exception. "Older kids were at each other's necks because they were so upset at how a game went," says Rabbi Nachum Wachtel, assistant principal at the Joseph Kushner Hebrew Academy in Livingston, N.J., who has discouraged the game in his school. The cards "can lead to disharmony and we try to avoid that."

For now, though, interest seems to be building.

"It's been a monster," says Steve Mandy, who runs a store called Attack of the Baseball Cards in Union, N.J. "It's given kids a reason to collect cards again."

In recent years, Mr. Mandy resorted to running seminars to teach kids the basics about baseball cards, such as how to flip and collect them, trying to revive interest. Now he expects to sell as many as 200 packs of the new cards a week, up from 100 last summer.

Mr. Eisner is pushing Topps to extend the Attax line into candy, gum and maybe even a television show.

"I'm like a crazed man about this," says Mr. Eisner, whose group paid $385 million for Topps. "It's not my job to analyze it, but to make it grow."

Alan Narz, who runs Big League Cards, a store outside Orlando, Fla., holds Attax tournaments where fans can compete. Some kids line up outside the store before it opens on tournament days, Mr. Narz says.

He even sees some kids bending cards and shoving them in back pockets, something unthinkable several years ago when most of his customers were focused on treating baseball cards delicately, to protect their value.

"They've changed my store because they're fun," Mr. Narz says.

Revenue Recognition Practices - Premature or Fictitious?

The revenue recognition criteria of earned and collectible offer managements considerable latitude in deciding whether or not revenue should be recognized.

Premature revenue recognition is in the eyes of the beholder.

- More to do with management conservatism than with strict application of GAAP.
- The more aggressive managements become, the earlier they might consider recognition.
- Premature revenues are not necessarily fictitious nor fraudulent.
- Though the line between aggressive and fraudulent recognition is only a matter of degree.
    - What may seem to be simply aggressive at the time may, in hindsight, be attributed a fraudulent intent.

Premature Vs. Fictitious Revenue Recognition

Premature Revenues

Examples of Premature Revenue Recognition (Prosecuted by SEC)

Company	Premature Revenue
Acclaim Entertainment, Inc.	Recognized revenue on a foreign distribution agreement in advance of required product delivery
Bausch & Lomb, Inc.	Used aggressive promotion campaign to encourage orders and shipments that could not be economically justified
Peritus Software Services, Inc.	Revenue recognized for valid order that was not shipped until a later period
Pinnacle Micro Corp.	Books left open and revenue recognized for shipments made in a later period
Telxon Corp.	Shipment to reseller that was not financially viable
Twinlab Corp.	Revenue recognized for valid orders that were not completely shipped

Premature Vs. Fictitious Revenue Recognition (cont'd)

Fictitious Revenue Recognition

Fictitious revenue recognition entails recognizing revenue for shipments for which orders were not expected or worse, for nonexistent shipments.

Boston Scientific

Shipped product (medical devices) to leased commercial warehouse space and stored the goods there. Sales were recorded to nonexistent customers.

Credits were later issued (in new accounting period) to the non-customers and the same goods were later "resold" to different customers.

Fictitious Revenue Recognition (cont'd)
California Micro Devices Corp.

The company's acts of fictitious revenue recognition included, ". . . booking bogus sales to fake companies for products that didn't exist."

In fact, evidence obtained in a criminal trial of the Company's former chairman and former treasurer indicated that one-third of its $45 million of revenue in one year was spurious.

Revenue was recognized for product shipped to customers before it was ordered and those sales were not reversed when the product was returned.

In other cases, distributors were paid special handling fees to accept product that had unlimited rights of return. Revenue was recognized when product was shipped to those distributors.

As the fiction developed, the Company began recording sales for fake shipments.

In fact, as the alleged fraud grew and more of the Company's staff became involved in it, a running joke developed in which staff would say to each other, ". . . like in a Bugs Bunny cartoon, 'What's Wevenue?'"

Fictitious Revenue Recognition (cont'd)
Flight Transportation

- Air charter carrier
- Overstated tourist charter revenue by over 62%.
- Recorded revenues for flights that were not made.
- Key factor helping to uncover the deception
  - President of an air charter company that Flight Transportation was trying to acquire concluded that the company's fleet of planes did not have the physical capacity to generate the amount of revenue claimed.
  - Later, in documents provided the company's auditor, it was stated that in one year, the company made 120 flights, 12 during the first three quarters and 108 during the fourth quarter.

Revenue per some measure of physical activity is a good barometer for identifying premature or fictitious revenue.

This manager used revenue per plane. What are others?

Premature Vs. Fictitious Revenue Recognition (cont'd)

In some instances identifying when revenue has been recognized prematurely is very straight-forward.

Most would agree that revenue is recognized prematurely when it is recorded for a shipment made immediately after a period's cutoff date to fill a valid order from a creditworthy customer.

The revenue is not fictitious because the sale exists. It was recorded early.

Most would also agree that revenue recorded for nonexistent sales to nonexistent customers is fictitious. Here a sale simply does not exist.

Between these two extremes, however, it is difficult to get consensus on what constitutes premature and what constitutes fictitious revenue recognition.

The point to remember is that whether revenue is recognized in a premature or fictitious manner, it should not have been reported. Earnings expectations derived from reported amounts will be overstated.

As an aside: fictitious revenue recognition typically entails much more in the way of "cover-up" activities. Moreover, penalties for discovery are steeper., occasionally entailing criminal prosecution.

Revenue Recognition Cover-Up Activities

Company	Cover-Up
Advanced Medical Prods, Inc.	Did not mail invoices and monthly statements to "customers" that had not placed orders
Automated Telephone Management Systems, Inc.	Prepared fictitious sales contract, completion of installation document, and audit confirmation letter
Cambridge Biotech Corp.	Provided money to customer to pay for an order, netted receivable out as part of an acquisition of a customer, paid commission to a third party to provide funds to customer to pay amount due
Cendant Corp.	Charges to cancellation reserve kept off the books
Cylink, Inc.	Shipments made to third-party warehouse
Informix Corp.	Backdated license agreements to earlier periods
Laser Photonics, Inc.	Did not record credit memos for returns
Photran Corp.	Backdated order and shipping documents Shipments made to third-party warehouse
Premier Laser Systems, Inc.	Prepared fictitious customer order form Shipments made to third-party warehouse

Case Assignment
Disk Drive Corp.
(Miniscribe, Inc.)

Disk Drive Corp. is a manufacturer of computer disk drives sold to original equipment manufacturers for incorporation into microcomputer systems. From just over $5 million in sales in 2010, the company's volume of business grew rapidly to over $120 million its fiscal year ended 2014. During this period of rapid growth, however, the company was typically unable to report an operating profit. Those losses continued into 2015 as the company's sales declined to $114 million. The company's fortunes changed in 2016. That year, sales grew markedly to $185 million and the company was able to report a $24 million operating profit. The turnaround came at just the right time, as the company was scheduled to issue $97.7 million in bonds the month following the release of its results for 2016.

Excerpts from the company's financial statements and footnotes for the years ended December, 2016, 2015 and 2014 are provided below.

Required:

1. When and how does the company account for sales of its disk drives.

2. What is the reserve for gross margin and how does it work?

3. What specific items in the financial statements lead you to be concerned about the sustainability of earnings reported for 2016?

4. Where would you look for corroborating evidence?

5. Would you go so far as to say that earnings for 2016 were artificially inflated? By how much?

Disk Drive Corp.

From the balance sheet . . .

	2016	2015
Current assets:		
Cash and cash equivalents	$16,329	$23,244
Accounts receivable, less allowance for doubtful accounts of $736 and $752, respectively	39,766	16,041
Inventories	45,106	22,501
Other current assets	936	239
Total current assets	$102,137	$62,025
Current liabilities:		
Accounts payable	$37,160	$12,228
Current portion of long-term debt	946	1,742
Accrued compensation and related expenses	2,820	1,746
Accrued warranty expense	1,374	2,083
Other current liabilities	4,386	3,274
Total current liabilities	$46,686	$21,073

From the income statement . . .

	2016	2015	2014
Net sales	$184,861	$113,951	$123,606
Cost of sales	137,936	111,445	110,577
Gross profit	46,925	2,506	13,029
Selling, general and administrative	14,459	12,217	9,798
Research and development	8,555	4,204	8,307
Total operating expenses	23,014	16,421	18,105
Income (loss) from operations	$ 23,911	$(13,915)	$(5,076)

Disk Drive Corp.

From the notes . . .

Description of Business

Disk Drive Corporation and subsidiaries (the Company) design, develop, manufacture and market micro-technology disk drives for incorporation by original equipment manufacturers into microcomputer systems. The Company considers its operations to be in one industry segment.

During the fiscal year ended December 28, 2016, one customer accounted for approximately 17% of net sales. During the fiscal year ended December 29, 2015 and December 30, 2014 two customers accounted for approximately 16% and 42%, respectively, of net sales. No other customer accounted for 10% or more of net sales in any of the three years.

Revenue Recognition

Revenue is generally recognized upon shipment of products to customers. A reserve for gross margin has been recorded based upon inventory levels at distributors.

Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or market.

Inventories consist of:	2016	2015
Raw materials	$26,902	$15,309
Work-in-process	10,195	3,657
Finished goods	8,009	3,535
	$45,106	$22,501

In 2015, the Company increased its reserve for excess inventory as a result of general decline in the demand for micro-drives and severe price competition. In 2016, this reserve was reduced by $2.1 million as a result of a general improvement in demand and the ability of the Company to sell the inventory at higher prices than had been anticipated.

Warranty expense

The Company warrants its products against defect for approximately one year. A Provision for estimated future costs relating to warranty returns is recorded when products are shipped.

Disk Drive Corp. (cont'd)

From the Business section of the 10K. . .

Marketing and Customers

The company's products are sold domestically through its own sales organization and through independent distributors and VAD-VAR's (value-added distributors and value-added resellers). The distributors serve smaller OEM's, systems integrators and certain VAD-VAR's. The Company maintains sales offices in Longmont, Colorado; King of Prussia, Pennsylvania; Dallas, Texas; Fountain View, California, Campbell, California; Marlborough, Massachusetts; Hong Kong, Taiwan and West Germany.

Backlog

At December 28, 2016, the Company's backlog of orders for shipment by June 2015 was approximately $30 million, of which 55% was from 13 customers. On December 29, 2015, backlog for shipment within a comparable period was approximately $35 million.

Backlog includes only those units for which a customer has released a purchase order and specified a delivery schedule. Such orders generally may be canceled or rescheduled by the customer without significant penalty, and it has been the Company's experience that orders are frequently rescheduled and occasionally canceled.

Case Assignment
Global Resources, Inc.

Global Resources provides recreational travel opportunities for individuals interested in prospecting for gold. The company describes its business as follows:

> The Company's principal business activities consist of the promotion and sale of an "Alaska trip", a recreational gold mining expedition to the company's Cripple River property located near Nome, Alaska, and the sale of LDMA/AU memberships which entitle members to engage in recreational prospecting on its Burnt River (Baker County, Oregon), Junction Bar Place (Siskiyou County, California) and Land Mine (White County, Georgia) properties. The company has also signed a mutual use agreement with Lost Dutchman's Mining Association, under which members of either LDMA/AU or Lost Dutchman's Mining Association would be entitled to engage in recreational prospecting on certain of each other's properties.

A big growth opportunity for the company has been in the sale of prospecting memberships. The company describes its revenue recognition policy for the sale of these memberships as follows:

> The Company has sold memberships primarily on an installment basis. Memberships include contracts that give purchasers recreational prospecting and mineral rights to the Company's land and undivided interests in the land and facilities. The contracts are generally non interest bearing, unsecured and provide for a down payment and monthly installments of $25 for periods of up to ten years. Sales revenue is recognized upon execution of a sales contract, expiration of the refund period, and receipt of cumulative payments of at least 10% of the sales price. Cumulative payments received on contracts where the refund period has not expired, or which are less than 10% of the original contract amount are recorded as deposits. Deposits are fully refundable for sixty days. The contracts are discounted over the contractual repayment period at a discount rate of 2% over the prime rate.

According to the company memberships sell for $3,500, though a discount of $1,000 is given for a $250 down payment and payments of $25 per month. In addition, there is a yearly maintenance fee of $96 that commences once the initial membership fee is paid. As of December 31, 2015, a total of 1,500 memberships had been sold.

Selected account balances from the company's 2015 annual report are provided below:

Global Resources, Inc.
Selected Account Balances
(dollar amounts in thousands)

Year ended	December, 2014	December, 2015
Membership sales	$ 560	$ 701
Membership contracts receivable	$ 614	$1,090
Less unearned interest	(120)	(226)
Less allowance for cancellations	(49)	(86)
Membership contracts receivable, net	$ 445	$ 778
Total assets	$2,296	$3,020
Stockholders' equity	$1,552	$1,975
Net income	$ 153	$ 403

Selected account balances for the nine months ended September, 2015 and 2016 are provided below:

Global Resources, Inc.
Selected Account Balances
(dollar amounts in thousands)

Nine months ended	September, 2015	September, 2016
Membership sales	$ 611	$1,568
Membership contracts receivable	$ 913	$2,654
Less unearned interest	(195)	(611)
Less allowance for cancellations	(69)	(218)
Membership contracts receivable, net	$ 649	$1,825
Total assets	$2,836	$4,308
Stockholders' equity	$1,891	$2,764
Net Income	$ 387	$ 784

In examining these financial results, the company appears to be on a roll. Membership sales revenue and net income are up dramatically. In a press release, the company described its results for the third quarter ended September, 2016 as follows:

> Temecula, California - Management of GLOBAL RESOURCES, INC., an Alaskan corporation, today announced the Company had significant increases in revenues and earnings for the Third quarter ended September 30, 2016, compared to the third quarter of 2015. Revenues for the third quarter of 2016 were up 37% to $965,534 from $707,065 for the third quarter of 2015. Net Income was up 450% to $259,316 or $.18 per share from $47,674 or $.04 per share. . .
>
> Global has had several straight years of increased earnings and revenues. This trend is expected to continue. The Company had a significant number of membership sign ups in the first nine months of 2016 and is projecting significant growth to continue throughout the year and into 2017.

Required:

1. How much revenue does the company recognize on a membership sale when a contract is signed and a $250 down payment is received? After 60 days and the receipt of two monthly installments of $25? What is the contract receivable balance at this 60-day point? Assume a 3% prime rate.

2. The company nets against its contract receivable balances 8% of the contract amounts for uncollectibility. Is that enough?

3. Profitability notwithstanding, Global Resources operating cash flow has run a bit short due to the rapid growth in its membership notes receivable balances. You've been approached to gauge your interest in providing financing to help the company maintain that growth. Are you interested?

Special Terminology
Premature or Fictitious Revenue

Bill and Hold Sale

A sales agreement where goods that have been sold are not shipped to a customer but, as an accommodation, simply are segregated outside of other inventory of the selling company or shipped to a warehouse for storage, awaiting customer instructions. Must be done to accommodate customer's wishes.

What can go wrong? When bill and hold is used to accommodate the seller in order to encourage a purchase that would not have been made. Seller may even "ship" to a company warehouse awaiting an "order" to buy.

Sunbeam Corp. sold outdoor grills to reseller customers (e.g., Kmart) under bill and hold arrangements. Revenue should not have been recognized.

Special Terminology
Premature or Fictitious Revenue (cont'd)

Channel Stuffing

Shipments of product to distributors who are encouraged to overbuy under the short-term offer of deep discounts.

Sales in such a setting are uneconomic and are at the expense of future shipments. Can be used if customers are paying for product.

What can go wrong? Customers may be given special provisions that payment for shipments received is not due. In such a setting, sales are actually consignment sales.

Bausch & Lomb, Inc. Used significant discounts to forcibly ship contact lenses to resellers who could not be expected to sell amount of product shipped. Special provisions for deferring payment were offered.

Special Terminology
Premature or Fictitious Revenue (cont'd)
Side Letters

A separate agreement that is used to clarify or modify the terms of a sales agreement. Side letters become a problem for revenue recognition when they undermine a sales agreement by effectively negating some or all of an agreement's underlying terms and are maintained outside of normal reporting channels.

Sales-Agreement Side Letters

Company	Side-Letter Provisions
Cylink Corp.	Provided right to exchange software products for hardware
Engineering Animation, Inc.	Absolved reseller of payment unless software resold
Hybrid Networks, Inc.	Provided absolute right of return
Informix, Corp.	Committed Company to use its own sales force to find customers for reseller Offered to assign future end-user orders to resellers Extended payment terms beyond twelve months Committed Company to make future purchases from resellers under terms that effectively refunded license fees paid by them Diverted Company's own future service revenue to resellers as a means of refunding their license fees.
Insignia Solutions, PLC	Provided more liberal rights of return
Kendall Square Research Corp.	Absolved customers of payment obligation if anticipated funding not received
KnowledgeWare, Inc.	Provided unconditional right of return Absolved reseller of payment unless software resold
McKesson HBOC	Offered rights for continuing negotiation Offered right to cancel agreement
Platinum Software Corp.	Offered right to cancel agreement
Scientific Software-Intercomp, Inc.	Excused payment Treated sales agreement as ineffective until goods resold

Financial Warnings Checklist
Premature or Fictitious Revenues

What is the company's revenue recognition policy?

- Before delivery or performance?
  - Is it really earned?

- At delivery or performance?
  - Is there a right of return or price protection?
    - Adequate provision for returns or price adjustments?
  - Does the company offer separate letters offering the right of return or price protection not contained in the actual sale contract?

- After delivery or performance and full customer acceptance?

- Does the company employ sales-type lease accounting?
  - Is there risk of lease cancellation?

- Was there a change in the revenue recognition policy?
  - Did the change result in earlier revenue recognition?

Are there any unusual changes in revenues reported in recent quarters?

- What are revenues for each of the last four to six quarters?

- Does any one quarter show unusual activity not explained by seasonal factors?

- How do quarterly changes in revenues compare with the industry or selected competitors?

Does the company have the physical capacity to generate the revenues reported?

- What are revenues per appropriate measure of physical capacity for each of the last four to six quarters?

- How do they compare with the industry or with selected competitors?

- Possible measures of revenue per physical capacity:
    - Revenues per employee
    - Revenues per dollar of total assets
    - Revenues per dollar of fixed assets

Are there signs of overstated accounts receivable?

- What are receivables in days for each of the last four to six quarters?

- What are the implications of changes noted in receivables in days over the last four to six quarters?

- How does the absolute level of receivables in days and changes therein compare with the industry and selected competitors?