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# How Sales Executives Can Avoid Accounting Fraud Allegations

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# How Sales Executives Can Avoid Accounting Fraud Allegations

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**Abstract**

Is accounting fraud only a concern for CEOs and financial executives? This article discusses recent cases in which the Securities and Exchange Commission (SEC) charged Sales Vice Presidents for their role in accounting fraud. The authors offer suggestions to help sales executives steer clear of accounting fraud allegations.

**Introduction**

Accounting fraud has dominated business headlines in recent years. Companies such as Enron, WorldCom, Qwest, Tyco, Adelphia, HealthSouth, and others have been investigated for massive frauds, and many executives have faced criminal charges. As a result of fraud, companies' shareholders have lost billions, and investors' faith in the U.S. capital markets has been shaken. In response to the spate of frauds, Congress passed the Sarbanes-Oxley Act of 2002 (SOX 2002), which provides tough new penalties for those committing accounting fraud, including lengthy prison terms [3]. In this environment, sales executives should ask, "Do I need to worry about accounting fraud, or do the SEC and federal prosecutors typically sanction only CEOs and financial executives in fraud cases?"

This article explains the accounting rules for recording sales (recognizing revenue) and discusses prior research on the prevalence of revenue fraud in U.S. public companies. We illustrate the role of sales executives in accounting fraud by reviewing some recent SEC enforcement cases charging Sales Vice Presidents with fraud. These cases often involve sales executives overstating company sales, often by creating "contingent sales" – transactions that give the buyer the right to walk away with no penalty – that were recorded by the company as fully-completed sales. Finally, we discuss the tough new Sarbanes-Oxley penalties and offer several suggestions to help sales executives minimize the risk of trouble with the SEC and federal prosecutors.

**Revenue Recognition**

Sales cannot be recorded in the accounting system ("recognized") until two conditions are met [5]: (1) the company has provided the service or delivered the goods under an existing arrangement with a fixed or determinable price, and (2) the company has been paid or reasonably expects to be paid. In other words, before it can be recorded, the revenue has to be *earned* (the company has done its part and met all of its obligations to the customer) and *realized* or *realizable* (the company has collected cash or will be able to turn the sale into cash). If sales are recorded before both conditions are met, then the company's financial statements are not fairly stated. If the misstatement of revenues is intentional, then the company has committed fraud.

**Revenue-Based Accounting Fraud**

The 1999 report, *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies* [1], profiled 200 SEC accounting fraud cases and found that revenue (sales) frauds accounted for 50 percent of all the frauds. Within the group of revenue frauds, approximately half involved recording legitimate sales too early (before the revenues were earned or realizable), while the other half involved recording fictitious sales.

More recently, the SEC's *Report Pursuant to Section 704 of the Sarbanes-Oxley Act* [6] examined 227 enforcement cases (many of which alleged fraud) from 1997-2002. The SEC found that 56 percent of the cases in this later period involved overstated revenues, so revenue misstatements continue to be prevalent. The SEC report also noted that many revenue misstatements involved recording sales too early.

*If the misstatement of revenues is intentional, then the company has committed fraud.*





**The Role of Sales Executives in Recent Accounting Frauds**

To offer insights into the role of sales executives in recent accounting frauds, we searched the SEC's formal reports of its enforcement actions – its Accounting and Auditing Enforcement Releases (AAERs) – for recent cases in which Sales Vice Presidents were charged with fraud from September of 2003 through mid-September of 2005 (available at http://www.sec.gov).[1] In this recent two-year period, we identified eight public company accounting fraud cases in which at least one Sales Vice President was charged by the SEC with violating the anti-fraud provisions of the U.S. securities laws.[2] The key elements of these cases, as described by the SEC, are presented in the Exhibit. Note that the information provided should be viewed as allegations, and in many cases, the parties charged have not admitted guilt. Some cases are still pending at this time.

Several interesting patterns are revealed in these cases. First, the sample is dominated by technology/software /internet firms – typically growth companies with intense pressure to meet sales targets and analyst expectations.

Second, many of the eight cases involve companies significantly overstating revenues by, among other methods, intentionally creating contingent sales whereby the companies improperly recorded sales when products were shipped to customers before the customer was ready or obligated to purchase the goods. These arrangements sometimes were made through secret side letters that were unknown to others in the company, which allowed the customer to withdraw from the transaction at a later date or contained other contingencies/unusual terms. In one instance, the SEC disclosed the text of the secret side letter that invalidated the sale (Legato is the supplier, and Logicon is the customer; http://www.sec.gov/litigation/complaints/comp18327.htm):

> *The order letter meets the GAP [sic] requirement 97-4 [sic] for revenue recognition. The order letter allows Legato to recognize revenue for our third quarter ending 9-30-99.... The order letter gives us 30 days to reach mutually agreeable terms and conditions. In the unlikely event that we do not reach "mutually agreeable terms and conditions," Logicon will have the right to terminate the order letter and all obligations. This contingency may not be expressly stated in the order letter, because of the impact on revenue recognition. However, you have my assurance that in the event that we can not [sic] reach terms we will not hold you to the commitment to pay referenced in the order letter.*

The company recorded the sale in its financial statements as of September 30, 1999, even though the above side letter clearly gave the customer the right to "undo" the purported sale without penalty after that date. Amazingly, the side letter even referred to the revenue recognition issue and explained why this escape clause could not be included in the actual order letter.

Third, in addition to contingent sales with side letters, other methods used to overstate sales or income included: (1) shipping products that the company knew would be returned; (2) creating bogus sales; (3) treating goods loaned to others on a trial or consignment basis as completed sales; (4) shipping product to the company's own warehouse and recording a sale; (5) funneling cash to customers for use as payment back to the company for the "purchased" product; and (6) failing to record products returned by customers. Each of these methods resulted either in sales being recorded too early or in phony sales being recorded.

Fourth, the penalties imposed in these cases included such elements as disgorgement of ill-gotten gains, civil fines, being barred from serving as an officer or director of a public company, and jail time in a case also involving insider trading (some cases are still unresolved). Also, job loss is a common outcome for those charged with accounting fraud.[3]

Finally, others were charged in all eight of these cases. Sales executives typically do not act alone in committing accounting fraud, but often are working in concert with others, or are implementing fraud schemes directed by higher-level personnel.

**Criminal Penalties Under Sarbanes-Oxley**

The Sarbanes-Oxley Act establishes a number of tough new criminal penalties for fraud and related offenses, including: (1) destruction, alteration, or falsification of records in federal investigations – up to 20 years in prison; (2) securities fraud – up to 25 years; (3) mail and wire fraud – previous five-year penalties increased to up to 20 years; and (4) failure of corporate officers to certify financial reports – up to 20 years for willful misstatements. In addition, the law extends the statute of limitations for securities fraud and provides for enhanced protection of whistle-blowers [3]. On the whole, since the passage of Sarbanes-Oxley, the stakes have been raised significantly for those engaged in public company accounting fraud.

**Suggestions for Sales Executives**

Given the stiff criminal penalties and the SEC's willingness to pursue civil charges against sales executives who participate in accounting frauds, we offer four suggestions to help sales executives and their staff minimize their exposure to accounting fraud allegations.

• **Education.** Educate yourself and your staff on revenue recognition criteria, including the elements of *Staff Accounting Bulletin No. 101* [5] and its subsequent updates. Public company executives, whether in sales or finance, are expected to understand (and are being held legally accountable for understanding) the basics of revenue recognition under generally accepted accounting principles, or "GAAP." Sales staff should appreciate that "playing games" with sales can become accounting fraud.

• **Culture.** Do not understate the importance of the organization's culture (see COSO [2] for a discussion of the "tone at the top"). If the culture in the organization is "make your sales targets or you're fired," or, "we never miss our sales forecasts," then the company is much more likely to have trouble with revenue recognition. Under such pressure, people are more likely to push the envelope to boost their sales numbers, perhaps by making contingent sales to customers or recording fictitious sales. Such actions to meet internal sales targets become accounting fraud when the financial results are released publicly.

*Public company executives, whether in sales or finance, are...legally accountable for understanding...the basics of revenue recognition under generally accepted accounting principles, or "GAAP."*

• **Compensation.** Be very careful when using incentive-based compensation that could drive people to become too aggressive at the end of the quarter or year. For example, bonuses and commissions that are based on quarterly or annual sales can drive some people to hold the books open, backdate contracts, or issue side letters to customers so as to boost sales and maximize their compensation. Some organizations may consider basing bonus payments on periods that do not coincide with accounting periods (e.g., 9/1/XX – 11/30/XX instead of the fourth quarter of the year, 10/1/XX – 12/31/XX). In this example, even if some people pushed too hard at 11/30/XX to get sales into November, it is less likely that the company's fourth quarter results would be affected (i.e., any sales pulled from

[1] Specifically, we searched the SEC website using the following search strings: "Accounting and Auditing Enforcement Release" (or "Accounting and Auditing Release") AND ["Vice President of Sales" OR "Vice President for Sales" OR "Sales Vice President"]. Our search strings will not identify all cases against sales executives, so the sample of cases described in this paper is smaller than the true population. For example, on May 17, 2004, Lucent Technologies, Inc. settled an SEC enforcement case alleging that it fraudulently overstated fiscal 2000 sales by over $1 billion. The Lucent case involved securities fraud charges against nine company employees, including several individuals with sales-related responsibilities [7]. This case did not show up in our Sales VP searches.

[2] We went only back to September of 2003 so as to keep the number of cases profiled at a manageable number. Our intent is not to document all recent SEC cases against sales professionals, but rather to provide insights from a selection of recent cases.

[3] Given the time lag in the SEC's enforcement process, many of the alleged frauds underlying these cases preceded the Sarbanes-Oxley Act and its tougher new accounting fraud penalties, which are discussed below. It is reasonable to expect even more stringent penalties in similar future cases.

December up to November would still be legitimate fourth quarter revenues). Overall, sales executives should watch their people closely to make sure that end-of-period manipulation of sales is not taking place and is not rewarded by the company.

• **Whistle-blowing.** If you are aware of revenue recognition issues in your company,
(a) report the problem immediately to senior management and the board (perhaps through the company's whistle-blowing channels), and
(b) be prepared to seek employment elsewhere if the problem is not ultimately resolved to your satisfaction.

According to Scannell and Latour [4], simply complaining to a higher level of management and remaining with the company may not insulate an employee from civil or criminal liability in accounting fraud cases. Employees with concerns about accounting issues must be willing to inform the board and possibly even regulators (e.g., the SEC) of the problem if management does not take appropriate corrective action. While leaving one's job is a painful and costly proposition, it clearly is preferable to becoming entangled in an accounting fraud case and facing personal liability.

### Conclusion

We encourage sales executives to educate themselves and their staff on revenue recognition criteria and to contribute to a culture of ethical financial reporting. What may be viewed by some as "game playing" to reach a sales quota may be viewed by federal prosecutors as accounting fraud – warranting criminal prosecution. In this environment, sales executives are wise to avoid any behavior that could be construed as revenue fraud, to stay alert for any sign of revenue recognition abuses by others, and to be extremely vocal regarding any suspicions of trouble.

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| **1. Take-Two Interactive Software, Inc. (VP of Sales)** – Publisher and distributor of video games; AAER No. 2259 (also see AAER No. 2260); June 9, 2005. | | |
| **Fraud Allegations Charging Sales Executive:** Take-Two systematically recognized sales revenue from approximately 180 "parking" transactions in which the company, at or near the end of fiscal quarters or year end, shipped hundreds of thousands of video games to distributors who had no obligation to pay for the product, fraudulently recorded the shipments as if they were sales, and then accepted return of the games in subsequent reporting periods. In many cases, Take-Two created fraudulent invoices to disguise the returns as "purchases of assorted product." Take-Two also improperly recognized sales revenue for games that were still being manufactured and could not in fact be shipped, and in fiscal year 2000, improperly accounted for the acquisition of two video game publishers. The sales executive arranged and executed several of these transactions. For example, the sales executive arranged a shipment of 230,000 video games to Capitol with the understanding that the shipment would be returned. Take-Two improperly recorded $5.4 million in revenue from the shipment—which at that time was Take-Two's largest sale ever. Capitol subsequently returned the entire shipment.<br><br>Take-Two's fraudulent accounting practices allowed it to improperly recognize approximately $60 million in revenue during 2000 and 2001, and report after-tax fiscal year 2000 earnings that were inflated by $20 million. Take-Two's quarterly revenue and/or earnings were materially overstated in nine of fifteen quarters from 2000 through the third quarter of 2003. | **Penalties/Status of Case:** Penalty of $50,000; disgorgement and interest of $64,508. | **Other Information:** The former Chairman/CEO, former EVP/COO, and former CFO also were charged. |

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| **2. Liberate Technologies (Sales VP)** – Seller of software and services for interactive television; AAER No. 2114 (also see AAER No. 2268); September 29, 2004. | | |
| **Fraud Allegations Charging Sales Executive:** The former COO, on his own and with assistance from the Sales VP on several deals, devised a series of fraudulent transactions to inflate Liberate's quarterly and year-end financial results. As a result, Liberate's quarterly revenue was artificially inflated by as much as 17% during the company's 2002 and 2003 fiscal years. Liberate ultimately restated its financial statements in September 2003 to reverse and defer revenue from the fraudulent transactions.<br><br>According to the complaint, the COO employed various devices to inflate Liberate's reported results. For instance, the COO, aided by the Sales VP, effectuated an improper "round-trip" deal whereby Liberate supplied its customer with the money to make the purchase. In this deal, Liberate received no net economic benefit, essentially using its own funds to create the false appearance of legitimate revenue. In another fraudulent transaction, the COO negotiated a side agreement with a customer that granted the customer future financial concessions, and then hid the agreement from Liberate's finance department. The concessions the COO secretly granted, if accounted for properly, would have wiped out the revenue Liberate reported to the public for the sale. The complaint also alleges that the COO and Sales VP lied to Liberate's outside auditors and to Liberate's own financial group, which enabled the fraud to remain undetected. | **Penalties/Status of Case:** $28,000 disgorgement; $50,000 civil penalty; 10-year bar from serving as an officer or director of a public company. | **Other Information:** The former COO/ head of sales faced civil and criminal charges. |

*…"game playing" to reach a sales quota may be viewed by federal prosecutors as accounting fraud – warranting criminal prosecution.*



| **3. Fleming Companies, Inc. (Senior VP of Sales and Marketing at Dean Dairy Group, a supplier of Fleming)** – Grocery wholesaler; AAER No. 2100; September 14, 2004. | | |
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| **Fraud Allegations Charging Sales Executive:** During 2001 and the first half of 2002, Fleming improperly executed a series of transactions, called "initiatives," to fabricate earnings to "bridge the gap" between actual operating results and Wall Street expectations. In these initiatives, Fleming fraudulently structured otherwise ordinary transactions in forms that, on paper, justified and maximized an immediate increase in earnings. One type of initiative that Fleming used frequently during this period was accelerating recognition of up-front payments received under forward-looking vendor agreements. On multiple occasions, Fleming persuaded vendors to provide side letters that described up-front payments – which Fleming and the vendors plainly intended to secure future rights and services – as compensation for some past event, such as a rebate or expense item. Fleming then used these letters to justify recognizing the entire up-front payment as an offset to expenses immediately, rather than over time as generally accepted accounting principles ("GAAP") required. These illicit bookings enabled Fleming to meet securities analysts' earnings expectations. Dean allegedly issued one of these side letters, related to a $2.5 million payment. | **Penalties/Status of Case:** Dean sales executive agreed to $50,000 civil fine; Dean agreed to $400,000 civil fine. | **Other Information:** Other vendors and Fleming executives also faced SEC sanctions. Fleming entered Chapter 11 in April 2003. |

| **4. Symbol Technologies, Inc. (Senior VP of Worldwide Sales and Service, VP of Sales Finance)** – Supplier of mobile information systems using bar code scanners; AAER No. 2029; June 3, 2004. | | |
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| **Fraud Allegations Charging Company and 11 Executives:** The SEC's complaint alleges that from at least 1998 until early 2003, Symbol and the other defendants engaged in numerous fraudulent accounting practices and other misconduct that had a cumulative net impact of over $230 million on Symbol's reported revenue and over $530 million on its pre-tax earnings.<br><br>The complaint alleges that Symbol and other defendants engaged in a fraudulent scheme to inflate revenue, earnings and other measures of financial performance in order to create the false appearance that Symbol had met or exceeded its financial projections. The former President/CEO and others fostered a "numbers driven" corporate culture obsessed with meeting Wall Street estimates.<br><br>With no regard for generally accepted accounting principles, they used the following fraudulent schemes to align Symbol's reported financial results with market expectations:<br>• A "Tango sheet" process through which baseless accounting entries were made to conform the raw quarterly results to management's projections;<br>• The fabrication and misuse of restructuring and other non-recurring charges to artificially reduce operating expenses, create "cookie jar" reserves and further manage earnings;<br>• Channel stuffing and other revenue recognition schemes, involving both product sales and customer services; and<br>• The manipulation of inventory levels and accounts receivable data to conceal the adverse side effects of the revenue recognition schemes. | **Penalties/Status of Case:** Charges against the individuals are still pending. The company settled for $37 million and several remedial measures. | **Other Information:** Numerous company executives have been charged. Four of these executives appear to have had sales responsibilities. |



| **5. Critical Path, Inc. (Sales VP)** – Internet messaging products and services; AAER No. 1971 (also see AAER No. 1619); March 9, 2004. | | |
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| **Fraud Allegations Charging Sales Executive:** This executive participated with other sales executives to fraudulently inflate Critical Path's sales by $2.125 million. Another sales executive had a Critical Path salesman contact a former colleague, who now worked for an Internet shopping provider. The former colleague agreed to "evaluate" Critical Path software, but warned the Critical Path salesman that under no circumstance would his company purchase the product.<br><br>The executive charged in this case knew that the purpose in instructing the sales force to prepare evaluation agreements and ship software before year-end was to further the scheme to improperly record revenue in the fourth quarter of 2000. On or about December 29, 2000, the executive directed the other Critical Path salesman to prepare a non-binding software evaluation agreement between Critical Path and the Internet shopping provider. Neither Critical Path nor the Internet shopping provider ever intended to honor the contract, and the executive knew this. He understood that, as part of the deception, the deal with the Internet shopping provider would be written off as a bad debt during the first quarter of 2001. This "sale" was improperly included in the company's fourth quarter revenues. The executive also traded on non-public information during the time of the fraud. He avoided losses of $586,368 by selling shares during this time. | **Penalties/Status of Case:** Disgorged losses avoided on insider trades (mostly waived due to executive's financial status); sentenced to three months in prison and two years of supervised release. | **Other Information:** Three other sales executives previously were charged by the SEC, as was the company's President. The company's IPO was in March 1999. |

| **6. Schick Technologies, Inc. (VP of Sales and Marketing)** – Medical and dental devices; AAER No. 1915 (also see AAER No. 2265); November 17, 2003. | | |
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| **Fraud Allegations Charging Sales Executive:** The executive (along with the CEO/Chairman) overstated sales in three quarters of fiscal 1999 by $9 million (24%). The methods used to inflate revenues were:<br>• Recording as sales the shipment of product to customers on a trial basis with the express understanding that the customer had no obligation to purchase;<br>• Recording consignment shipments as sales;<br>• Recording outright bogus sales;<br>• Recording sales upon shipment of product to a warehouse leased by the company; and<br>• Not recognizing the massive product returns that were occurring.<br><br>The two executives also misled the company's independent auditors by failing to disclose the true nature of two promotional programs under which customers had no obligation to purchase product, by failing to disclose the true facts concerning product shipments to a warehouse, and by procuring a false audit confirmation in at least one instance. | **Penalties/Status of Case:** Permanently barred from serving as an officer or director of a public company; monetary penalty of $250,000 (total of disgorgement, interest, and penalty). | **Other Information:** The company's CEO/Chairman also was charged by the SEC. The company's IPO was in July 1997. |

| **7. PurchasePro.com (Senior VP of Sales and Strategic Development)** – Internet business-to-business electronic-commerce software and services company; AAER No. 1868 (also see AAER Nos. 2110, 2152, and 2165); September 23, 2003. | | |
|---|---|---|
| **Fraud Allegations Charging Sales Executive:** In 2000 and 2001, the executive knowingly or recklessly participated in a series of acts and transactions designed to inflate PurchasePro's sales by several million dollars. The executive negotiated or otherwise had reason to know about side agreements with several customers that induced them to buy marketplace licenses from the company, thereby materially inflating PurchasePro's publicly announced and reported revenues. In these side agreements, PurchasePro committed to reimburse the customer at an amount up to the payment owed to PurchasePro or to buy product from the customer at an amount at least equal to the amount purchased from PurchasePro. The executive also concealed these side agreements from the auditors, and falsely represented to the auditors that there were no such side agreements.<br><br>The executive also participated in the improper recognition of $3.7 million in revenue from a purported agreement with AOL, which the executive knew or was reckless in not knowing was improper because, among other things, the parties never reached an agreement with respect to the services at issue and because the services were not performed as stated in the agreement. Finally, the complaint alleges that, during April 2001, the executive requested that his e-mail messages relating to the first week of that month be deleted. | **Penalties / Status of Case:** Permanently barred from serving as an officer or director of a public company; disgorged bonus (waived due to executive's financial condition); now facing criminal charges of conspiracy to commit wire fraud. | **Other Information:** Several other company executives and others faced civil and/or criminal charges. The company filed for Chapter 11 bankruptcy in September 2002 and sold substantially all of its assets to a private company in January 2003. |

| **8. Legato Systems, Inc. (Vice President in charge of sales to government purchasers at Logicon, Inc., a customer of Legato Systems, Inc.)** – Software; AAER No. 1850 (also see AAER No. 2311); September 8, 2003. | | |
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| **Fraud Allegations Charging Sales Executive:** The executive, employed by Logicon, Inc. (the customer), aided and abetted a fraud committed by sales executives at a supplier, Legato Systems, Inc. by drafting a secret side letter provided to Logicon. Specifically, the executive assisted two former Legato sales executives in drafting a side letter in connection with an order by Logicon to purchase Legato software for resale to the U.S. Air Force. The side letter granted Logicon the right to cancel the transaction, and noted that the cancellation provision could not appear on the face of Logicon's purchase order "because of the impact on revenue recognition." Unaware of the side letter and the cancellation provision, Legato's finance department caused the company to recognize revenue on the order. As a result of this transaction, Legato's original Form 10-Q for the Sept 30, 1999, quarter improperly overstated the company's net income by approximately $2 million (146%). Legato later restated this income, and the transaction was ultimately cancelled following the discovery of the side letter. | **Penalties/Status of Case:** $35,000 civil penalty. | **Other Information:** Two Legato Systems, Inc. sales executives previously were charged with securities fraud by the SEC. Both Legato and Logicon's parent company continue to be publicly traded. |

**Source:** U.S. Securities and Exchange Commission. Most of the wording above is directly quoted or adapted from enforcement releases and related complaints on the SEC web site (http://www.sec.gov).

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- Specialized Industries
- Tax Accounting
- Special Topics

The elective Business Course (three credits) allows the candidate to select one course from the offerings of the Graduate Division of the Tobin College of Business or one additional tax course.

### Admission Requirements

Candidates for admission must satisfy the following requirements:

- Possess an undergraduate or graduate degree in accounting or a related business field. Students must have completed core business courses or must take such courses before completing the degree.
- Successful completion of the GMAT (or an appropriate alternative examination). The successful completion of the uniform certified public accountants examination (CPA), the certified management accountants examination (CMA) or an equivalent examination could be used in lieu of the GMAT examination.