How Sales Executives Can Avoid Accounting Fraud Allegations

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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 Logicom 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,” Logicom 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 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 and provides for enhanced protection of whistle-blowers [3]. On the whole, 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.”

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• 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

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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 is clearly 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 revenue fraud—warranting criminal prosecution. In this environment, sales executives are wise to avoid any behavior that could be construed as fraud, to stay alert for any sign of revenue recognition abuses by others, and to be extremely vocal regarding any suspicions of trouble.

**References**


**Fraud Allocations Charging Sales Executive:** Take-Two systematically recognized sales revenues from approximately 185 “pumping” transactions in which the company, at or near the end of the fiscal quarters or years until, unaunched 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 also improperly recognized sales revenue for games that were still being manufactured and could not be shipped at all, and in fiscal year 2000, improperly accounted for the acquisition of two video game publishers. The sale executive arranged and oversaw several of these transactions. For example, the sale executive arranged a shipment of 238,000 video games to Capitol with the understanding that the shipment would be returned. The shipment was returned, and the sale executive, who at that time was Take-Two’s chief executive officer, received a significant capital gains-type of return.

**Penalties/Status of Case:**
- Penalty/Disgorgement of $50,000,000, and interest of $64,988.

**Other Information:**
- The former CEO, David Sacks, resigned from the company.
- The SEC also charged the company with violations of the 1933 and 1934 Securities Acts.

**Libertex Technologies (Sales VP):** The former COO of Lucent Technologies was accused of misappropriating revenue from the sale of certain software products. The former COO, who had been at Lucent, was charged with fraudulently recognizing revenue from the sale of software products that had not been shipped.

**Penalties/Status of Case:**
- Payment of $500,000 in disgorgement and interest.
- Other Information: The former COO is facing criminal charges.
"game playing" to reach a sales quota may be viewed by federal prosecutors as accounting fraud – warranting criminal prosecution.

FRAUD ALLEGATIONS CHARGING SALES EXECUTIVE: During 2001 and the first half of 2002, Fleming improperly executed a series of transactions, called "tricks", to inflate earnings to "squeeze the gap" between actual operating results and Wall Street expectations. In these initiatives, Fleming fraudulently structured otherwise ordinary transactions in forms that, in effect, justified and maximized an increase in earnings. One type of initiative that Fleming employed frequently during this period was accelerating recognition of up-front payments received under forward-looking vendor agreements. On multiple occasions, Fleming personnel would issue sales letters that described up-front payments – which Fleming and the vendors clearly 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 fictitious bookings enabled Fleming to meet securities analysts' earnings expectations. Even allegations cited one of these same letters, related to a $2.5 million payment.

FRAUD ALLEGATIONS CHARGING COMPANY AND 11 EXECUTIVES: The SEC's complaint alleges that from at least 1998 until early 2002, 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 $350 million on its pretax earnings. 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 make 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.

With no regard for generally accepted accounting principles, they used the following fraudulent scheme to align Symbol's reported financial results with market expectations:

- A "lags sheet" process through which baseless accounting entries were made to confirm the raw quarterly results; management's projections;
- The fabrication and misuse of restructuring and other non-recurring charges to artificially reduce operating expenses, create "cookie jar" reserves and further manage earnings;
- Channel stuffing and other revenue recognition schemes, involving both product sales and customer service; and
- The manipulation of inventory levels and accounts receivable data to conceal adverse side effects of the revenue recognition schemes.

FRAUD ALLEGATIONS CHARGING SALES EXECUTIVE: The executive (along with the CEO/Chairman) overstated sales in three quarters of fiscal 1999 by $8 million (24%). The methods used to inflate revenues were:

- Recording as sales the shipment of product to customers on a trial basis with the understanding that the customer had no obligation to purchase;
- Recording consignment shipments as sales;
- Recording returns as sales;
- Recording sales upon shipment of product to a warehouse leased by the company; and
- Not recognizing the massive return product returns that were occurring.

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 focus concerning product shipments to a warehouse, and by preparing a false audit confirmation in at least one instance.
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