



## **When It Comes to Revenue Recognition, There Are Mistakes Execs Don't Want to Make**

*By John Yates and Paul Arne, Special To LTW*

**John Yates chairs and Paul Arne is a partner in the Technology Group of the law firm Morris, Manning & Martin, LLP.**

ATLANTA- If you're running a technology company, then revenue is a key to your growth. Along with revenue comes the need to adopt and follow the correct revenue recognition rules to comply with legal and accounting standards.

These revenue recognition rules are the centerpiece of several recent court cases. The cases revolve around Computer Associates International ("CA"), one of the world's largest software companies.

On January 12, 2004, CA announced that it had received a so-called "Wells Notice" from the staff of the Securities and Exchange Commission (SEC). The SEC's Division of Enforcement issues a Wells Notice when it plans to recommend an enforcement action to the Commission. (The SEC only brings an enforcement action after the full Commission has voted on the matter.)

According to CA's press release, the possible charges arose from CA's premature recognition of revenue from software license contracts in CA's fiscal year ending March 31, 2000. The apparent basis for the charges centered on recognition of revenue from contracts that were not fully executed or otherwise finalized until after the applicable quarter. In other words, revenue was recognized too early for accounting purposes.

A similar case involved a former senior executive at CA.

On January 22, 2004, Lloyd Silverstein, a former Senior Vice President of Finance at CA, pleaded guilty to a felony charge of obstructing justice in Brooklyn federal court. In a statement made to the court in connection with his guilty plea, Silverstein admitted to backdating software contracts and conspiring with "several senior level CA executives" to hide the practice from federal investigators, as reported in The Wall Street Journal.

Silverstein also asserted that backdating and falsifying contracts to help the company meet quarterly revenue targets was "widespread" from 1998 to 2000, and referred to it as the "35-day month practice."

On the same day, Silverstein settled civil charges brought by the SEC. Among other things, the SEC's complaint alleged that Silverstein and others had:

- held CA's books open after the end of each quarter
- improperly recorded revenue from contracts that had not been finalized and executed before the expiration of the quarter, and

- concealed these practices by using licensing contracts that falsely bore preprinted signature dates for the last day of the quarter that had just expired (rather than the subsequent dates on which the contracts actually were executed).

The SEC further alleged that Silverstein and others at CA engaged in these fraudulent practices in order to meet earnings expectations, and that when CA refrained from recognizing revenue prematurely during the second quarter of fiscal year 2001, the company missed its earnings estimate. As a result, CA's stock price dropped over 43% in a single day.

Without admitting or denying the allegations of the SEC's complaint, Silverstein consented to a permanent injunction and a prohibition from serving as an officer or director of a public company.

### **Lessons for others**

The revenue recognition stories of CA and Mr. Silverstein are instructive for other companies. A 43% drop in shareholder value in a single day from a missed quarterly target shows the revenue pressures of public companies that may motivate them to bend the law. It also shows the severe penalties for a misstep in this area: criminal fraud and obstruction of justice charges against the individuals; SEC enforcement actions against the company.

It also suggests how tech companies can avoid revenue recognition problems by having policies against certain actions related to the contracting process. Consider the suggestions below for your revenue recognition and contracting policies.

- Don't date license agreements on an "as of" basis – date them only as of the date they're actually signed.
- Provide for a date to be actually hand-written just above or below the signature block. Don't use a pre-printed date.
- A defined "Effective Date" should be the last date actually handwritten in the signature block. If you need a separate "Effective Date" make sure you have a separate "Execution Date" concept in your license agreement.
- Where possible, don't have signature pages that are separated from the text of the license agreement.
- Have a policy of not requesting or accepting signature pages before the license agreement is fully completed.
- Don't "hold open" a quarter to allow contracts actually agreed after the quarter to be included in the quarter's revenues.

*John Yates Chairs the Technology Group of the law firm Morris, Manning & Martin, LLP, which has offices in Atlanta, Charlotte and Washington, D.C. He can be reached at [jcy@mmmlaw.com](mailto:jcy@mmmlaw.com) and (404) 504-5444. Paul Arne is a Partner in the Technology Group of the law firm Morris, Manning & Martin, LLP. His practice focuses on ecommerce and internet legal issues, and complex computer and technology agreements. He can be reached at [pha@mmmlaw.com](mailto:pha@mmmlaw.com) and (404) 504-7784. This column is presented for educational and information purposes and is not intended to constitute legal advice.*