a roundtrip ticket to trouble

When a seemingly legitimate transaction isn't.

BY SID R. EWER, CMA

Can a public company that has substantive transactions and doesn't overstate net income run afoul of the Securities & Exchange Commission (SEC)? Yes, when those transactions involve roundtripping and the company doesn't report them appropriately.

A roundtrip transaction occurs when one company sells or exchanges goods or services or monetary assets with another company and, in return, buys similar goods, services, or monetary assets from the other company for equal—or almost equal—value. The result is little or no profit to either company.

Some roundtrip bargains do have legitimate business purposes. Broadcasters, for example, often barter advertising air-time for goods or services. In such good-faith transactions between the broadcaster and its customer/supplier, the broadcaster will credit revenue for the fair value of on-air advertising while debiting accounts in equal amounts for the nonmonetary goods or services it received. In fact, there has been a rash of both monetary and nonmonetary exchanges recently, many of which have been legitimate arrangements where need and capacity were balanced between exchange partners. Often, one or both companies had a shortage of cash or credit.

But too many of these transactions have caught the SEC's attention. The Commission is concerned that some transactions may seem to be economically substantive but, in reality, are ploys to increase a company's reported volume and revenue. Because of egregious or careless reporting of barter or similar deals, responsible financial officials of companies conducting comparable yet legitimate arrangements should take special care in protecting their companies from being snagged in what I call a roundtripping "trap."

DISTORTED FINANCIAL REPORTS

Financial professionals need to make sure that each element of roundtrip transactions doesn't result in financial reporting distortions. How could that occur? Let's suppose Company A distributes a product across the U.S. Company B also distributes an almost identical product in the U.S. Each has regional distribution centers. Company A is short $5 million of product to meet its orders from East Coast customers, and Company B has an excess of product in its eastern region. Company A contracts to buy $5 million of product from Company B and agrees to sell $5 million of product to Company B the next week. Company B is willing to make this accommodation because it knows it may be in a similar situation in the future. Assuming a 40% normal gross profit on its product, Company A may record the two transactions over the course of two weeks as follows:

WEEK ONE:

To Record Purchase of Merchandise from Company A:

Inventory	$5,000,000	
Cash		$5,000,000

To Record Sale of Merchandise Inventory to Customary Customers:

Accounts Receivable	$5,000,000	
Sales		$5,000,000
Cost of Goods Sold	$5,000,000	
Inventory		$5,000,000

WEEK TWO:

To Record Sale of Merchandise to Company B:

Cash	$5,000,000	
Sales		$5,000,000
Cost of Goods Sold	$3,000,000	
Inventory		$3,000,000

If Company A reports the transactions as recorded above, it made no profit on its sale to its customary clientele and made its normal profit on its sale to Company B. Its net income won't be overstated, but its sales will be, and, furthermore, its gross profit percentage will be distorted. Here's how:

	Amount	Percent of Sales
Sales	$10,000,000	100
Cost of Goods Sold	8,000,000	80
Gross Profit	2,000,000	20

Had Company A credited cost of goods sold for the restocking sale to Company B, the resulting financial report would reflect the economic substance of the two transactions more accurately, as illustrated below:

WEEK TWO:

To Record Sale of Merchandise to Company B:

Cash	$5,000,000	
Cost of Goods Sold		$5,000,000
Cost of Goods Sold	$3,000,000	
Inventory		$3,000,000

The resulting reporting would be as follows:

	Amount	Percent of Sales
Sales	$5,000,000	100
Cost of Goods Sold	3,000,000	60
Gross Profit	2,000,000	40

GAAP FOR ROUNDTRIP DEALS

Violations of GAAP for roundtrip transactions could trigger an SEC investigation. In the previous example, an argument can be made that Company A's $5 million delivery of product to Company B to repay B wasn't a delivery of goods to a customer.

The Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Concepts (SFAC) No. 6, "Elements of Financial Statements," defines revenues as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations." SFAC No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," provides guidance on recognition criteria for recording revenue. Paragraph 84 of SFAC No. 6 notes that one of the two conditions for recognizing revenues is delivery of product or services to customers.

For nonmonetary barter transactions, SFAC No. 5, paragraph 84, says revenues "may be recognized on the basis that they have been earned and the transaction is completed…[and]…depends on the provision that the fair values involved can be determined within reasonable limits." Furthermore, Accounting Principles Board (APB) Opinion No. 29, "Accounting for Nonmonetary Transactions," says to use reasonably determinable fair market value as the starting basis of recording nonmonetary exchanges. Paragraph 21 of APB No. 29 says "an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange [does not] culminate the earning process." In such a case, the basis of the accounting should not be fair value but the carrying amount of the asset relinquished.

Although the SEC often looks at GAAP violations in roundtrip transactions, it has been investigating some prominent companies for roundtrip transactions that lack economic substance. In two cases, for example, involving former officials of Homestore, Inc. and Interspeed, Inc., the SEC indictments were for egregious offenses centered primarily on the elaborately circuitous route, apparently cloaked in deliberate obscurity, that monetary outflows wound their way back onto corporate books—and publicly presented reports—as revenue inflows. In a case involving Dynegy, Inc., however, the SEC didn't charge the company with intentional deception, though it did penalize the company for its roundtripping exercise.

DYNEGY

Dynegy, an energy company, accepted an offer on November 15, 2001, from another company (that the SEC didn't name) to buy and sell power to each other for the same price, terms, and volume. This resulted in no profit to Dynegy but did increase its revenues. In the company's news releases, according to the SEC, Dynegy included the roundtrip transactions as a part of its operations and volume. The SEC disagreed. It said the roundtrip sales were not a part of ordinary business operations. But the SEC did give Dynegy some credit for trying "to ensure that the results of the roundtrip trades were not reported…." Instead, the SEC went after Dynegy mainly for the company's failure to "implement comprehensive safeguards" that would have kept the roundtrip transactions off the company's reported business activity.

Only the corporation was penalized; no individuals were cited for any role in the affair, nor did the Commission use the terms "fraud" or "deceit." Dynegy was fined $3 million, a minuscule fine given that the company had, at the end of its fiscal 2001 year, assets of more than $24 billion and earned a profit of more than $600 million. Moreover, the $3 million fine included a sanction for another alleged offense related to Dynegy's cash flow statement, which makes the fine even more minuscule.

HOMESTORE

In the Homestore case, the SEC charged some of the company's officers with violating securities regulations, but the company wasn't charged because of its "swift, extensive, and extraordinary cooperation in the Commission's investigation," the SEC said.

Homestore is an Internet service company that offers real-estate services to consumers and realtors. A major part of its business is advertising revenue. During 2000 and 2001, Homestore purchased services and products from vendors. The vendors in turn purchased online advertising from Homestore of approximately the same value. In its complaint, the SEC said Homestore's purchases weren't needed, were in amounts that approached the upper limits of supportable fair market values, and were paid for up-front but permitted delivery over a period of two to five years (which consequently allowed Homestore to defer some of the expense). Homestore officials confounded most of these roundtrip schemes further by injecting two third-party intermediaries into the arrangements. Homestore required the vendors to convey most of its payments to the vendors to one of two media-buying companies. The media-buying companies then purchased online advertising from companies other than Homestore on behalf of the vendors. Then the media-buying companies, on behalf of nonvendor customers who paid the media companies, purchased online advertising from Homestore in approximately the same amounts of Homestore's vendor purchases.

The three Homestore officials charged included the chief operating officer, who at one time had been Homestore's CFO; the CFO; and an official called the vice president of transactions, who reported to the CFO. Both the CFO and the COO were CPAs and, according to SEC charges, became aware of the roundtrip schemes on or about March 2001. All three benefited financially from trading in Homestore stock during the time of the roundtrip revenue reporting, and all three were disciplined severely by the SEC for their knowledge and active participation in the contrivance.

INTERSPEED, INC.

The SEC alleged that three former officials of Interspeed, a now-defunct Internet hardware developer, weren't only trying to meet "Street" sales expectations but were also attempting to give themselves incentive bonuses based on meeting quarterly or annual sales projections. In an alleged collusion, the vice president of worldwide sales had delivered inventory to a customer called Solunet, which didn't have to pay for it until it found another third-party buyer. Interspeed's CFO hadn't been involved in structuring the deal and didn't find out until he inquired about payment. But instead of correcting recorded revenue upon discovering the subterfuge, the CFO allegedly went along with it.

Solunet never could find an end-user buyer, so Interspeed's vice president of worldwide sales and another of its sales officers arranged for a third-party user, I-Way, to lease some of the product held by Solunet in order to make the original sale look authentic. I-Way wasn't financially able to buy the product or make lease payments, so, according to the SEC complaint, the two Interspeed sales officers and the CFO plotted to convey, through falsified expenditure documents, enough corporate funds to I-Way to enable it to lease $300,000 worth of the product. They then arranged a sale of $300,000 of the product by Solunet to a fourth-party leasing agent, from which I-Way leased the product.

TRIPPING ROUNDTRIP TRAPS

In each of these cases, GAAP seem to have been violated, but that doesn't appear to be the main reason for the SEC's complaints. What is most interesting about these cases is that, under slightly different circumstances or a

how to ethically report roundtrip transactions

Improper reporting of roundtripping transactions is more than a distortion; it's unethical.

The following components of IMA's Standards of Ethical Conduct for Members could help you report roundtrip transactions properly:

COMPETENCE

- Perform…professional duties in accordance with relevant laws, regulations, and technical standards.
- Prepare complete and clear reports and recommendations after appropriate analyses of relevant and reliable information.

INTEGRITY

- Communicate unfavorable as well as favorable information and professional judgments or opinions.

OBJECTIVITY

- Communicate information fairly and objectively.
- Disclose fully all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, comments, and recommendations presented.

According to IMA ethics standards, if conflicts can't be resolved, the financial professional may have to resign and make appropriate disclosures, an action any loyal professional wants to avoid.

change of one factor, the transaction could be considered legitimate. The point is that corporate finance and accounting officers of publicly held companies need to guard against what I call "tripping into a roundtrip trap." Imagine circumstances in which similar details characterize transactions, even roundtrip transactions, with justifiable business purposes.

Dynegy's accommodation to the company that requested the roundtrip arrangement evidently didn't cause sanctions against the other company. Furthermore, although the use of intermediaries in the Homestore and Interspeed cases weren't for valid business purposes, you can imagine the legitimate use of intermediaries in a barter deal. Intermediaries are common with exchange partners either as negotiators, for which the intermediary more often than not receives compensation, or as a third or fourth party in a transactional association. Moreover, it isn't hard to imagine one company favoring another company by influencing one exchange partner to do business with another.

What's wrong with a broadcaster bartering advertising for goods for which it has little immediate need, if it thinks the space won't be sold? Air-time is an extraordinarily perishable "inventory" item; it can't sit on a shelf and wait to be sold the next time. Once an hour has passed, it's gone. Broadcasting isn't the only industry that has such perishable inventory. Internet companies, hotels, airlines, and certain types of healthcare facilities do as well. Accountants in manufacturing industries are used to making deals with available capacity. Is it so hard to imagine service companies making use of unused capacity?

Let's look at circumstances similar to Homestore's, but ones that aren't a ruse. An Internet or broadcasting company could barter online time or air-time for commodities and services it needs, such as office supplies and software from office supply and software dealers. The Internet company is an online real-estate enterprise; office supply dealers and accounting software vendors might believe their advertising is more effective if it's placed somewhere other than on the website of a real-estate firm. The Internet company thus contracts with a media-buying company to buy the advertising it is obligated to furnish for its office supply and software vendors from another media outlet in turn for agreeing to give advertising for other clients of the media-buying company. The media-buying company's clients, such as architects, home decorators, and moving services, would be interested in advertising on the Internet company's site.

Even similar actions that Interspeed officials could have taken might be applied to legitimate circumstances. It may be a bit of a stretch to think that arranging for a leasing agent for a customer's customer and then providing funds for that ultimate customer to take possession of the goods is legitimate, but making arrangements for a leasing agent for a customer is a common, authentic business action.

AVOIDING THE PITFALL

Because of the abuse of roundtrip transactions, legitimate ones can be perilous, and managerial finance professionals should be aware of those perils.

As is often true in accounting, the word "intent" reigns supreme. If a transaction involves a circuitous direction, the legitimate intent and business purpose of the transaction should be made crystal clear. The word "transparency" associated with financial reporting takes on added significance when a recorded economic event borders on possible roundtrip interpretations. Accounting for the transaction should avoid a manner of recording that will distort underlying economic substance of the transaction in financial reports. Care should be taken that all reports—not just actual financial statements—do *not* use elements of the transactions inappropriately. Financial officers need to effectively communicate to all corporate parties involved in structuring deals the hazards roundtrip transactions could have on corporate legal compliance and their potential dangers to culpable corporate officials.

If financial officers notice a roundtrip transaction for which there isn't a proper business reason, he or she shouldn't allow the contrivance. In the Homestore situation, the only defendants initially were financial officials or, in one instance, an ex-finance person. But they obviously didn't initially structure the deals because, according to the SEC complaint, none of them knew of the orchestration until March 2001, even though it had begun in 2000.

In today's corporate governance climate, financial professionals are being held to a higher standard. Society has always relied on the integrity of the corporate financial professional to keep financial reporting free from distortion. That means it's important to be especially careful that legitimate transactions don't distort financial reporting. ■

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