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Creativity and financial reporting don't always mix

By: Joseph J. Floyd and Casey M. Perryman   May 23, 2017

The recent Ixia settlement with the U.S. Securities and Exchange Commission provides significant insights for attorneys who advise clients on drafting and structuring contracts for transactions that are ultimately reported in financial statements.

Ixia's problems arose out of how it structured customer contract documentation in an attempt to obtain a more favorable revenue recognition result.

However, Ixia failed to consider that Generally Accepted Accounting Principles mandate reporting based on the substance of economic events and transactions, no matter how one describes or presents the transaction documentation. In the accounting literature, that is referred to as "faithful representation," which according to Financial Accounting Concept Statement No. 8 is the requirement that states "financial information represents the substance of an economic phenomenon rather than merely representing the legal form."

According to the SEC's Feb. 3 release, the former CEO of Ixia led an initiative to create documentation to circumvent GAAP and improperly accelerate the timing for Ixia's revenue recognition with major customers.

The company referred to the plan as "Split POs." Before describing the plan, a brief discussion of the software revenue recognition rules will provide context for the CEO's actions and the accounting standards that Ixia allegedly sought to circumvent.

As a software company, Ixia generally sells a combination of its products and services to customers in bundled transactions. In accounting parlance, sales that include several items are referred to as "multiple-element arrangements." Importantly, the different elements may not be delivered or provided during the same accounting period, which raises timing issues for proper revenue recognition treatment.

Significantly, under GAAP, revenue from a multiple-element arrangement involving software products and services must be allocated to each element based on the fair value of each element (e.g., dollar value established through evidence of a consistent price paid by customers for the same or similar element), as measured by vendor-specific objective evidence of fair value, or VSOE.

Now for the problem that can frustrate certain management teams: if VSOE does not exist for certain elements of the transaction, then per GAAP, any software revenue from the multiple-element arrangement must be deferred until either the point in time when all elements have been delivered to the customer, or when VSOE does exist for each undelivered individual element, whichever occurs earlier. Alternatively, the revenue for the entire contract may be recognized ratably over the contract life.

Consistent with GAAP, Ixia's internal revenue recognition policy provided that:

"If evidence of fair value (or VSOE) cannot be established for an undelivered element within the software group or software arrangement, we defer revenue on the entire order until the earlier of (i) delivery of all elements or (ii) establishment of VSOE of the undelivered element. We have not been able to establish VSOE for our Professional Services, therefore, if the only undelivered element is Professional Services, the entire order or group is recognized as revenue over the service term or when the service is completed, depending on the arrangement."

Historically, Ixia never established VSOE for its professional services, so deferral of revenue and ratable revenue recognition were frequent occurrences for Ixia. That can happen when professional services are not sold as a standalone service by a company and there is no independent evidence for the fair value of the services.

Accordingly, the former CEO knew that whenever Ixia sold a combination of software and professional services in a multiple-element arrangement, Ixia could not recognize revenue from its sale of the software element until the professional services element of the transaction was fully delivered, or it could recognize prorated revenue over the contract's service term. When under pressure to meet quarterly revenue targets, either outcome can be difficult to accept.

For Ixia, frustration with the accounting for multiple-element sales appears to have reached its apex in late September 2012, when Ixia closed a significant sale to a large technology company. The transaction was a multiple-element arrangement comprised of software, along with a nominal amount of hardware and professional services.

Although the value of the deal was substantial, under GAAP, Ixia could not recognize any of the revenue from the software licensed in the transaction in the third quarter of 2012 because the professional services sold to Ixia's customer would not be delivered before quarter-end.

Adding to Ixia's frustration, the sale's revenue recognition would be deferred even further because Ixia's customer had decided that it wanted delivery of the professional services to be completed in 2013, rather than during fourth quarter 2012.

As a result, according to the SEC, under the leadership of the former CEO, Ixia crafted a creative idea to alter the contract documentation and recognize a significant amount of revenue from the sale.

Specifically, Ixia asked its customer to "split" its original purchase order into two purchase orders. One purchase order would refer to software and already completed professional services. The other purchase order would reference the uncompleted professional services previously negotiated and agreed to by the customer.

Ixia's customer agreed to the request to submit new purchase orders. Now, under the guise of two separate customer orders, Ixia prematurely recognized approximately $530,000 of software revenue in its financial statements for the year ended Dec. 31, 2012, as reported in its Form 10-K. The terms of the original negotiation and customer agreement were in substance unchanged, but based on Ixia's Spilt POs plan, the company documented two separate sales and achieved the recognition of revenue that it desired.

Per the SEC, it was the sale to the large technology company that focused the former CEO and others on the impact of professional services on Ixia's inability to immediately recognize revenue.

As a result, the former CEO and others at the company fundamentally changed the way Ixia documented its sales transactions by instructing the team to separate all professional services from software sales.

Importantly, Ixia's sales practices didn't change and still involved negotiating and packaging the sale of products and services as a bundled offering to potential customers. However, when it came to contract documentation, Ixia began to submit two quotes to a potential customer, with one quote reflecting professional services and the other reflecting all the remaining components of the sale.

Following Ixia's new Split POs practice, it would then request that its customers submit two separate purchase orders, matching the paperwork for the two quotes, thereby creating a paper trail reflecting the purchase of professional services as an independent transaction.

The former CEO sent an email on April 21, 2013, to Ixia management that stated:

"Carrier deals that involve services need to be quoted with [professional services] on a separate quote. We cannot have [hardware/software] and Services quoted on the same order. That includes [professional services,] RE, or any other custom work. Ixia cannot deliver the quarter or meet revenue recognition any longer if we continue to book orders in this manner … . Its [sic] not a business choice. It's a business reality … ."

Ixia hoped to achieve two important goals with its Split POs plan.

First, in sales that included both software and professional services, Ixia could recognize the revenue from software immediately because professional services had been excised from the sale.

Second, Ixia planned to separately establish VSOE for professional services through the misleading Split POs as if they reflected the substance of a standalone negotiation.

Both notable goals, but both resulting from structure and form that had no basis in the substance of the negotiation, packaging and delivery of Ixia's products and services.

Per the SEC, using Split POs violated Ixia's revenue recognition policy and circumvented Ixia's internal accounting controls. Split POs also created a trail of sales documentation, including sales quotes, purchase orders and invoices that did not accurately reflect the true nature and substance of the sale.

Interestingly, Ixia's audit committee identified the Split POs plan after learning about integrity problems with the company's former CEO and conducting an investigation into company practices. The former CEO apparently lied about his undergraduate and graduate degrees when he was hired as a salesperson for the company, many years before becoming the CEO.

This case serves as another example why management integrity is essential in general, and to financial reporting.

Needless to say, there are a plethora of areas in which law and accounting overlap and work in unison to support and report the economic events and transactions that a business experiences and conducts. Examples include customer contracts such as described above with Ixia, leases, licenses, related party transactions, employment contracts and many more.

Indeed, there are many ways to be creative in crafting legal structures and contracts, but reporting substance when making financial statement assertions and judgments must always control for the statements to be fairly stated, free from material misstatement, and importantly, not misleading to the user of the information.

As one can observe from the Ixia case, it is imperative that companies report their activities in a manner consistent with the substance of their business operations as required by GAAP.

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