



## The Aker Computer Company

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### *Abstract*

*Aker Computer Company, which has been a successful business, is now facing mounting losses, and some of its accounting choices have been called into question. Read the following case facts and determine if criticisms of the company's accounting are justified. Does Michelle Sanders have reason to be concerned?*

### **Background**

Randall French, the chief financial officer of Aker Computer Company, swiveled his chair to look at the view from his 10th floor office at company headquarters. He had just received a call from Michelle Sanders, chair of the audit committee of the board of directors. Michelle had told Randall that she would like him to meet with the audit committee on Friday (today was Wednesday). The topics of concern were some accounting questions raised by Barker and Staples, LLP, the company's independent auditors. The auditors wished to discuss some questions related to items on the 2000 financial statements that they had discovered in the just-completed audit fieldwork.

Aker Computer had begun its operations in 1990 when Mark Aker, the chief executive officer, had left a large personal computer maker and formed his own company to make and sell PCs. Because of Mark's entrepreneurial and managing skills the company had grown rapidly. The company had issued an initial public offering in 1995 and Randall had been hired that year as the company's first CFO. Aker's revenue had risen to \$1.926 billion by 2000 and the net income for 2000 was set currently at approximately \$39 million. The audit for 2000 was in its final stages.

The return on net sales was just over a 2%. This return was less than the 3.5% return of 1999 and the 9.8% return, the highest ever, of 1998. During 1997, because of lagging sales, the company had created a new division, AirDiscount.com, which offered discounts on airfares to Internet shoppers. Aker Computer had also purchased PAS Software, which installed software for accounting systems. These two moves had increased revenue and profits in 1998. In 1999 revenues increased, but the return on sales decreased. Randall French knew that the first quarter of 2001 would likely generate the first net loss from operations the company had suffered since the IPO. This loss was likely to exceed \$30 million just for one quarter!

Randall was perplexed about Michelle's call because he had met just last week with Ken Staples, the partner overseeing the Aker audit. Ken and Randall had discussed some of the problems with the financial statements. Although there was not complete agreement



between the two, Randall felt that he had justified to Ken that the financial statements of the calendar year 2000 conformed to generally accepted accounting principles.

Ken Staples had contacted Michelle Sanders because of three different areas of concern on the 2000 financial statements. The first related to the Aker Computer's practices of handling the sales of personal computers, while the second touched on revenue reporting by AirDiscount.com. The third the handling of software installation contracts by PAS Software. After the CPAs' discussion with the audit committee, the committee decided it wanted to hear Randall French's views on the questions raised.

### **Sales of Personal Computers**

Aker Computer Company's normal practice was to record revenue on sale of PCs when they were shipped to the customer. All shipping terms were FOB shipping point. Over the years Aker had developed some continuing relationships with various corporate buyers who regularly purchased large quantities of PCs. Usually, these corporations placed purchase orders followed by a written sales agreement signed by both seller and buyer. In the last week of 1999 (Aker's fiscal year was the calendar year), Aker had received purchase orders totaling \$20 million. Aker had signed the sales agreement, but the buyers had not signed them until January of 2000. Aker recognized the sale of \$20 million in December of 1999 and Barker and Staples had made no comment on this practice during its audit or 1999.

In the last week of 2000 Aker received purchase orders of some \$9.2 million on which sales agreements were not yet signed. Ken Staples now maintained that the sale was not complete until the agreements were signed. In both 1999 and 2000, the PCs had been shipped to the buyer in December. Randall French had noted the practice of recognizing the revenue from 1999 and thought that Ken Staples had agreed to it.

Another issue Ken raised centered on \$5.6 million in sales related to purchase orders received from a company that had purchased large numbers of PCs in the past. The purchase order was received and filled in December 2000, but the PCs were not shipped because the buyer indicated that renovations were under way and space would not be available in their business location until April 2001. Aker segregated the PCs in its warehouse and labeled them as sold. Revenue was recognized in December 2000. The buyer had not entered into a written sales agreement in the past, but had taken delivery and subsequently paid upon the shipment and receipt of the PCs. Staples argued that revenue had not been earned and should not be recognized. French argued strenuously that--based on past practice--the sale was essentially complete.

### **Airfare Discounts**

When PC sales started lagging in late 1996 and 1997, Sue Liker, vice-president of marketing, had an idea. Sue had joined Aker from an e-commerce venture that had been successful in creating new types of sales. Sue went on to create an Aker division called AirDiscount.com, which would create online sales with a minimum cost. AirDiscount.com, the seller, booked airfares for customers at a discounted rate. Customers contacted AirDiscount online with a request for travel by air to a specified



location. AirDiscount searched for the lowest fare and offered it to the customer at a price slightly above AirDiscount's cost. If the customer accepted, AirDiscount completed the sale. In 1998 and 1999 this division was successful and generated over \$200 million in total revenues. Direct costs in those two years were about \$190 million. In 2000, the division revenues decreased to \$50 million while costs totaled about \$70 million.

AirDiscount.com recognized the amount of the sale in revenues and the cost of the airfare to AirDiscount in cost of goods sold. It purchased the airline ticket from the airline before it resold it to the seller. The airline ticket was purchased only when the seller acknowledged it would buy the ticket. AirDiscount required a credit card number from the potential buyer before it searched for the airline ticket.

Ken Staples had proposed an adjustment reversing the revenues and related costs previously recognized in 1998 and 1999 (\$190 million in revenues) and the \$50 million revenues in 2000. Only the net amount of revenues and costs would then be shown on the financial statements. Randall French had vociferously protested this adjustment. Ken had said he would think about it. Randall had not heard from Ken so he assumed Ken had dropped his proposal for the adjustment.

### **The PAS Subsidiary**

Still on Wednesday, Randall called Pamela Martinez, the controller for PAS Software Corp., the subsidiary purchased in 1998. Randall told her about the coming meeting with the audit committee and asked for information on revenue recognized in 2000 on a PAS software installation contract with Crain Aviation Co. The revenue recognized during 2000 on this contract had totaled \$30 million. Randall had become very animated in the discussion. He was upset to learn only two days before the audit committee meeting that this amount of revenue was in question and he had not been informed.

Pam had definitely felt threatened by Randall's tone. Her discussion with Rick Tanner, audit manager at Barker and Staples, had involved some questions about software installation accounting issues, but Pam felt she had answered them adequately. The Crain Aviation contract, which had been signed early in 2000, was for \$50 million, with a completion date sometime in early 2002. After requesting information on the progress of the software installation from the PAS software engineers, Pam had been told by one engineer that he estimated 60% of the contract would be complete at the end of 2000, while another had estimated only 35% of the contract complete. When Pam asked about the difference, each had stood by his estimate. Costs incurred in the contract at year-end were about 40% of the total estimated costs while payment for about 20% of the contract had been received at the end of December 2000.

In conversations during the past year, Randall had often mentioned to Pam Aker's falling sales and the issue of developing a positive approach in finding ways to increase profits. As the year progressed, Pam had felt under a lot of pressure to show positive operating results from PAS. However, she felt very strongly that she not stooped to doing anything unethical.



### **A Final Resolution**

Michelle Sanders sat in her office at Main National Bank on Thursday pondering the circumstances at Aker Computer. As chief executive officer for a local bank in the city where Aker Computer was headquartered, Michelle felt a strong attachment to Aker. After Mark Aker learned of the audit committee meeting on Friday, he told Michelle that she as chair could make any recommendations to the board that she wished. Mark had also mentioned that the audit results would be released shortly. He was very concerned that the prices for Aker stock—which had fallen recently--would be further adversely affected if the return on sales for 2000 dropped below the already informally publicized 2%.

The auditors concerns left Michelle with an uneasy feeling. Were Aker revenues and net income fairly stated? She had carefully studied the issues surrounding the concerns raised by Barker and Staples. She was considered to be the most knowledgeable audit committee member in the areas of finance and accounting. In her further discussion of the issues with Randall French and Ken Staples, both were adamant that their views were correct. What was Michelle Sanders to do?

### ***Comments on “The Aker Computer Company”***

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*“Michelle, as chair of the audit committee, must keep in mind her fiduciary responsibilities to Aker shareholders.”*

Michelle Sanders has a very difficult job as chair of the audit committee of Aker Computer Company. She must attempt to provide an independent view of the numerous accounting issues surrounding this company. This will be particularly difficult due to the recent problems with Aker’s financial results, the declining stock price and pressure from company management to show good results. However, Michelle must keep in mind her fiduciary responsibilities to Aker shareholders and complete her task independently and fairly. Michelle should consider the following responses to the issues identified:

#### ***Sale of Personal Computers***

Aker’s negotiated terms of FOB shipping point would normally allow the company to record sales even if the goods had not reached the customer location by the accounting cut-off date. However, in this case, the customer had not yet signed the sales agreement accepting delivery of the product by the end of Aker’s accounting period. As a result, title had not passed to the customer and risk of loss remained with Aker. Therefore, the \$30 million sale recorded in December 1999 should be reversed and booked as part of year 2000 activity.



Similarly, the \$5.6 million sale recognized in December 2000 should be reversed based on the fact pattern described. The personal computers had not been shipped by the end of the accounting period and Aker did not have a signed sales agreement from the customer. Therefore, the company had no basis to record the corresponding revenue in 2000.

### ***Airfare Discounts***

Aker's revenues for the AirDiscount.com business unit should be reported net in accordance with Emerging Issues Task Force Issue 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*. The strongest indicator that these results should be net is the fact that the airline is the primary obligor from the customer's perspective. In other words, the customer will make the ultimate decision whether to select a particular airline or flight, not AirDiscount.com. As a result, Ken Staples' position is correct: The adjustment to revenues and costs should be accepted, with only the net amount of revenues and costs presented.

### ***PAS Subsidiary***

Given the recent volatility surrounding PAS operations, Aker had taken a very aggressive accounting position by recognizing \$30 million (60%) of the total contract revenue. Michelle Sanders should consider recommending a completed-contract method of accounting for the Crain Aviation Company software development contract. Under this accounting method, income is recognized only when the contract has been substantially completed. Costs incurred during the life of the contract are capitalized as an asset until an actual billing is made to the customer. The asset remaining on the books represents total costs incurred to date, less amounts that have been billed. Given the variability of different contractor's estimates regarding the stage of contract completion, this is a more conservative and desirable way to account for the revenues.

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*“Michelle should read the SEC’s Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements, for guidance.”*

This case presents three issues that current financial executives may face that affect the quality of earnings reported to the public. Each example deals with potential problems involving revenue recognition methods.

The first issue is when to recognize revenue on the sale of personal computers. The main question in this example is whether a written sales agreement, signed by both the seller and buyer, is necessary for the sale to be complete. Aker's chief financial officer relied on the fact that this practice had been used in prior years without objection from the independent auditors. It would seem that consistency is one of main elements in revenue recognition. However, Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, says that it presumes that contractual customer acceptance



provisions are substantive and, therefore, revenue should not be recognized until customer acceptance occurs. Customer sign-off is the best evidence of customer acceptance. Accordingly, Aker's practice of recognizing revenue before the sales agreement is signed by both parties may be considered aggressive and, therefore, may not add to the quality of earnings.

The second issue involves reselling airline tickets through an Internet company that is an Aker subsidiary. As more companies establish themselves on the Internet, more potential financial reporting problems related to the quality of earning seem to appear. The main issue is whether to recognize revenue in the gross amount of revenue billed to the customer (and the cost of the ticket purchased by the subsidiary) or simply to record the net amount (the amount of revenue billed to the customer minus the cost of the ticket purchased by the subsidiary). One might wonder what difference it makes since both methods would result in the same gross profit. However, some investors have begun to value companies, especially dot-coms, based on a multiple of revenues rather than a multiple of gross profit or earnings. Accordingly, the difference in recognizing revenue may be very important in investors' perceived valuation of a company. EITF 99-19, *Recording Revenue Gross as a Principal versus Net as an Agent*, discusses whether a company should recognize the revenue as gross or net. Financial executives should use their professional judgment, based on several factors or indicators, in each case in determining whether revenues should be reported at gross or net.

The final example deals with how much revenue to recognize during 2000 on a software installation contract that will not be completed until 2002. During 2000 the controller of the subsidiary had recognized 60% of the contract price as revenue, based on one engineer's estimate of completion. However, another engineer estimated that the completion was only 35%. Costs related to project were about 40% of total estimated costs while payments for about 20% of the contract have been received. In this example, the subsidiary's controller has chosen to use the estimate that allows for realization of the highest amount of revenue because she felt great pressure to show positive operating results for the subsidiary. This appears to be somewhat aggressive, adding to the erosion in the quality of earnings. Based on Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*, it would seem to be more appropriate to recognize revenue not exceeding 40% of the contract. In this case, it appears that the controller may be able to choose between 40% (the amount of the cost incurred), 35% (the amount estimated by one engineer), or 20% (if future receipts are questionable) of the contract price.