

CASE STUDY: PROVEN PROCESSES ENABLE RAPID, EFFECTIVE AIDING AND ABETTING ANALYSIS

Overview

Our client is a large, publicly traded technology company that develops sophisticated customer relationship management (CRM) and process automation solutions. The company provides strategic tools and applications to many multimillion-dollar, complex organizations.

Background

The software our client develops is typically obtained by customers through multiple-year license agreements. In accordance with accounting rules, customers often seek to classify licensing, development, implementation and other upfront payments made to develop software as capitalized fixed assets (rather than expensing the payments at the time they are made). In so doing, they achieve an accounting outcome that spreads the expense associated with the software over the time period the software will be used.

Prior to executing licensing contracts, our client occasionally accommodated customer requests to modify certain standard licensing contract terminology, including changes to language used to define and describe services provided in conjunction with license agreements.

After becoming aware of these terminology changes within a number of customer contracts, our client's external auditor raised concerns to the audit committee that this activity potentially violated Securities and Exchange Commission (SEC) rules, including those prohibiting companies from aiding and abetting clients to achieve preferential accounting treatment.

The auditors believed that some standard terms in the company's agreements were modified, creating potentially ambiguous definitions of services, especially with regard to warranties and maintenance. Specifically, the external auditors expressed concern that the company may have:

1. Disguised services delivered to customers in an effort to assist customers achieve desired accounting outcomes (the capitalizing of assets which could ordinarily not qualify for such treatment under Generally Accepted Accounting Principles)

2. Misreported its financial statements by recognizing revenue on the sale of services that contained uncertain value and could not be measured with available vendor-specific objective evidence (VSOE)

Further complicating matters, the client had a filing deadline approaching in only a few weeks; the company needed to quickly find a financial investigation resource. That resource would have to understand its accounting model and be able to rapidly evaluate historical accounting entries and determine whether the company faced significant securities law and accounting violations.

RSM's technical accounting consulting team was already involved with the client, assisting with the transition to new revenue recognition guidelines (Accounting Standards Codification 606, Revenue from Contracts with Customers). Advisors worked through records on a customer-by-customer basis to determine how to apply those new revenue rules and whether the company needed to accelerate or delay the recognition of revenue. RSM therefore had an intimate familiarity with the client and an understanding of customers, clients and revenue recognition models.

The external auditor suggested leveraging RSM for the financial investigation, given the existing knowledge and the accelerated timeline needed to achieve results. The company's external counsel retained RSM's financial investigations team, comprised of experienced technical advisors in the adoption and implementation of complex accounting standards to investigate auditor aiding and abetting and accounting concerns.

Project

RSM, working at the direction of external counsel, followed the general approach developed by the SEC and courts to investigate aiding and abetting concerns. Specifically, our fact-finding investigation included:

- Interviews with key personnel and review of relevant company emails
- Collection and analysis of relevant documentation supporting scope of transactions
- Evaluation and comparison of contracts, licensing agreement terms and other relevant information with the organization's accounting workbook, revenue write-up summary and resulting proposed accounting entries
- Evaluation of evidence of the existence of undelivered, nonstandard elements not identified and accounted for by the company

The RSM team developed a strategy to evaluate a tremendous amount of data in a compressed timeline due to the impending filing deadline. Forensic accountants analyzed desk files, laptops, server files and anything that might be relevant to determine what employees knew, who was responsible for changing contract terms and what the level of discussion was with customers.

Given the significant amount of company data within the scope of the investigation—including millions of emails—RSM leveraged advanced investigative techniques, and teamed with external counsel and experienced third-party e-discovery

professionals. The combined team understood the industry and the company's operations and brought significant additional technical experience into the probe. These elements enabled an efficient and comprehensive investigation.

In addition, to avoid triggering potential concern from customers, RSM posed as a part of the external audit team and distributed notifications to customers to collect key information. These questionnaires were designed to determine what customers thought they were entitled to, based on the vague contract terms.

Ultimately, the RSM investigation assessed the level of transparency within the transactions and the company's ability to offset any concerns of aiding and abetting. After developing a complete picture with information from contracts, invoices, emails and other business documents, the investigative team sought to determine whether customers had sufficient knowledge of what they were receiving in terms of warranties and maintenance.

With a well-integrated team of accountants, lawyers and digital forensics professionals, we conducted a thorough investigation quickly and presented our findings to the client and its auditors. Our reporting included a presentation of all relevant evidence, which was used to determine whether aiding and abetting violations occurred, a summary of internal control remediation recommendations, and a detailed description of events to be considered by our client when evaluating potential disciplinary actions.

Outcomes

Due to rapid investigation planning and execution, we were able to complete a complex financial investigation in a very condensed time period. The utilization of technology in document review was a key to success, allowing us to leverage machine learning, e-discovery, video conferencing and other enhanced technology tools. As a result, the company completed its year-end audit and filed its financial statements, avoiding unnecessary adverse disclosures and the negative impact of delayed filings.

We developed recommendations for the company's consideration to enhance internal controls related to the sales cycle (contracting, legal, finance review and billing), including:

- Establishment of a policy prohibiting undefined material terms in contracts
- Establishment of a process for increased scrutiny of nonstandard terms in contracts, including requirement of finance and legal review and testing by internal audit
- Establishment of a contract management system to ensure that all relevant documents for a given contract are retained and easily accessible
- Incorporation of the above themes in employee training and educating employees on contract accounting from the customers' perspective

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