**JCOM: WHEN WILL THE SEC CALL AN ERROR AN ERROR?**

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The business enterprise j2 Global Communications (JCOM) in [its first quarter 2011 filing](http://www.sec.gov/Archives/edgar/data/1084048/000107261311000453/form10q_17103.htm) made an accounting change and called it a change in estimate. As several observers have noted, what the Company called a change in *estimate* is really an accounting *error*. What we would like to know is when will the SEC take JCOM’s managers to the woodshed and call an error an error.

[Gradient Analytics](http://www.gradientanalytics.com/) may have been the first to report this anomaly. In its November 21, 2011 report, it gave JCOM an earnings quality grade of “F” (boy, were they grumpy or what?). In part, this failing grade was due to the Company’s mislabeling an error as a change in estimate. Basically, JCOM through transparency right out the window.

Sam Antar pointed out this discrepancy in his [blog “White Collar Fraud.”](http://whitecollarfraud.blogspot.com/2011/11/should-j2-global-communications-restate.html) Tracy Coenen likewise raised questions about this sleight of hand in her post [“[JCOM] …Trying to Hide Accounting Errors.”](http://www.sequenceinc.com/fraudfiles/2011/11/j2-global-communications-trying-to-hide-accounting-errors/) Both of them referred to the research by Gradient Analytics, and both of them agreed that this change was an accounting error.

Here are the details. In footnote 1 of the 10-Q (Q1 2011), JCOM writes:

“In the first quarter of 2011, the Company made a change in estimate regarding the remaining service obligations to its annual eFax® subscribers.  As a result of system upgrades, the Company is now basing the estimate on the actual remaining service obligations to these customers.  As a result of this change, the Company recorded a one-time, non-cash increase to deferred revenues of $10.3 million with an equal offset to revenues.  This change in estimate reduced net income by approximately $7.6 million, net of tax, and reduced basic and diluted earnings per share for the three months ended March 31, 2011 by $0.17 and $0.16, respectively.”

This description is baffling. Estimates are for unobservables, generally items that are future-oriented. For example, depreciation requires an estimate of the remaining life of the asset and an estimate of its salvage value at some unknown future date. As time goes by, managers may be in a better position to assess these unknowns, and any revisions will be changes in estimates. Similar statements can be made about depletion, amortization, bad debts, sales returns, and a variety of items. In every case, the estimates are for future items, be they the asset’s life, the amount of future cash collections from customers, the amount of future returns, etc.

It seems natural to base revenue estimates on the “actual remaining service obligations to these customers,” after all, the last time we checked, revenue has to be earned. So, what was JCOM basing it on beforehand?

Of course, it is possible that the previous accounting information system was inadequate for the job. In that case, the auditor SingerLewak LLP should not have blessed the internal control system in the 10-K. An accounting information system that cannot produce accurate data for such a basic process does not deserve an unqualified opinion. Such a system is pathetic.

The SEC sent a letter to JCOM on December 19, 2011. The SEC asked managers to explain why the actual remaining service obligations were not previously known. [The firm responded on January 3, 2012](http://www.sec.gov/Archives/edgar/data/1084048/000107261312000002/filename1.htm) (*intertwined with our thoughts*):

The actual remaining service obligations were not previously known because of inherent limitations in the company’s billing systems.  {*If so, does SAB 101 permit the revenue to be recognized?*} j2 began selling annual eFax® subscriptions early in its existence when it was a very small company with billing and collection systems less complete and integrated than those employed by j2 today.  Importantly, for the purpose of responding to your inquiry, the billing system was completely separate from the collection system and the two systems did not interact in a way that would permit the company to precisely calculate deferred revenue amounts with respect to specific customers. {*Does this imply the balance sheets were inaccurate?*} …

However, until completion of significant system upgrades in Q1 2011, the company could not match the deferred revenue amount associated with a given customer at the time of early cancelation or conversion to a monthly account to that customer.  As a result, the company was required under its revenue recognition policy to develop an estimation processes to calculate future service obligations.  This estimation process, which was performed annually, relied on historical cancellation patterns of annual customers. {*If they could not be tracked to customers, how does the investor know the reliability of this estimation procedure?*}

The estimation process consisted of identifying annual subscribers that cancelled their service during the preceding calendar year and determining how long each of them maintained their active subscription.  This provided an average remaining service obligation which the company then applied to all future annual signups throughout the year.  This cancellation data was the best source of information for j2’s estimation process at the time and the company believes it was very accurate. {*based on what evidence?*}

This estimation process was in place since the company’s inception.  However, j2 has grown significantly over the past 15 years in revenues, service offerings and customer base.  Today, j2 has more than two million paying customers and numerous different service offerings.  In response to the growing complexity of its business, the company has invested significant time and money to enhance its systems and fully integrate its billing and collection processes.  This development work was completed in Q1 2011, enabling j2 to move beyond its old estimation process and precisely determine its future service obligation to annual subscribers. {*Sounds like the internal control system is now working but has been deficient over the past several years.}*

The SEC responded with a wishy-washy [letter on January 6](http://www.sec.gov/Archives/edgar/data/1084048/000000000012000967/filename1.pdf). Months have passed, but the SEC seems to be doing nothing. We find JCOM’s explanation baffling at best, perhaps deceptive, and expect that the SEC would require restatement of previously issued reports. After all, ***ASC 250 clearly specifies that, when correcting an error in prior period financial statements, the term “restatement” is to be used.*** This assumes, of course, that the internal control system would enable one to measure revenue accurately. Also, the SEC should consider sharing this case with the PCAOB, as JCOM’s auditor needs to be held accountable as well.

The SEC is getting soft in its old age. We suggest that it get grumpy instead.

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*