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Revenue Recognition

Rules and Scenarios

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Wiley Bicentennial Logo: Richard J. Pacifico
Published by John Wiley & Sons, Inc., Hoboken, New Jersey
Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data:

Bragg, Steven M.
Revenue recognition / Steven M. Bragg.
p. cm.
ISBN: 978-0-471-78812-6 (cloth)
1. Revenue—Accounting. I. Title.
HF5681.R5B73 2007
657'.72—dc22 2006037554

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

To the former shareholders of Enron, for whom revenue recognition was no laughing matter.

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PREFACE

Revenue recognition is of critical importance to anyone in the business world, since it drives a large part of the perception of a company's value, which is reflected in its stock price. This in turn impacts the returns of investors and any earnings of employees that are tied to stock options. Given these pressures, it should be no surprise that the outer boundaries of revenue recognition rules are constantly being explored by company managers, which has led to the bulk of all cases of financial fraud.

Revenue Recognition not only provides a detailed view of the current accounting rules and regulations pertaining to revenue recognition, but also describes the exact sources of this information, how a company's treatment of revenue recognition is to be disclosed alongside the financial statements, and what policies, procedures, and controls can be used to enforce it in a consistent manner.

Revenue recognition rules vary not only by type of transaction, but also for some industries. Accordingly, the chapters of this book are clustered into transaction-related revenue recognition rules, and then into industry-related revenue recognition rules. Chapters 1 through 4 cover revenue recognition for transactions, including general principles, when collection is uncertain, when there is a right of return, and when there are multiple deliverables. Chapters 5 through 12 then address revenue recognition for the following industries:

- Franchising
- Construction
- Motion pictures
- Not-for-profits
- Real estate
- Recording and music
- Services
- Software

Chapter 13 addresses a variety of miscellaneous topics too small for separate chapters, such as loan guarantee fees, sales with guaranteed resale values, advertising barter transactions, sales incentive plans, and so on. Finally, Chapter 14 summarizes the status of a project to codify the bulk of all revenue recognition rules into a single standard.

This book is intended to be a source book for *all* aspects of revenue recognition—how to account for it, report it, and set up systems and controls to ensure that the rules are properly followed. Hopefully, *Revenue Recognition* will assist you in consistently recognizing revenue in the correct amounts, at the right time, and in accordance with generally accepted accounting principles.

Steven M. Bragg
Centennial, Colorado
November 2006

ABOUT THE AUTHOR

Steven Bragg, CPA, CMA, CIA, CPIM, has been the chief financial officer or controller of four companies, as well as a consulting manager at Ernst & Young and auditor at Deloitte & Touche. He received a master's degree in finance from Bentley College, an MBA from Babson College, and a bachelor's degree in economics from the University of Maine. He has been the two-time president of the Colorado Mountain Club, and is an avid Alpine skier, mountain biker, and certified master diver. Mr. Bragg resides in Centennial, Colorado. He has written the following books through John Wiley & Sons:

Accounting and Finance for Your Small Business
Accounting Best Practices
Accounting Control Best Practices
Accounting Reference Desktop
Billing and Collections Best Practices
Business Ratios and Formulas
Controller's Guide to Costing
Controller's Guide to Planning and Controlling Operations
Controller's Guide: Roles and Responsibilities for the New Controller
Controllership
Cost Accounting
Design and Maintenance of Accounting Manuals
Essentials of Payroll
Fast Close
Financial Analysis
GAAP Guide
GAAP Implementation Guide
Inventory Accounting
Inventory Best Practices
Just-in-Time Accounting
Managing Explosive Corporate Growth
Outsourcing
Payroll Accounting
Payroll Best Practices
Revenue Recognition
Sales and Operations for Your Small Business
The Controller's Function
The New CFO Financial Leadership Manual
The Ultimate Accountants' Reference
Throughput Accounting

Also:

Advanced Accounting Systems (Institute of Internal Auditors)
Run the Rockies (CMC Press)

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1 REVENUE RECOGNITION GENERAL PRINCIPLES AND SYSTEMS

OVERVIEW OF REVENUE RECOGNITION

The principles guiding recognition of revenues for financial reporting purposes are central to generally accepted accounting principles (GAAP) and in most instances are unambiguous and straightforward. In fact, the underlying principles have not changed in decades. However, as business transactions have become more complicated over time, GAAP has been expanded in a piecemeal fashion by different standard-setting entities to include detailed rules for certain types of revenue recognition issues. There are now more than 140 pieces of authoritative literature dealing with various aspects of revenue recognition. This book summarizes these issues by topic and industry, covering such industries as motion pictures, software development, franchising, and real estate, while also addressing such cross-industry topics as situations when there is a right of return, or if collection is uncertain.

Each chapter begins with an itemization of the source GAAP documents that are referenced later in the chapter. If only a few paragraphs within a source document are referenced, then those specific paragraph numbers are itemized. The chapters then continue with an overview of the topic, definitions of key terms, and a discussion of the key revenue recognition issues. If GAAP mandates or recommends disclosure of revenue recognition information alongside the financial statements, then these disclosures are also noted, along with examples. Finally, a number of policies, procedures, and controls are covered that can support the systems needed to accumulate and report revenue transactions. These supporting systems are quite necessary, in light of the fraudulent reporting problems that are discussed later in this chapter.

REVENUE RECOGNITION GENERAL GUIDELINES

Revenue, whether from the sale of product or provision of services, is to be recognized only when it has been earned. According to the Statement of Financial Accounting Concepts No. 5 (CON 5), *Recognition and Measurement in Financial Statements of Business Enterprises,*

> *…(a)n entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.*

In other words, in order to be recognized, revenue must be realized or realizable, and it must have been earned.

CON 5 notes that "the two conditions (being realized or realizable, and being earned) are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities and gains and losses from sales of other assets are commonly recognized at the time of sale (usually meaning delivery)." Moreover, "if services are rendered or rights to use assets extend continuously over time (for example, interest or rent), reliable measures based on contractual prices established in advance are commonly available, and revenues may be recognized as earned as time passes." In other words, for most traditional and familiar types of transactions, the point at which it is appropriate to recognize revenue will be quite clear.

The Securities and Exchange Commission (SEC), reflecting on the conceptual foundation for revenue recognition, observed in Staff Accounting Bulletin 101 (SAB 101), and its replacement, SAB 104, that

> *Revenue generally is realized or realizable and earned when* ***all*** *of the following criteria are met:*
>
> 1. *There is persuasive evidence that an arrangement exists,*
> 2. *Delivery has occurred or services have been rendered,*
> 3. *The seller's price to the buyer is fixed or determinable, and*
> 4. *Collectibility is reasonably assured.*

Note that, while SEC rules and "unofficial" guidance are not necessarily to be deemed GAAP for nonpublic companies, to the extent that these provide insights into GAAP standards, they should always be viewed as relevant guidance and followed, absent other, contradictory rules established under GAAP. In the absence of any other source found in the GAAP rules, SEC pronouncements may represent the best thinking on the subject and are considered authoritative for all reporting entities.

With regard to the four criteria set forth above, consideration should be directed at the following discussion, which is drawn partially from SAB 101 and SAB 104.

First, regarding persuasive evidence of an arrangement, attention must be paid to the customary manner in which the reporting entity engages in revenue-producing transactions with its customers or clients. Since these transactions are negotiated between the buyer and seller and can have unique or unusual terms, there are (and can be) no absolute standards. Thus, for an enterprise that traditionally obtains appropriate documentation (purchase orders, etc.) from its customers before concluding sales to them, advance deliveries to customers, even if later ratified by receipt of the proper paperwork, would not be deemed a valid basis for revenue recognition at the time of delivery.

When evaluating purported revenue transactions, the substance of the transactions must always be considered, and not merely their form. It has become increasingly commonplace to "paper over" transactions in ways that can create the basis for inappropriate revenue recognition. For example, transactions that are actually consignment arrangements might be described as "sales" or as "conditional sales," but revenue recognition would not be appropriate until the consigned goods are later sold to a third-party purchaser.

Careful analysis of the rights and obligations of the parties and the risks borne by each at various stages of the transactions should reveal when and whether an actual sale has occurred and whether revenue recognition is warranted. In general, if the buyer has a right to return the product in question, coupled with a deferred or conditional payment obligation and/or significant remaining performance obligations by the seller, revenue will not be recognizable by the seller at the time of initial delivery. Similarly, if there is an implicit or explicit obligation by the seller to repurchase the item transferred, a real sales transaction has not occurred. The buyer must assume the risks of ownership in all cases if revenue is to be recognized.

With regard to whether delivery has occurred or services have been rendered, ownership and risk taking must have been transferred to the buyer if revenue is to be recognized by the seller. Thus, if the seller is holding goods for delivery to the buyer because the buyer's receiving dock workers are on strike and no deliveries are being accepted, revenue generally cannot be recognized in the reporting period, even if these delayed deliveries are made subsequent to period-end. (There are limited exceptions to this general principle, typically involving a written request from the buyer for delayed delivery under a "bill-and-hold" arrangement, having a valid business purpose.)

Delivery, as used here, implies more than simply the physical relocation of the goods to the buyer's place of business. Rather, it means that the goods have actually been accepted by the customer which, depending on the terms of the relevant contract, could be conditioned on whether inspection, testing, and/or installation have been completed, and the buyer has committed to pay for the items purchased. For revenue recognition to be justified, substantial performance of the terms of delivery must have occurred, and if any terms remain uncompleted, there should be a basis grounded on historical experience to assume that these matters will be satisfactorily attended to.

In some instances there are multiple "deliverables"; in such cases, revenue is not recognized for any given element if later deliverables are essential for the functionality of the already delivered element. In other situations, such as in various licensing arrangements, physical "delivery" may occur well before product usage by the buyer can take place (e.g., software for the future year's tax preparation delivered before the current year-end), and revenue is not to be recognized prior to the initial date of expected use by the buyer.

In the case of many service transactions, large up-front fees are often charged, nominally in recognition of the selling of a membership, the signing of a contract, or for enrolling the customer in a program. (An example is initiation fees to join a health club where the terms of membership also obligate the member to pay ongoing fees.) Unless the services provided to the customer at inception are substantial, the presumption is that the revenue received has not been earned, but rather must be deferred and recognized, usually ratably, over the period that substantive services are provided. Thus, initiation fees are amortized over the membership period.

The seller's price to the buyer is fixed or determinable when a customer does not have the unilateral right to terminate or cancel the contract and receive a cash refund. Depending on customary practice, extended return privileges might imply that this condition has not been met in given circumstances. Prices that are conditional on the occurrence of future events are not fixed or determinable from the perspective of revenue recognition.

In theory, until the refund rights have expired, or the specified future events have occurred, revenue should not be recognized. As a practical matter, however, assuming that the amount of refunds can be reliably estimated (based on past experience, industry data, etc.), revenues, net of expected refunds, can be recognized on a pro rata basis. Absent this ability to reliably estimate, however, revenue recognition is deferred.

The final factor, reasonable assurance of collectibility, implies that the accrual for bad debts (uncollectible accounts receivable) can be estimated with reasonable accuracy, both to accomplish proper periodic matching of revenue and expenses and to enable the presentation of receivables at net realizable value, as required under GAAP. An inability to accomplish this objective necessitates deferral of revenue recognition—generally until collection occurs, or at least until it becomes feasible to estimate the uncollectible portion with sufficient accuracy.

An extreme situation, calling for not merely accrual of losses from estimated uncollectible receivables, is to defer revenue recognition entirely until collectibility is assured (or actually achieved). The most conservative accounting alternative, first set forth in Accounting Research Bulletin No. 43 (ARB 43) and then again cited in CON 5, is to record revenue only as collected. It states "(i)f collectibility of assets received for product, services, or other assets is doubtful, revenues and gains *may* be recognized on the basis of cash received" (emphasis added). The permissive language, which (it must be assumed) was deliberately selected in preference to a mandatory exhortation (e.g., "must"), suggests that even in such a situation, this hyperconservative departure from accrual accounting is not truly prescriptive but is a possible solution to a fact-specific set of circumstances.

REVENUE RECOGNITION FRAUD

Though the basic principles of revenue recognition are uncomplicated, it is nonetheless true that a large fraction of financial reporting frauds over the period beginning about 1995 were the result of misapplications, often deliberate, of revenue recognition practices prescribed under GAAP. Apart from outright fraud (e.g., recording nonexistent transactions), there were several factors contributing to this unfortunate state of affairs.

First, business practices have continued to grow increasingly complex, involving, among other things, a marked shift from manufacturing to a services-based economy, where the proper timing for revenue recognition is often more difficult to ascertain. Second, there has been an undeniable increase in the willingness of managers, whose compensation packages are often directly linked to the company's stock price and reported earnings, to "stretch" accounting rules to facilitate earnings management. This has particularly been the case where GAAP requirements have been vague, complex, or abstruse. And third, it has been well documented that independent auditors have sometimes been willing to accommodate managements' wishes, particularly in the absence of specific rules under GAAP to support a denial of such requests. These actions have often had disastrous consequences.

Errors or deliberate distortions involving revenue recognition fall into two categories: situations in which revenue legitimately earned is reported in the incorrect fiscal (financial reporting) period, often referred to as "cutoff" errors, and situations in which revenue is recognized although never actually earned. Given the emphasis on periodic reporting (e.g., quarterly earnings announcements in the case of publicly held entities), even simple "cutoff" errors can have enormous impact, notwithstanding the fact that these should tend to offset over several periods. As a practical matter, all instances of improper revenue recognition are very serious, and these constitute a challenge to all accountants attempting to properly interpret and apply GAAP, including independent auditors.

EVOLVING PROBLEMS IN REVENUE RECOGNITION

Certain problems currently found in the application of the general principles of revenue recognition, which can sometimes lead to fraudulent reporting, are discussed in the following paragraphs.

Financial Statement Presentation: Gross vs. Net

In general, it is well established that reporting on a "gross" basis is appropriate when the entity takes ownership of the goods being sold to its customers, with the risks and rewards of ownership accruing to it. For example, if the entity runs the risk of obsolescence or spoilage during the period it holds the merchandise, gross reporting would normally be appropriate. However, if the entity merely acts as an agent for the buyer or seller from whom it earns a commission, then "net" reporting would be more appropriate.

In recent years there have been increasing reports of enterprises that inflate revenues reported in their income statements by reporting transactions on a "gross" basis, notwithstanding that the entity's real economic role is as an agent for buyer and/or seller. This distortion became widespread in the case of Internet companies and other start-up and innovative businesses typically not reporting earnings, for which market valuations were heavily influenced by absolute levels of and trends in gross revenues. Reporting revenues "gross" rather than "net" often had an enormous impact on the perceived value of those enterprises.

The Emerging Issues Task Force (EITF) Consensus No. 99-19 provides guidance on whether an entity is an agent for a vendor-manufacturer, and thus recognizes the net retainage (commission) for serving in that capacity, or whether that entity is a seller of goods (i.e., acting as a principal), and thus should recognize revenue for the gross amount billed to a customer and an expense for the amount paid to the vendor-manufacturer.

The EITF identifies the following factors to be considered when determining whether revenue is to be reported as the net retainage (hereinafter, "net") or the gross amount billed to a customer ("gross"). None of the indicators are presumptive or determinative, although the relative strength of each indicator is to be considered.

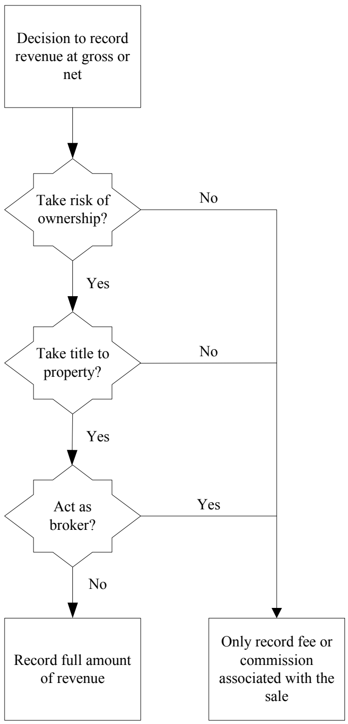
- Is the company the primary obligor in the arrangement; that is, is the company responsible for the fulfillment of the order, including the acceptability of the product or service to the customer? If the company, rather than a supplier, is responsible, that fact is a strong indicator that the company records revenue gross. Responsibility for arranging transportation for the product is not responsibility for fulfillment. If a supplier is responsible for fulfillment, including the acceptability to the customer, that fact indicates that the company recognizes only the net retainage.
- Does the company have general inventory risk? General inventory risk exists if a company takes title to a product before the product is ordered by a customer or will take title to the product if the customer returns it (provided that the customer has a right of return). In considering this indicator, arrangements with a supplier that reduce or mitigate the company's risk level are to be considered. Unmitigated general inventory risk is a strong indicator that the company recognizes revenue gross.
- Does the company have physical loss inventory risk? Physical loss inventory risk exists if the title to the product is transferred to the company at the shipping point and then transferred to the customer upon delivery. Physical loss inventory risk also exists if a company takes title to the product after the order is received but before the product is transferred to the shipper. While less persuasive than general inventory risk, this indicator provides some evidence that a company records revenue gross.
- Does the company establish the selling price? If a company establishes the selling price, that fact may indicate that the company recognizes revenue gross.
- Is the amount earned by the company fixed? If a company earns a fixed amount per transaction or if it earns a percentage of the selling price, that fact may indicate that the company reports revenue net.
- Does the company change the product or perform part of the service? If a company changes the product (beyond packaging) or performs part of the service ordered by the customer such that the selling price is greater as a result of the company's efforts, that fact is indicative that a company recognizes revenue gross. Marketing skills, market coverage, distribution system, and reputation are not to be evaluated

in determining whether the company changes the product or performs part of the service.

- Does the company have multiple suppliers for the product or service ordered by the customer? If a company has the discretion to select the supplier, that fact may indicate that the company records revenue gross.
- Is the company involved in determining the nature, type, characteristics, or specifications of the product or service by the customer? If so, that fact may indicate that the company records revenue gross.
- Does the company have credit risk for the amount billed to the customer? Credit risk exists if a company must pay the supplier after the supplier performs, regardless of whether the customer has paid. If the company has credit risk, this fact provides weak evidence that the company records revenue gross. If the supplier assumes the credit risk, the company is to record revenue net.

The decision tree in Exhibit 1.1 shows the criteria that a company must pass before it can record revenue at the gross amount. All the criteria must be satisfied; otherwise, only the commission or broker fee associated with the sale can be recorded as revenue.

Exhibit 1.1: Decision tree for recording revenue at gross or net



Barter Transactions

Barter transactions (nonmonetary exchanges, as described in Accounting Principles Board Opinion No. 29) are not a problem, assuming that they represent the culmination of an earnings process. However, in recent years there have been many reports of transactions that appear to have been concocted merely to create the illusion of revenue-generating activities. Examples include advertising swaps engaged in by some entities, most commonly "dot-com" enterprises, and the excess capacity swaps of fiber-optic communications concerns under "indefeasible right to use" agreements. Both these and many other situations involved immediate recognition of revenues coupled with deferred recognition of costs, and typically, in aggregate, were equal exchanges not providing profits to either party. Furthermore, these examples do not represent culminations of the normal earnings process (e.g., fiber-optic networks were built in order to sell communications services to end users, not for the purpose of swapping capacity with other similar operations).

In hindsight, most observers can see why these and many other aggressive reporting practices deviated from established or implied GAAP; although there are still some who insist that because GAAP failed to explicitly address these precise scenarios, the accounting for the transactions was open to interpretation. Since GAAP (even the highly rules-based U.S. GAAP) cannot possibly hope to overtly address all the various innovative transaction structures that exist and will be invented, it is necessary to apply basic principles and reason by analogy to newly emerging circumstances. Of great importance to financial statement preparers (and internal and external auditors) are obtaining a thorough understanding of the nature and normal operations of the business enterprise being reported upon, application of "substance over form" reasoning, and the goal of faithfully representing the economics of transactions.

Channel Stuffing

Many difficult issues of revenue recognition involve practices that may or may not involve GAAP departures, depending on the facts and circumstances. Channel stuffing is a prime example of this issue, where sales are actually made prior to the period-end cutoff but are stimulated by "side agreements," such as a promise to customers of extended return privileges or more liberal credit terms. In such circumstances, there might be a greater likelihood that a substantial portion of these sales may be subsequently nullified, as unrealistically large orders inevitably lead to later large returns made for full credit.