REVENUE RECOGNITION RED FLAGS: REVENUE AFTER CASH COLLECTION

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Revenue Recognition after Sale

- **Revenue is recognized when it is both:**
  - Earned (i.e. goods or services are provided) and
  - Realizable (i.e. price is fixed and collection is probable)
- **Revenue is sometimes recognized after cash collection ("noncash revenue")**
  - Company has "multiple deliverables"; i.e. deliver some goods or services now, with the remainder being delivered in the future
  - Company will have an Unearned or Deferred Revenue liability when it receives cash but does not recognize all Revenue at time of sale
- **Watch for aggressive deferral of revenues to future periods**
  - Company can smooth spike in current sales across future periods by creating more Unearned Revenue
- **Watch for aggressive recognition of unearned revenue in current period**
  - Company can smooth drop in current sales by recognizing more Unearned Revenue as earned Revenue in the period

Deferred or Unearned Revenue

- **At time of sale, receive $100 cash from customers and deliver software**
  - **Current software is only 70% of goods and services that customer is buying**
  - **Other 30% is for customer service and software updates delivered next year**

- **2015**
  - **New sales**
    - **Increase Cash** 100
    - **Increase Revenue** 70
    - **Increase Unearned Revenue liab.** 30

- **2016**
  - **New sales**
    - **Increase Cash** 110
    - **Increase Revenue** 77
    - **Increase Unearned Revenue liab.** 33
  - **Rest of revenue is earned from 2015**
    - **Reduce Unearned Revenue liab.** 30
    - **Increase Revenue** 30

- **2016 Total revenue = 77 + 30 = 107**
- **2016 Cash collections (bookings) = Revenue + Change in Unearned Revenue = 107 + (33 – 30) = 110**

YoY Growth in Unearned Revenues and Bookings

- **Noncash revenues could reflect revenue (and earnings) smoothing activities**
  - Noncash revenues are accompanied by changes in Unearned Revenue
- **YoY Growth in Unearned Revenue (UR)**
  - (UR end of this quarter – UR end of same quarter last year) / UR end of same quarter last year
- **YoY Growth in Bookings**
  - Bookings (Cash) = Revenue + Chg. in Unearned Revenue
  - (Bookings this quarter – Bookings same quarter last year) / Bookings same quarter last year
- **Benchmarks**
  - Time-series
  - Cross-sectional
  - YoY Revenue growth

Ratios

- **Days Unearned Revenue**
  - **Increase means slower future recognition of revenue; decrease means faster future recognition**
  - **Quarterly Days = (Average UR past 5 quarters / TT Revenue) * 365**
    - TT = Trailing Twelve months = sum of past four quarters
- **Unearned Revenue/Revenue**
  - **"Cookie jar" of future noncash revenue**
  - **UR/Revenue = Unearned Revenue / TT Revenue**
- **Bookings/Revenue**
  - **Relates cash collections (bookings) to revenue recognition**
  - **Bookings/Revenue = Bookings (cash) this period / Revenue this period**
    - Greater than 1 means growth in new business

DoggieSoft Case

- **DoggieSoft makes biometric tracking software for dogs along with wearable tracking devices**
  - **Recognizes 70% of revenue upon sale to reflect delivery of wearable device and software**
  - **Recognizes 30% of revenues in future years based on**
    - Providing access to customer service
    - Providing software patches and updates
- **Recent Performance**
  - **Steady 10% growth in revenue through 2013**
  - **Introduces new DS 4 tracking device in Q1 of 2014**
    - Sales growth jumps up to 14% in 2014
  - **Introduces new DS 4R tracking device in Q1 of 2015**
    - Sales of DS 4R are rumored to be "disappointing"
    - Releases new software update for DS 4 in Q1 of 2015
    - Sales growth remains steady at 14% in 2015