

REVENUE RECOGNITION RED FLAGS: REVENUE BEFORE CASH COLLECTION

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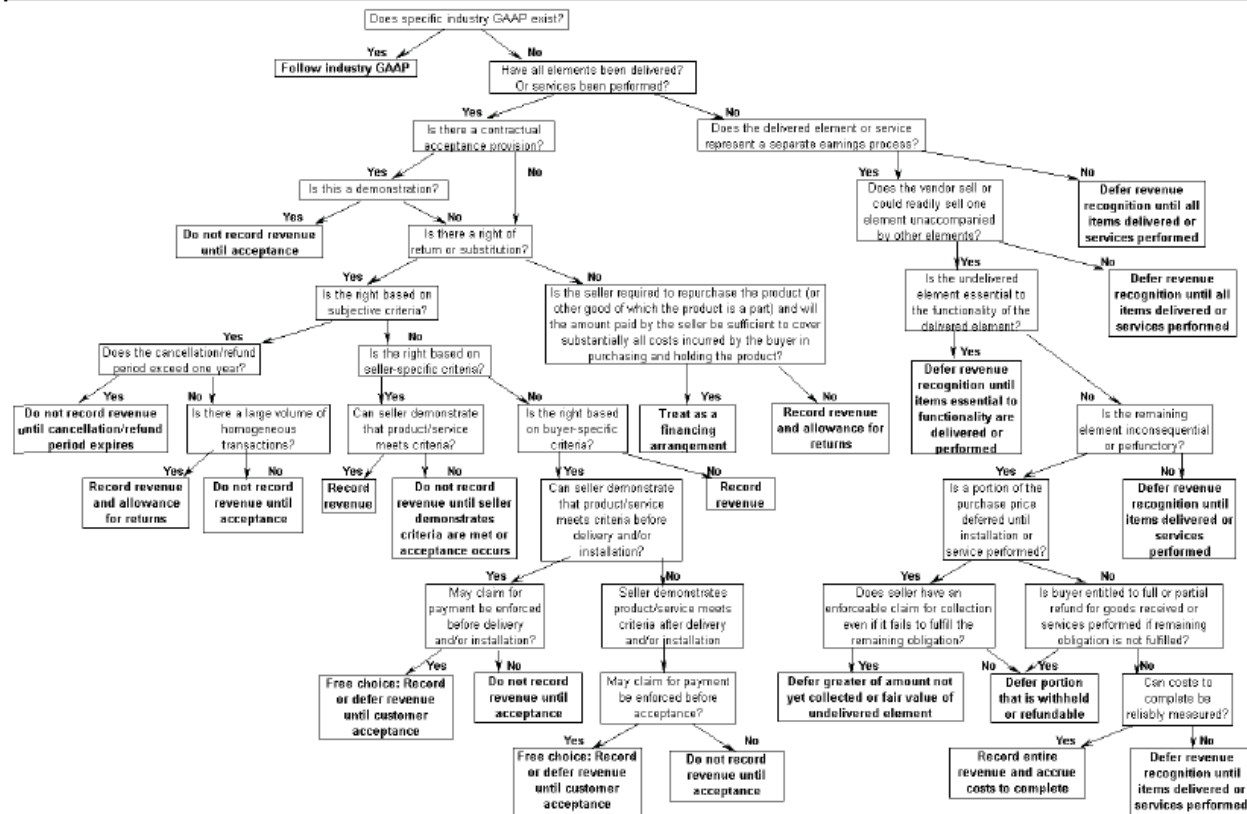


Revenue Recognition

- **Revenue is recognized when it is both:**
 - **Earned** (i.e. goods or services are provided) and
 - **Realizable** (i.e. price is fixed and collection of cash is probable)
- **Revenue can be recognized before cash collection (“noncash revenue”)**
 - **At delivery of goods or services, increase Revenue and Accounts Receivable**
 - **At time of cash collection, increase Cash reduce Accounts Receivable**
- **Watch for acceleration of revenue into current period**
 - **Recognize before full delivery**
 - **Provide right of return if not resold by customer**
- **50% of SEC enforcement actions are related to revenue recognition**

SAB 101: Simplified Flow Chart

SAB 101: Revenue Recognition Flow Chart



Source: Bear, Stearns & Co. Inc.

Revenue Recognition Red Flags

- **We will use red flags to identify potential changes in revenue recognition policies**
 - **Unusual seasonally-adjusted quarterly trends**
 - Growth in Revenue
 - Growth in Accounts Receivable
 - **Unusual trends in Ratios**
 - Days Receivable and Accounts Receivable/Revenue
 - Revenue per Capacity Unit
- **Then, we will try to find what happened**
 - **Do earnings management incentives exist?**
 - **Is there anything unusual in the Revenue Recognition policy?**

Year-over-year Revenue Growth Trends

- Growing firms tend to have revenue growth in all four quarters, whereas earnings management is more likely to happen in a specific quarter
- Most firms have some seasonality in revenue during year, so need to compare to same quarter the prior year
- YoY (Year over year) Revenue Growth
 - $(\text{Revenue this quarter} - \text{Revenue same quarter last year}) / \text{Revenue same quarter last year}$
- Benchmarks
 - Time-series: is growth unusual in one specific quarter for the firm?
 - Cross-sectional: is growth unusual for the industry in a given quarter?

Year-over-year Growth in Accounts Receivable

- **Noncash revenue is accompanied by changes in Accounts Receivable (AR)**
- **YoY Growth in AR**
 - $(\text{AR end of this quarter} - \text{AR end of same quarter last year}) / \text{AR end of same quarter last year}$
- **Benchmarks**
 - **Time-series:** is growth unusual in one specific quarter for the firm?
 - **Cross-sectional:** is growth unusual for the industry in a given quarter?
 - **Revenue:** how much of revenue growth is noncash?
 - Compare to growth in revenue and growth in cash collected
 - $\text{Cash Collected} = (\text{Revenue} + \text{Beginning AR}) - \text{Ending AR}$

Ratios

- **Days Receivable**
 - Large increase could indicate spike in noncash revenue at end of quarter
 - Annual Data $\Rightarrow (\text{Average AR} / \text{Annual Revenue}) * 365$
 - Quarterly Data $\Rightarrow (\text{Average AR past 5 quarters} / \text{TT Revenue}) * 365$
 - TT = Trailing Twelve months = sum of past four quarters
- **Accounts Receivable/Revenue**
 - Large increase could also indicate a spike in noncash revenue
 - $\text{AR/Revenue} = \text{AR} / \text{TT Revenue}$
- **Revenue per Capacity Unit**
 - Large increase could indicate fraudulent revenue that is beyond normal capacity of company to produce
 - $\text{Revenue per employee} = \text{TT Revenue} / \text{Number of employees}$
 - $\text{Revenue per PP\&E} = \text{TT Revenue} / \text{Gross PP\&E}$

Pawsome Electronics Case

- **Pawsome Electronics manufactures consumer products for dogs**
 - Microchip-enabled food bowls, electric toothbrushes, soothing-sound machines, electric blankets, aromatherapy vaporizers
- **Sell products to retail stores and to on-line retailers**
 - No direct sales to customers
- **Pawsome was struggling in 2012-3**
 - Hired a new CEO who was a turnaround expert
- **Changes in 2013-4**
 - Increased marketing budget
 - Implemented new “just-in-time” automatic retail delivery arrangements
 - Reduced product line to focus on “winners”
 - Closed 18 of 26 factories
 - Cut workforce from 12,000 to 7,500 employees

Pawsome Electronics Case

- **Pawsome has awesome turnaround in performance in 2014**
 - Revenues up 19%, Net income of \$123 million vs. net loss of \$196 million in 2013
 - Stock price has risen 59 percent
 - Eight security analysts have “buy” or “strong buy” recommendations
- **TV pundits are spreading rumors about the company**
 - Rumors that company is looking to acquire other companies
 - Rumors that CEO got a job offer from another company
- **Does Pawsome have any earnings management incentives?**
- **Are there any red flags in the ratios?**

Pawsome Conclusion

- **Pawsome's CEO engaged in a channel-stuffing scheme**
 - Manipulated automatic “just-in-time” system to deliver extra goods to retailers just before quarter end
 - Increased revenue, but all noncash
 - Retailers returned excess inventory to Pawsome
 - Returns happened in the next quarter
- **Pawsome used high stock price to acquire two other companies**
 - Doubled size of company
- **Some analysts raised concerns about high growth in AR**
- **Auditor questioned the revenue recognition practices in prior year**
 - Pawsome had to restate prior results to remove questionable revenue
- **Pawsome's reputation took a hit with customers and investors**
 - Filed for bankruptcy within three years of scheme
 - Eventually acquired by DogWorld Industries

