REVENUE RECOGNITION RED FLAGS: REVENUE BEFORE CASH COLLECTION

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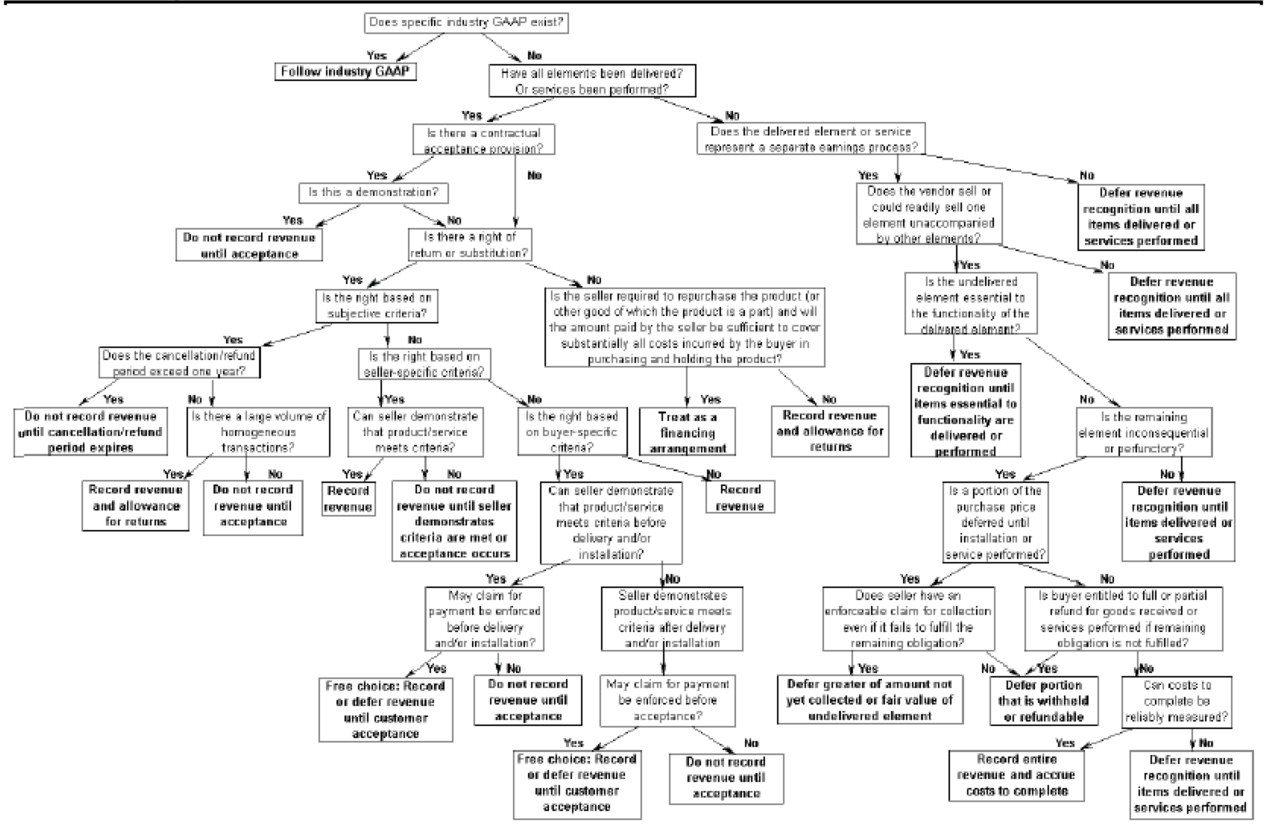
Revenue Recognition

- **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**
  - **(Revenue this quarter – Revenue same quarter last year) / 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
  - (AR end of this quarter – AR end of same quarter last year) / 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
    - Cash Collected = (Revenue + Beginning AR) – Ending AR

Ratios

- **Days Receivable**
  - Large increase could indicate spike in noncash revenue at end of quarter
  - Annual Data => (Average AR / Annual Revenue) * 365
  - Quarterly Data => (Average AR past 5 quarters / 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
  - AR/Revenue = AR / TT Revenue
- **Revenue per Capacity Unit**
  - Large increase could indicate fraudulent revenue that is beyond normal capacity of company to produce
  - Revenue per employee = TT Revenue / Number of employees
  - Revenue per PP&E = TT Revenue / 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

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