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
 - Increase Revenue
 - Increase Unearned Revenue liab.

100

- 2016
 - New sales
 - Increase Cash 110
 - Increase Revenue
 - Increase Unearned Revenue liab. 33

77

- 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

70

30

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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

