HARVARD | BUSINESS | SCHOOL

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PAUL HEALY

MARSHAL HERRMANN

Accounting for Revenues

In early March 2020, Alessandra Morales, an experienced analyst at a large U.S. brokerage firm was asked to provide an overview on accounting for revenues for the incoming cohort of new hires in the firm's research department, most of whom had only limited accounting background. Morales decided to focus on three areas where she had observed there were opportunities for managers to exercise judgement in revenue reporting: (i) allocating transaction prices to obligations performed in different periods, (ii) estimating customer return allowances, and (iii) estimating revenue collections. To illustrate these, she selected companies where the issues were particularly relevant and constructed the following three cases.

Allocating performance obligations to current and deferred revenues at Southwest Airlines

Under Southwest's frequent flyer program, Rapid Rewards, loyal customers earned miles from traveling with Southwest, and redeemed those awards for free, discounted or upgraded air travel and non-travel awards. For financial reporting, Southwest recognized a portion of the ticket price as revenue when a Rapid Rewards member traveled and earned miles for future flights. The remainder was considered a separate performance obligation and was deferred, recorded as "air traffic liability" on the balance sheet, similar to prepaid tickets. Air traffic liability related to the loyalty program was recognized as revenue when the customer later redeemed miles. In its 2020 financial statement footnotes, the company explained this accounting as follows:

> The Company records a liability for the relative fair value of providing free travel under its loyalty program for all points earned from flight activity or sold to companies participating in the Company's Rapid Rewards loyalty program as business partners that are expected to be redeemed for future travel. The loyalty liability represents performance obligations that will be satisfied when a Rapid Rewards loyalty member redeems points for travel or other goods and services. Points earned from flight activity are valued at their relative standalone selling price by applying fair value based on historical redemption patterns. … The Company records passenger revenue related to air transportation when the transportation is delivered. The marketing elements [other goods and services different from travel received by members in exchange for their loyalty points] are recognized as Other - net revenue when earned.

Professor Paul Healy and Teaching Fellow Marshal Herrmann prepared this exercise as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

Southwest reported Passenger revenues of $7,665m and $20,776m in 2020 and 2019, respectively. In its footnotes, Southwest provided the following information on loyalty program (**Exhibit 1**, in $ millions):

Exhibit 1

	Twelve Months Ended December 31,	
	2020	**2019**
Air traffic liability - loyalty program - beginning balance	$3,385	$3,011
Amounts deferred associated with points awarded	2,125	2,941
Revenue recognized from points redeemed - Passenger	(1,003)	(2,487)
Revenue recognized from points redeemed - Other	(60)	(80)
Air traffic liability - loyalty program - ending balance	$4,447	$3,385

Source: Southwest Airlines, 2020 Annual Report, p. 115, Note 6 "Revenue," **https://www.southwestairlinesinvestorrelations.com/~/media/Files/S/Southwest-IR/LUV_2020_Annual%20Report_.pdf**, accessed May 2021.

Estimating customer return allowances at Purple

In 2013, Tony and Terry Pearce invented and patented Mattress Max, a machine that allowed them to create and mold large pieces of elastic polymers into mattresses. Using this proprietary "hyper-elastic polymer" material the brothers constructed a mattress that provided support and also dissipated heat for users. In September 2015, the company began selling its mattresses and launched a series of videos to explain the underlying science to potential customers, promising a full refund to any customers who were dissatisfied within their first 100 nights' sleep. The videos went viral, attracting more than 100 million viewers, and sales soared, from $72 million in 2016 to $319 million in 2018.

Other web-based mattress companies, such as Casper, Helix, Leesa, Lull, Saatva, and Tuft and Needle, also had a 100-day customer return policy. Under U.S. GAAP, if sales transactions provided customers with a right of return, the seller was required to report revenues for the period net of the value of products expected to be returned, as well as a liability for the expected refunds. If returned assets were expected to have any value they should be recorded as an asset with an adjustment to cost of sales. Since Purple discarded any returned mattresses, it would not have to make any adjustments to assets or cost of sales upon receiving a return.

Purple provided the following information on net sales and sales returns from 2016 to 2018 in $m:

Exhibit 3

	2018	2017	2016
Income Statement			
Annual sales, net	285,791	196,859	65,473
Gross Profit	112,600	85,020	21,480
Balance Sheet			
Accrued sales returns, beginning balance	4,825	2,054	17
Additions that reduced net sales	33,543	19,779	7,278
Deductions for current year returns	(32,911)	(17,008)	(5,241)
Accrued sales returns, ending balance	5,457	4,825	2,054

Source: Purple Innovation, Inc., 2018 Annual Report, p. 92, http://d18rn0p25nwr6d.cloudfront.net/CIK-0001643953/03c8b587-0cb9-4ae6-99a8-13ef83b6c914.pdf, accessed August 2020.

Estimating revenue collections at Crocs, Inc

Crocs, Inc developed and marketed casual footwear for men, women and children. Its shoes were known for being colorful, soft, comfortable, lightweight, non-marking and odor-resistant. From its inception in 2002 to 2017, Crocs had sold more than 600 million pairs of shoes in more than 90 countries around the world.

In 2015, Crocs experienced delayed payments and defaults from distributor partners in China, and determined that it would need to increase its bad debt expense and allowance. The following (**Exhibit 4)** reports information on Croc's gross receivables, allowances, write-offs and operating earnings for the years ended December 31, 2014-17 in $m:

Exhibit 4

	2017	2016	2015	2014
Accounts receivable (gross)	101.8	111.2	120.0	114.8
Allowance for doubtful accounts	?	32.9	36.4	13.6
Accounts receivable (net)	?	78.3	83.6	101.2
Write-offs	15.8	9.6	3.5	2.1
Operating earnings before bad debt expense	18.5	0.0	(46.1)	7.4

Source: Crocs, Inc. 2015 Annual Report, p. 87, p. 120, https://d18rn0p25nwr6d.cloudfront.net/CIK-0001334036/88456197-52b4-4096-94d8-02a4e90c26f7.pdf); Crocs, Inc. 2017 Annual Report, p. 67, p. 97, https://d18rn0p25nwr6d.cloudfront.net/CIK-0001334036/62c1d6b3-61df-4cc1-9ef1-1050640672f9.pdf, accessed August 2020.