Revenue Recognition Concerns Expressed in Recent SEC Pronouncement 12/14/99

On September 28, 1998, in response to growing concerns about companies managing earnings in order to achieve consensus estimates, SEC Chairman Arthur Levitt gave a memorable speech on the subject entitled The Numbers Game. In the area of premature revenue recognition, Levitt used the following analogy:

"Think about a bottle of wine. You wouldn't pop the cork on that bottle before it was ready. But some companies are doing this with their revenue - recognizing it before a sale is complete, before the product is delivered to a customer, or at a time when the customer still has options to terminate, void, or delay the sale."

Over the past year, the SEC has issued two staff accounting bulletins (SABs) to address earnings management problems: one in August addressing materiality in the preparation of financial statement (SAB No. 99), and another in November addressing restructuring charges (SAB No. 100). On December 3, 1999, the SEC issued a third SAB, No. 101, which provides guidance on the recognition, presentation, and disclosure of revenue in financial statements. (SABs are not rules; rather they represent interpretations and practices followed by the staff of the Office of the Chief Accountant and the Division of Corporation Finance in administering the federal securities laws.)

SAB No. 101 does not change any existing accounting rules for revenue recognition. Rather, it spells out the basic criteria that must be met before companies can record revenue. Those criteria reflect the recurring revenue recognition themes found in the existing accounting literature. This SAB provides guidance in such areas as bill-and-hold transactions, up-front fees when the seller has significant continuing involvement, long-term service transactions, refundable membership fees, and contingent rental income.

Revenue Recognition – General

Revenue should not be recognized until it is realized (or realizable) and earned. A company's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its major ongoing or central activities. Revenue is considered to have been earned when that entity has substantially completed this activity.

The SEC staff believes that revenue is realized (or realizable) and earned when all of the following criteria are met:

- Persuasive evidence of an arrangement exists
- Delivery has occurred or services have been rendered
- The seller's price to the buyer is fixed or determinable
- Collectibility is reasonably assured
I. Persuasive evidence of an arrangement exists

(a) Determine that the seller followed its normal and usual internal procedures required before revenue is recognized. If such practices require a written sales agreement signed by the legal department, then an oral agreement consummated on the last day of the quarter would permit no revenue to be reported during that period.

(b) Ascertain that risks and rewards of ownership of the product and title transferred seller (or consignor) to buyer. Thus, products delivered to a consignee pursuant to a consignment arrangement are not sales and do not qualify for revenue recognition until a sale occurs.

(c) Other situations may exist where title to delivered product passes to a buyer, but the substance of the transaction is that of a consignment or a financing. The following characteristics in a transaction may preclude revenue recognition even if title to the product has passed to the buyer.

1. The buyer has the right to return the product
2. The seller is required to repurchase the product at specified prices
3. The transaction possesses the characteristics set forth in EITF Issue No. 95-1, Revenue Recognition on Sales with a Guaranteed Minimum Resale Value
4. The product is delivered for demonstration purposes

II. Delivery has occurred or services have been rendered

(a) Delivery is not considered to have occurred unless the customer has taken title and assumed the risks and rewards of ownership of the products specified in the purchase order or sales agreement. Typically this occurs when a product is delivered to the customer's delivery site (when terms are FOB destination) or when a product is shipped to the customer (when terms are FOB shipping point).

(b) The SEC still permits revenue recognition when no delivery has occurred when the following criteria are met:

1. The risks of ownership have passed to the buyer
2. The customer made a fixed commitment to purchase the goods, preferably in writing
3. The buyer, not the seller, must request that the transaction be on a bill-and-hold basis. The buyer must have a substantial purpose for ordering the goods on a bill-and-hold basis.
4. There must be a fixed schedule for delivery that is reasonable and consistent with the buyer's business purpose.
5. The seller must not have retained any specific performance obligations such that the earning process is not complete
6. The ordered goods must have been segregated from the seller's inventory and not subject to being used to fill other orders.
7. The equipment (product) must be complete and ready for shipment.

(c) Layaway sales to customers. Provided the other criteria for revenue recognition are met, a seller should recognize revenue from sales made under its layaway program upon delivery of merchandise to its customer. Until then, any cash received should be recognized as a liability -- "deposits received from customers for layaway sales." The seller is not permitted to record revenue at the earlier stage when collecting as cash deposit because the risk of ownership still remains with the seller.

Revenue Recognition Concerns Expressed in Recent SEC Pronouncement (12/14/99)
©1999 by the Center for Financial Research and Analysis, Inc. (CFRA)
(d) Revenue recognition related to nonrefundable, up-front fees. (Examples include: (1) selling a lifetime membership to a health club, (2) receiving an "activation fee" when entering into an arrangement to provide telecommunications services, or (3) receiving a nonrefundable "technology access fee" for providing research and development services.

According to the SEC, deferral of revenue is generally appropriate in each case; unless the up-front fee is in exchange for products delivered or services performed that represent the culmination of the earnings process. Since customers are buying on-going rights, revenue should be deferred. The up-front fees (even if nonrefundable) are earned as the product and/or services are delivered and/or are performed and generally should be deferred and recognized systematically over the periods that the fees are earned.

III. The seller's price to the buyer is fixed or determinable

Cancellation and termination clauses provide complications in making revenue recognition decisions. Close attention should be given to "side" agreements. If the cancellation privileges expire ratably over a stated contract term, the sales price is considered to become determinable ratably over the stated term.

Companies that derive revenue from membership fees (e.g., Costco, MemberWorks, and Cendant) must defer recognition of revenue from any fees paid in advance when the customer has the unilateral right to cancel at any time and still receive a full refund since the SEC believes that the sales price in such arrangements is neither fixed nor determinable. Thus, when the cancellation privilege expires over the term of the contract, the SEC believes that the sales price becomes determinable ratably over that period. Therefore, the membership fee should be credited to a monetary liability account such as "customers’ refundable fees," and no revenue should be recorded until the membership period has lapsed without the refund being granted. Nonetheless, the SEC notes that over the years the accounting for membership refunds has evolved from SFAS No. 48—a standard that permitted revenue recognition (net of estimated refunds) under certain circumstances. For the SEC to prohibit such accounting may result in a significant change in practice. Thus, pending further action on the matter by the FASB, the SEC staff will not object to this practice, providing each of the following criteria are met:

1. The estimates of terminations or cancellations and refunded revenues are made from large homogeneous pools
2. Reliable estimates of the expected refunds can be made on a timely basis
3. There is a sufficient company-specific historical basis upon which to estimate the refunds and the company believes that such historical experience is predictive of future events
4. The amount of the membership fee specified in the agreement at the outset of the arrangement is fixed, other than the customer's right to request a refund

Gross vs. Net Revenue

When is it appropriate for an internet company to record "grossed-up revenue" (including the cost of sales), rather than a net-revenue basis (similar to a commission)?

• Illustration: Company A operates an internet site from which it will sell Company T's products. Customers place their orders for the product by making a product selection directly from the internet site and providing a credit card number for payment. Company A receives the order, processes the credit card and passes the order on to Company T. Company T ships the product directly to the customer. Company A does not take title to the product and has no risk of loss or other responsibility for the product. The product typically sells for $175 of which Company A

Revenue Recognition Concerns Expressed in Recent SEC Pronouncement (12/14/99)
©1999 by the Center for Financial Research and Analysis, Inc. (CFRA)
receives $25. In the event a credit card transaction is rejected, Company A loses its margin on the sale (i.e., $25). How much is Company A’s revenue on the transaction?

- The answer is $25. It would be incorrect to “gross-up” the revenue to $1.75 (include the $150 cost of sales).

In general, to determine whether revenue should be reported gross, consider if the Company:

- acts as principal (not sales agent) in the transaction;
- takes title to the products;
- has risks and reward of ownership, such as the risk of loss for collection, delivery, or returns; and
- acts as an agent or broker (including performing services as such) with compensation on a commission or fee basis.

If the Company performs as an agent or broker without assuming the risks and reward of ownership of the goods, sales should be reported on a net basis.

**Disclosure Requirement**

The SEC stated in Financial Reporting Release 36 (FRR 36) that Management Discussion and Analysis (MD&A) should “give investors an opportunity to look at the registrant through the eyes of management by providing historical and prospective analysis of the registrant’s financial condition and results of operations, with a particular emphasis on the registrant’s prospects for the future.” Examples of such revenue transactions or events that the staff has asked to be discussed are:

1. Shipments of product at the end of a reporting period that significantly reduce customer backlog and that reasonably might be expected to result in lower shipments and revenue in the next period.
2. Granting extended payment terms that will result in a longer collection period for accounts receivable and slower cash inflows from operations, and the effect on liquidity and capital resources.
3. Changing trends in shipments into, and sales from, a sales channel or separate class of customer that could be expected to have a significant effect on future sales or sales returns.
4. An increasing trend toward sales to a different class of customer, such as a reseller distribution channel that has a lower gross profit margin than existing sales that are principally made to end users.
5. Seasonal trends or variations in sales.
6. A gain or loss from the sale of an asset.