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Revenue Recognition

Rules and Scenarios

SECOND EDITION

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PREFACE

Revenue recognition is of critical importance to anyone in the business world, since it drives a large part of the perception of a company's value, which is reflected in its stock price. This in turn impacts the returns of investors and any earnings of employees that are tied to stock options. Given these pressures, it should be no surprise that the outer boundaries of revenue recognition rules are constantly being explored by company managers, which has led to the bulk of all cases of financial fraud.

Revenue Recognition not only provides a detailed view of the current accounting rules and regulations pertaining to revenue recognition, but also describes the exact sources of this information, how a company's treatment of revenue recognition is to be disclosed alongside the financial statements, and what policies, procedures, and controls can be used to enforce it in a consistent manner.

Revenue recognition rules vary not only by type of transaction, but also for some industries. Accordingly, the chapters of this book are clustered into transaction-related revenue recognition rules, and then into industry-related revenue recognition rules. Chapters 1 through 5 cover revenue recognition for transactions, including general principles, when collection is uncertain, when there is a right of return, and when there are multiple deliverables. These chapters include commentary about the revenue recognition positions of the Securities and Exchange Commission, as well as international financial reporting standards.

Chapters 6 through 13 then address revenue recognition for the following industries:

- Franchising
- Construction
- Motion pictures
- Not-for-profits
- Real estate
- Recording and music
- Services
- Software

Chapter 14 addresses a variety of miscellaneous topics too small for separate chapters, such as loan guarantee fees, sales with guaranteed resale values, advertising barter transactions, sales incentive plans, and so on.

This book is intended to be a source book for *all* aspects of revenue recognition—how to account for it, report it, and set up systems and controls to ensure that the rules are properly followed. Hopefully, *Revenue Recognition* will assist you in consistently recognizing revenue in the correct amounts, at the right time, and in accordance with generally accepted accounting principles.

Steven M. Bragg
Centennial, Colorado
March 2010

ABOUT THE AUTHOR

Steven Bragg, CPA, CMA, CIA, CPIM, has been the chief financial officer or controller of four companies, as well as a consulting manager at Ernst & Young and auditor at Deloitte & Touche. He received a master's degree in finance from Bentley College, an MBA from Babson College, and a bachelor's degree in economics from the University of Maine. He has been the two-time president of the Colorado Mountain Club, and is an avid Alpine skier, mountain biker, and certified master diver. Mr. Bragg resides in Centennial, Colorado. He has written the following books:

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Accounting Control Best Practices
*Accounting Policies and Procedures
Manual*
*Billing and Collections Best
Practices*
Business Ratios and Formulas
The Controller's Function
Controller's Guide to Costing
*Controller's Guide to Planning and
Controlling Operations*
*Controller's Guide: Roles and
Responsibilities for the New
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1 REVENUE RECOGNITION GENERAL PRINCIPLES AND SYSTEMS

OVERVIEW OF REVENUE RECOGNITION

The principles guiding recognition of revenues for financial reporting purposes are central to generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS) and in most instances are unambiguous and straightforward. In fact, the underlying principles have not changed in decades. However, as business transactions have become more complicated over time, GAAP and IFRS have expanded to include detailed rules for certain types of revenue recognition issues. Revenue recognition for GAAP is now aggregated under Topic 605 of the Accounting Standards Codification, while the same topic is somewhat more dispersed among IFRS source documents. This book summarizes these issues by topic and industry, covering such industries as motion pictures, software development, franchising, and real estate, while also addressing such cross-industry topics as situations when there is a right of return, or if collection is uncertain.

Each chapter begins with an overview of the topic, definitions of key terms, and a discussion of the key revenue recognition issues. If GAAP or IFRS mandates or recommends disclosure of revenue recognition information alongside the financial statements, then these disclosures are also noted, along with examples. Finally, a number of policies, procedures, and controls are covered that can support the systems needed to accumulate and report revenue transactions. These supporting systems are quite necessary, in light of the fraudulent reporting problems that are discussed later in this chapter.

REVENUE RECOGNITION GENERAL GUIDELINES

Revenue, whether from the sale of product or provision of services, is to be recognized only when it has been earned. According to the Statement of Financial Accounting Concepts No. 5 (CON 5), *Recognition and Measurement in Financial Statements of Business Enterprises*,

...(a)n entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or cen-

tral operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

In other words, in order to be recognized, revenue must be realized or realizable, and it must have been earned.

CON 5 notes that “the two conditions (being realized or realizable, and being earned) are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities and gains and losses from sales of other assets are commonly recognized at the time of sale (usually meaning delivery).” Moreover, “if services are rendered or rights to use assets extend continuously over time (for example, interest or rent), reliable measures based on contractual prices established in advance are commonly available, and revenues may be recognized as earned as time passes.” In other words, for most traditional and familiar types of transactions, the point at which it is appropriate to recognize revenue will be quite clear.

The SEC’s Revenue Recognition Criteria

The Securities and Exchange Commission (SEC), reflecting on the conceptual foundation for revenue recognition, observed in Staff Accounting Bulletin 104 (SAB 104), that

*Revenue generally is realized or realizable and earned when **all** of the following criteria are met:*

- 1. There is persuasive evidence that an arrangement exists,*
- 2. Delivery has occurred or services have been rendered,*
- 3. The seller’s price to the buyer is fixed or determinable, and*
- 4. Collectibility is reasonably assured.*

Note that while SEC rules and “unofficial” guidance are not necessarily to be deemed GAAP for nonpublic companies, to the extent that these provide insights into GAAP standards, they should always be viewed as relevant guidance and followed, absent other, contradictory rules established under GAAP. In the absence of any other source found in the GAAP rules, SEC pronouncements may represent the best thinking on the subject and are considered authoritative for all reporting entities.

With regard to the four criteria set forth above, consideration should be directed at the following discussion, which is drawn partially from SAB 104.

Persuasive Evidence of an Arrangement

First, regarding persuasive evidence of an arrangement, attention must be paid to the customary manner in which the reporting entity engages in revenue-producing transactions with its customers or clients. Since these

transactions are negotiated between the buyer and seller and can have unique or unusual terms, there are (and can be) no absolute standards. Thus, for an enterprise that traditionally obtains appropriate documentation (purchase orders, etc.) from its customers before concluding sales to them, advance deliveries to customers, even if later ratified by receipt of the proper paperwork, would not be deemed a valid basis for revenue recognition at the time of delivery.

Example

The Minnetonka Motor Company has a new plastic engine available to ship to customers before the end of the current fiscal year. Wilson Trucks places an order for the new engine, and Minnetonka delivers the engine prior to the end of the year. Minnetonka's customary business practice is to require a signed sales agreement that must be signed by an authorized customer representative. Minnetonka issues the sales order, but the only person at Wilson authorized to sign the agreement is its president, who is on vacation. Wilson's purchasing manager has orally agreed to the contract and stated that it is highly likely that the president will sign the agreement upon his return from vacation.

Based on this scenario, the SEC does not believe that Minnetonka can recognize revenue in the current fiscal year, on the grounds that this arrangement has departed from Minnetonka's current business practice. In particular, the sales agreement is subject to a subsequent approval, which has not yet been obtained.

When evaluating purported revenue transactions, the substance of the transactions must always be considered, and not merely their form. It has become increasingly commonplace to "paper over" transactions in ways that can create the basis for inappropriate revenue recognition. For example, transactions that are actually consignment arrangements might be described as "sales" or as "conditional sales," but revenue recognition would not be appropriate until the consigned goods are later sold to a third-party purchaser.

Example

The Brass Fittings Company, maker of finely machined plumbing fittings, enters into an arrangement with Monaco Plumbing to deliver its products to Monaco on a consignment basis. The agreement specifically states that Monaco is the consignee, and that title to the products does not pass from Brass to Monaco until Monaco uses the fittings in its operations. Brass delivers product to Monaco and wants to recognize revenue at the time of shipment.

Based on this scenario, the SEC would not allow revenue recognition by Brass Fittings, on the grounds that products delivered to a consignee under a consignment arrangement are not sales and do not qualify for revenue recog-

dition until a sale occurs. Revenue recognition is not appropriate, because Brass Fittings retains the risks and rewards of ownership, and title has not passed to Monaco.

Careful analysis of the rights and obligations of the parties and the risks borne by each at various stages of the transactions should reveal when and whether an actual sale has occurred and whether revenue recognition is warranted. The SEC believes that one or more of the following characteristics of a sale arrangement will preclude revenue recognition, *even if title to the product has passed to the buyer*:

1. The product is intended to be for demonstration purposes.
2. The seller is obligated to repurchase the product at specific prices, where the repayment prices are adjustable to cover the costs incurred by the buyer to purchase and hold the product.
3. The buyer can return the product and
 - a. The buyer does not pay at the time of sale and is not obligated to do so on any specific dates; or
 - b. The buyer's obligation to pay is excused until the buyer resells or uses the product; or
 - c. The buyer will not have to pay if the product is damaged or destroyed; or
 - d. The buyer has no economic substance except for that provided by the seller; or
 - e. The seller has major obligations to assist the buyer in reselling the product.

Example

Scenario 1. The Guttering Candle Company, maker of beeswax candles, runs a special promotion during the slow first quarter of the year, where it refunds a portion of the original purchase price that is calculated based on the holding period of each buyer until such time as the buyer resells the candles to its customers.

Scenario 2. Guttering Candle pays interest costs on behalf of buyers under a third-party financing arrangement, until such time as they sell candles acquired from Guttering Candle.

Scenario 3. Guttering Candle provides below-market financing to buyers for the period beyond its customary 30-day payment terms and until the candles are resold.

Based on these scenarios, the SEC would not allow Guttering Candle to recognize revenue at the point of initial sale, because it is adjusting the purchase price to cover the holding costs of buyers.

In some countries, sellers commonly retain a form of title to goods delivered to customers until paid, so they can recover the goods in the event of a buyer default. Sellers are not entitled to direct the disposition of the goods and cannot rescind the transaction. In such a case, the SEC allows the seller to recognize revenue at the time of delivery. Only when the seller retains other rights normally held by the buyer of the goods will the SEC consider the transaction to be consignment, and not allow revenue recognition. The buyer must assume the risks of ownership in all cases if revenue is to be recognized.

Example

The Tidal Energy Company produces electrical turbines that are triggered by wave action. It enters into a formal agreement to sell ten of its most advanced turbines to the government of Vanuatu, located on an atoll in the Pacific Ocean. Tidal's sales manager also enters into a side agreement with the Energy Minister of Vanuatu, allowing for the return of all ten turbines within one year of installation if they do not provide the rated power levels.

Based on this scenario, the SEC would not allow Tidal to recognize revenue at the point of initial sale, on the grounds that the side agreement indicates that Tidal must continue to perform for one year before the revenue can be finalized. Also, if the side agreement was not properly documented and approved by Tidal's management, this is also a control breach that Tidal should recognize under the Sarbanes-Oxley Act.

Delivery Has Occurred or Services Rendered

With regard to whether delivery has occurred or services have been rendered, ownership and risk taking must have been transferred to the buyer if revenue is to be recognized by the seller. Thus, if the seller is holding goods for delivery to the buyer because the buyer's receiving dock workers are on strike and no deliveries are being accepted, revenue generally cannot be recognized in the reporting period, even if these delayed deliveries are made subsequent to period-end. (There are limited exceptions to this general principle, typically involving a written request from the buyer for delayed delivery under a "bill-and-hold" arrangement, having a valid business purpose.)

The SEC frowns upon bill-and-hold transactions. It will generally not allow revenue recognition in either of the following circumstances:

- When a company completes manufacturing of a product and segregates the inventory within its facility; or
- When a company ships products to a third-party storage facility while retaining title to the product and payment by the buyer will not occur until it is delivered to the buyer.

The SEC bases its opinion on the underlying concepts that revenue recognition does not occur until the customer takes title to the goods and assumes the risks and rewards of ownership. Consequently, the SEC uses all of the following criteria when determining whether revenue should be recognized:

1. Ownership risk must pass to the buyer;
2. The customer makes a (preferably) written commitment to buy the goods;
3. The buyer must request that the sale be on the bill-and-hold basis, and have a substantial business purpose for doing so;
4. There is a reasonable delivery schedule for the goods;
5. The seller has no remaining performance obligations;
6. The goods have been segregated, and cannot be used to fill other orders received by the seller; and
7. The product must be complete.

The SEC further points out that these criteria are not a checklist that will guarantee revenue recognition if a company can structure a transaction to meet all of the requirements; they are general criteria used to examine the intent of a transaction. In addition, the following factors should be considered in making the revenue recognition determination:

1. Whether the seller has modified its standard billing and credit terms for the buyer;
2. The seller's past pattern of using bill-and-hold transactions;
3. Whether the buyer has assumed the risk of loss if the market value of the goods declines;
4. Whether the seller's custodial risks of the goods purportedly sold are insurable and insured; and
5. That the business reasons for the bill-and-hold arrangement have not imposed a contingency on the buyer's commitment to accept the goods.

The SEC further states that delivery has generally not occurred unless the product has been delivered to either the customer or another site specified by the customer. If the customer specifies delivery to a staging site but a substantial portion of the sales price is not payable until delivery is ultimately made to the customer, then revenue recognition must be delayed until final delivery to the customer has been completed.

Delivery, as used here, implies more than simply the physical relocation of the goods to the buyer's place of business. Rather, it means that the goods have actually been accepted by the customer, which, depending on the terms of the relevant contract, could be conditioned on whether in-

spection, testing, and/or installation have been completed, and the buyer has committed to pay for the items purchased. For revenue recognition to be justified, substantial performance of the terms of delivery must have occurred, and if any terms remain uncompleted, there should be a basis grounded on historical experience to assume that these matters will be satisfactorily attended to.

The SEC holds that revenue should not be recognized until such time as any uncertainty about customer acceptance of goods or services has been eliminated. This requires an examination of customer acceptance provisions in the purchase agreement. For example, the agreement may allow the customer to test the product or require additional services subsequent to delivery, such as product installation. If these provisions exist, the SEC assumes that the customer specifically bargained for their inclusion in the agreement, which makes them substantive parts of the agreement. Consequently, revenue cannot be recognized until either the customer has accepted the goods or services, or the acceptance provisions have lapsed.

The SEC states that formal customer sign-off on a contractual customer acceptance provision is not always necessary. Instead, the seller can demonstrate that the criteria specified in the acceptance provisions are satisfied.

The SEC considers customer acceptance provisions to take one of four general forms, which are

1. *Acceptance for trial or evaluation purposes.* The customer agrees to accept the product strictly for evaluation purposes, so title remains with the seller. The customer may then actively affirm acceptance or do so simply through the passage of time; in either case, this is essentially a consignment arrangement where the seller should not recognize revenue until the customer confirms that it will purchase the product.
2. *Acceptance granting a right to return or exchange on the basis of subjective issues.* The customer has the right to return the product if dissatisfied with it. In this case, a company can recognize revenue at the initial point of sale, but only if it can reasonably estimate the amount of future returns and accrue for them. If the seller cannot make this estimate, then it must wait until the right of return has expired before recognizing revenue.
3. *Acceptance based on seller-specified objective criteria.* The customer has a right of return or replacement if the delivered product is defective or fails to meet its published specifications. If the seller has already demonstrated that the product meets its specifications and can reasonably estimate the amount of defective products, then

it can create a warranty reserve and recognize revenue at the point of sale. If the seller cannot prove that the product meets its published specifications, then it should defer revenue recognition until the specifications have been achieved.

4. *Acceptance based on customer-specified objective criteria.* The customer has created a specific set of acceptance criteria that the seller must meet before the customer will accept the delivery. This is best achieved with a formal sign-off document. Alternatively, the seller can demonstrate that the delivered product meets the customer's criteria (such as through preshipment testing). However, it may not be possible to conduct such testing prior to delivery, because performance may vary based on how the product works in combination with the customer's other systems. In this case, revenue recognition should be deferred until the product is actually installed and meets the stated criteria. Also, the seller must evaluate its ability to enforce a payment claim in the absence of a formal sign-off. If payment enforcement would be difficult, then revenue recognition should be deferred until formal customer sign-off.

This is perhaps the most subjective of the four forms of customer acceptance, so the SEC states that it will not object to a determination that is well reasoned on the basis of the guidance just described.

Example

The Dense Air Corporation manufactures air compressors in a variety of standard models. The contract for sale of every standard model provides for customer acceptance of the compressors after receipt and testing by the customer. The contract states that customers are entitled to a full refund if the equipment does not perform as specified. Customers can indicate their acceptance by signing a form, or by the passage of 45 days, as noted in the acceptance provisions. Dense Air tests all of its compressors prior to shipment to ensure that they meet specifications.

Dense Air receives an order for its standard Nitrox compressor model from Maldives Diving. Dense Air has produced that model for five years and has no reason to believe that it will behave differently at Maldives than it does in the Dense Air facility. Based on the circumstances, Dense Air can reasonably and reliably estimate the amount of its warranty obligation, and so can recognize revenue upon delivery of the equipment, along with an appropriate liability for warranty obligations.

Example

The Dense Air Corporation receives a special order for its Nitrox compressor from Compact Boat Company, which needs to fit the compressor into

an unusually small space on one of its boats. In addition to the usual customer acceptance provisions, Compact Boat can reject the compressor if it does not fit into the specified dimensions. Dense Air creates an installation space having the exact dimensions of those specified by Compact Boat, and verifies that the compressor both fits into this space and operates within the specifications.

Though the contract with Compact Boat contains a clause that includes customer-specific criteria, Dense Air demonstrates that the compressor meets the customer's objective criteria before it has shipped. Consequently, Dense Air can recognize revenue upon delivery of the equipment, along with an appropriate liability for warranty obligations.

Example

The Dense Air Corporation receives an order for its Nitrox compressor from Graphite Solutions, which plans to incorporate the compressor into a new filling station for its spun-graphite air tanks, which store compressed gases at extremely high pressure. Graphite may reject the compressor if it fails to meet the standard specifications, or cannot be integrated into the new filling station. Dense Air has no experience with this type of filling station, and cannot test it in advance to ensure compliance with Graphite's needs. However, the compressor meets all of Dense Air's standard performance criteria.

Because Dense Air cannot demonstrate that the compressor meets Graphite's criteria prior to shipment, it should wait until the compressor is successfully integrated into the filling station before recognizing revenue.

In some instances there are multiple "deliverables"; in such cases, revenue is not recognized for any given element if later deliverables are essential for the functionality of the already delivered element. In other situations, such as in various licensing arrangements, physical "delivery" may occur well before product usage by the buyer can take place (e.g., software for the future year's tax preparation delivered before the current year-end), and revenue is not to be recognized prior to the initial date of expected use by the buyer.

In the case of many service transactions, large up-front fees are often charged, nominally in recognition of the selling of a membership, the signing of a contract, or for enrolling the customer in a program. (An example is initiation fees to join a health club where the terms of membership also obligate the member to pay ongoing fees.) Unless the services provided to the customer at inception are substantial, the presumption is that the revenue received has not been earned, but rather must be deferred and recognized, usually ratably, over the period that substantive services are provided. Thus, initiation fees are amortized over the membership period.

According to the SEC, there are numerous situations where a customer must pay an up-front fee as part of a purchase transaction. For example, the fee may involve the conveyance of a license, or the delivery of a product or service. In many cases, the customer would not have paid the fee if the seller were not involved on a continuing basis with the provision of additional services. For example

- *Access fee.* A Web site that hosts a variety of databases charges a fee to its customers for unrestricted access to its data, which requires minimal additional cost by the Web site once the user has been given access to the system.
- *Activation fee.* A phone company mandates an activation fee when it sets up phone services for a new customer, as well as monthly usage fees.
- *Hosting fee.* A Web hosting company charges a fee for hosting a customer's Web site, where most of the cost is incurred during the initial installation.
- *Initiation fee.* A health club sells a membership to a customer, which includes an initiation fee and a continuing monthly fee.
- *Listing fee.* A Web site charges advertisers a fee to list their products on its Web site for a designated period of time, where there is a minimal cost associated with the advertisement during the period when it is posted.
- *Technology access fee.* The holder of intellectual property and research services requires its customers to pay a fee for access to its proprietary technology, as well as a periodic fee for its research services.

In all of the preceding examples, the SEC holds that revenue recognition of up-front fees should be deferred, unless the fees are in exchange for products or services that represent the completion of a separate earnings process. In essence, customers are really purchasing the ongoing rights, products, or services that the seller is providing through its continuing involvement under the sales arrangement. Thus, the SEC does not consider such activities as selling a membership or providing initial set-up services to be discrete earnings events.

There may be instance where the seller is incurring significant up-front costs, and so feels justified in recognizing revenue to the extent of those costs. However, because there is no separate deliverable associated with these costs (just an initial set-up), the SEC will usually object to such treatment. In most situations, the SEC believes that the up-front fee is coupled with the continuing performance obligation related to the services or products subsequently delivered to the customer; based on this judg-

ment, the SEC believes that up-front fees should be recognized as revenue as the seller provides products or services over the period of performance. A reasonable form of such recognition is to recognize the revenue systematically over the period of performance.

In cases where the seller is providing a service and requires an up-front fee, the SEC prefers that the fee be accounted for as revenue on a straight-line basis; this recognition shall be either over the term of the arrangement or the expected period during which services are to be performed, whichever is longer. The only situation where revenue is not recognized on a straight-line basis is when revenue is earned or obligations are fulfilled in a different pattern.

Even in cases where the seller's obligations to the buyer are inconsequential or perfunctory, the SEC believes that the substance of these transactions indicates that the buyer is paying for a service that is delivered over a period of time, which therefore calls for revenue recognition over the period of performance.

Price Is Fixed or Determinable

The seller's price to the buyer is fixed or determinable when a customer does not have the unilateral right to terminate or cancel the contract and receive a cash refund. Depending on customary practice, extended return privileges might imply that this condition has not been met in given circumstances. Prices that are conditional on the occurrence of future events are not fixed or determinable from the perspective of revenue recognition.

In theory, until the refund rights have expired, or the specified future events have occurred, revenue should not be recognized. As a practical matter, however, assuming that the amount of refunds can be reliably estimated (based on past experience, industry data, etc.), revenues, net of expected refunds, can be recognized on a pro rata basis. Absent this ability to reliably estimate, however, revenue recognition is deferred.

A contract with a customer may contain a provision where cancellation privileges expire ratably over a stated contractual period. If so, the SEC believes that the sales price is also determinable ratably over the stated term. This view does not apply to short-term rights of return, such as a money-back guarantee within the first 30 days of ownership by the customer.

If a company sells a membership fee that can be cancelled by customers for a full refund at any time during the membership period, then the SEC holds that revenue recognition cannot occur until the end of the contractual period. The reason for this position is that there is uncertainty as to