

Debate

The Challenges of Revenue Recognition

ISSUE: When should revenue be recognized in accounting?

Revenue recognition might seem straightforward at first. Small and privately-held companies can choose to recognize revenue or earned income after they receive cash for delivering a good or performing a service. However, this is not the case for public companies. A more transparent way of recording revenue is for the business owner to use accrual-based accounting. Accrual-based accounting recognizes revenue and expenses when a transaction occurs, whether or not money has exchanged hands. For instance, a business owner may purchase \$2,000 of inventory one month but not pay for it until the next month. In this case, the buyer would place the \$2,000 in accounts payable until she pays the vendor.

While this might seem to be a straightforward accounting method, it has its own set of challenges. Firstly, it makes it harder to track cash flow without careful monitoring. Secondly, it can be problematic with long-term contracts. For instance, if a contractor agrees to build something over the next six months for a fee, should he record the entire fee as revenue upfront even though he has not completed the work, or should he wait until he is finished? In these types of cases, revenue is often recorded as the contractor completes the work, whether or not he actually receives cash for it at the time.

Finally, recording revenue when a product is delivered gives the opportunity to inflate earnings in the short-term to make financial statements look better than they are. If a company records revenue when the product is shipped, then why not ship more products than the customer wants or needs to record more revenue? This is known as channel stuffing or trade loading. Discounts or special incentives at the end of the quarter can be used to drive sales beyond what would normally be purchased. It is not a long-term solution because the buyer will often send the unwanted product back. However, if this product is shipped at the end of a financial period and recorded as revenue, that financial period will look better. Because this is misleading, channel stuffing can be illegal. In 2004 Coca-Cola was accused of sending extra concentrate to Japanese bottlers between 1997 and 1999. They pressured bottlers to purchase more concentration on extended credit. The Securities and Exchange Commission found that channel stuffing had occurred. Yet despite the chances of getting caught—especially when companies are audited—the temptation to inflate revenues for short-term gain has continued to make channel stuffing a problem.

In detecting channel stuffing, the role of internal auditors is to determine if there are extraordinary returns in the first quarter of a new year. The term channel stuffing indicates that fraudulent financial reporting has occurred and is probably illegal. The gray area occurs when the buyer is willing to accept shipments of products, but if there are excess returns, this should be a red flag that the spirit of the law is being broken. Auditors may have to make decisions based more on general principles of financial reporting to evaluate and report ambiguous or gray areas.

To combat against this, the Financial Accounting Standards Board (FASB) claims that revenue should only be recognized “when (or as) the reporting organization satisfied a performance obligation.” It might be argued that excess shipments meets this obligation as long as the product is shipped, but if the buyer did not agree to the extra

product, then this is a manipulative tactic that does not satisfy an obligation. Yet even channel stuffing can be modified to make it look less like a manipulative tactic and more like a legitimate transaction. For instance, two ex-employees of a pharmaceutical company made a deal with wholesalers if they purchased drugs they did not need or intend to use. The tactic might be deceptive, but the transaction resulted in “real sales for real dollars,” but the pharmaceutical firm’s financial statements technically complied with Generally Accepted Accounting Principles (GAAP).

To try and simplify revenue recognition processes and make them more consistent with international standards, the FASB is working with the International Accounting Standards Board (IASB). The IASB prefers more principle-based accounting methods in which accountants would use accounting principles to determine when revenue generation is appropriate. However, as the previous examples show, because channel stuffing is such an easy way to inflate revenues in a society where investors expect results, it is tempting to use accrual-based accounting methods in ways that bypass the rules. Additionally, internal auditors may be challenged to detect channel stuffing because there may be legitimate reasons inventory may be returned.

There are two sides to every issue:

1. It is always acceptable to use accrual-based accounting to recognize revenue as soon as the product is shipped.
 2. Revenue should not be officially recognized if the purpose is to accelerate revenue to boost short-term sales and profits.
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