

Why Do We Care About Revenue Recognition?

- Revenue has BIG impact on bottom-line profitability ==> managers may be tempted to manage revenue
- Statistical Evidence: over 40% of SEC enforcement actions on accounting issues deal with Revenue Recognition
- Anecdotal Evidence: Recent experience of Bristol-Myers
 - In another setback for the beleaguered drug maker, Bristol-Myers Squibb Co. confirmed that the Securities and Exchange Commission has opened an inquiry into whether it improperly inflated revenue last year by as much as \$1 billion through use of sales incentives...Drug makers, like many other manufacturers, can boost near-term sales by extending lower prices to wholesalers, encouraging them to load up. But such "channel-stuffing" hurts later sales. --from WSJ, 7/12/2002

Criteria For Revenue Recognition

- Under accrual accounting, a firm recognizes revenue when it has:
 - Performed all, or a substantial portion of, the services to be provided.
 - Incurred a substantial majority of the costs, and the remaining costs can be reasonably estimated.
 - Received either cash, a receivable, or some other asset for which
 - a reasonably precise value can be measured
 - collectibility is reasonably assured.

Importance Of Accounts Receivables

Industry	<u>Receivables</u> Total Assets
Eating Places	1.6%
Family Clothing Stores (The GAP)	3.0
Race Track Operations	3.1
Grocery Stores	4.9
Intel	8.6
Semiconductors	11.3
Advertising Agencies	42.7
Trans. Freight/Cargo	43.1
Computer Software Wholesale	45.5
Overall Median	13.0%

Source: 5,933 industrial firms from 2000 Global Vantage

Allowance For Bad Debts (Uncollectibles)

- Methods
 - Direct Method
 - Percentage of Sales
 - Aging

- How might a firm's choice of method evolve over time?

I/S and B/S Relationships

Accounts Receivable (A)

Beginning Balance

+ Credit Sales

- Cash Collected

- Amounts Written Off

+ Reinstatements

= Ending Balance

- Allowance for doubtful Accounts (XA)

Beginning Balance

+ Amounts Recorded as Bad
Debt Expense

- Amounts Written Off

+ Reinstatements

= Ending Balance

Parallels Between Bad Debt And Other Accrued Expenses

	Cash	+ A/R	- ADA	Acc. = Liab.	Ret. + Earn
Accrue Expense				50 K	(50)K
Pay Liability	(50)K			(50)K	
Accrue Bad Debts			50 K		(50)K
Write Off Accounts		(50)K	(50)K		

Problem E6-7

See Problem E6-7 on pages 272-3 of the course textbook.

Problem E6-7 (Cont'd)

	AR	-ADA	L + CC + RE
BB			
Sales			
Write-Off			
Bad Debt Expense			
EB			

Allowance For Returns

- If customer has the right to return the product, the seller must estimate the dollar value of returns.
- Revenue is reported net of the amount expected to be returned.
- Typically, seller sets up a contra-asset account, *Allowance for Returns*:
 - Analogous to Allowance for Doubtful Accounts
 - When return actually occurs, reduce both Allowance and face value of Accounts Receivable (or Cash) by the invoice amount.
 - Return has no effect on Net Income, nor on Net Assets, just as Write-off of Uncollectible has no effect on these amounts.
 - BSE: $AR - \text{Allowance for Returns} = RE$
- Intel takes a slightly different approach: *Deferred Income Liability*.

Deferred Income: An Example

Shipments on 3/1 to OEMs and Distributors:

Total Billings	\$ 350,000	
Direct to OEMs		280,000
To Distributors (PP)		70,000
COGS	\$ 90,000	
Direct to OEMs		72,000
To Distributors (PP)		18,000

- Return / Price Protection expires for \$35K of sales on 3/31
- Invoice Price is reduced from \$35K to \$25K on the remainder of shipment on 4/15

Deferred Income: An Example

$$\text{AR} + \text{INV} = \text{Deferred Inc} + \text{RE}$$

OEM sales

Distrib. Sales

PP Expires
for \$35K

PP Applies
for 35K

Reverse Engineering: How Much Cash Did Intel Collect From Customers In 2002?

Reverse Engineering process:

- Identify Relevant Balance Sheet Accounts: A/R, Allowance for Doubtful Accounts, Deferred Income
- Identify the activities that affect these accounts:
 - Recognizing sales revenue as A/R
 - Recognizing bad debt expense
 - Writing off uncollectible accounts
 - Invoicing products that affect the Deferred Income Liability
- Obtain amounts from the Financial Statements, notes, other
 - i.e., Intel's Bad Debt Expense (\$10M) and Write-offs (\$21) are disclosed in its 10-K report filed with the SEC, but not in the annual report.
- Set up BSE template and “plug” the remaining numbers

Determining Intel's Cash Collections

	Cash	+AR	-ADA	+OA	=Def Inc	+RE
Begin Balance		2,675	68		418	
Sales Revenue						
Bad Debt Expense						
Write-Offs						
Change in Def Inc						
Cash Collected						
End Balance		2,631	57		475	

Summary Points

- Criteria for recognizing revenue
 - Collectibility: Match expected bad debts to the period in which the sales occur
 - Distinguish between Bad Debt Expense and Write-Offs
 - Methods for estimating Bad Debts / Uncollectible Accounts
 - Right of Return: match expected returns to the sales period, or more conservatively, defer revenue recognition until return protection / price protection ends.
- Reverse Engineering: infer the activities that underlie a firm's reported financial results