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Revenue Recognition In Volatile Economic Times

Law360, New York (November 07, 2008) -- The financial challenges posed by current financial market events affect Wall Street and Main Street alike.

With the approach of the 2008 fiscal year end, corporate America is not immune to the pressures generated by increased energy costs, tight credit markets, unease in consumer confidence and customers seeking sales concessions at year-end.

The SEC has long kept a vigilant eye on swings in the economy, knowing from over 70 years of experience policing the markets that tough economic times can foster an environment where meeting earnings expectations becomes increasingly difficult.

And, in certain circumstances, such pressures can contribute to lapses in judgments as companies attempt to achieve their numbers.

One practice that can lead to improper revenue recognition involves shifting sales from future to current fiscal periods by encouraging buyers to submit orders before they would ordinarily have done so.

While not fraudulent per se, over-selling an inventory channel (or “channel stuffing”) can form the basis for a securities fraud charge if the practices are done to mislead investors.

Accordingly, as corporate America closes out the 2008 third fiscal quarter, financial management and audit committees that oversee their work are well advised to take a fresh look at their revenue recognition policies and practices. In doing so, several items are worthy of careful review.

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What are the understandings between the parties (oral and written)? Does persuasive evidence of a sale exist?

When evaluating sales as potential revenue, financial management should consider critical revenue recognition principles and document its related judgments as a prudential matter.

Staff Accounting Bulletin No. 101 (December 3, 1999) expresses the SEC staff's views on the application of GAAP principles to revenue recognition. SAB 101 cautions that revenues generally are not earned unless several criteria are satisfied: (a) "persuasive evidence of an arrangement exists"; (b) "delivery has occurred or services have been rendered"; (c) "the seller's price to the buyer is fixed or determinable"; and (d) "collectibility is reasonably assured."

Is the transaction a bill and hold transaction? If so, are the Parness criteria satisfied?

In 2001, the SEC sanctioned Sunbeam Corporation and its senior management for, among other things, recognizing revenues from non-GAAP sales that, in certain cases, involved favorable concessions, such as "bill and hold" rights.

Noting views expressed in an earlier case, In re Stewart Parness, the SEC underscored that, under applicable accounting criteria, (a) the buyer (not the seller) must request a bill and hold structure; (b) the buyer must have a substantial business purpose for ordering the goods on a bill and hold basis; and (c) the risks of ownership must have passed to the buyer.

The SEC also cited as additional relevant factors "whether [the seller] has modified its normal billing and credit terms for this buyer" and whether "the seller's past experiences with and pattern of bill and hold transactions."

In sum, if "bill and hold" rights exist, the transaction should be closely scrutinized to confirm that such rights did not introduce contingencies into the transaction thereby rendering the sale non-GAAP compliant for purposes of revenue recognition.

Does the transaction include favorable rights of return or extended payment terms? Are FAS 48 requirements satisfied?

The SEC carefully scrutinizes the substance of transactions when analyzing the recognition of revenue from sales derived from channel stuffing programs.

FAS 48, the applicable pronouncement of the Financial Accounting Standards Board, provides criteria for recognizing revenue on a sale when a product may be returned by the customer or resellers of the product, whether as a matter of contractual right or business practice.

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When a seller gives a buyer return rights, FAS 48 requires that several conditions be met before the revenue from the transaction can be properly recognized as revenue.

In In re Microtune, Inc., the SEC brought enforcement proceedings against the company for entering into favorable sales agreements with several distributors that included sales concessions, various return rights, and extended payment terms.

The SEC contended that the liberalized sales concessions offered by the company were structured to induce customers and distributors to issue purchase orders for product quantities exceeding their inventory demands.

The SEC alleged that the company offered expanded rights of return (referred to as “stock rotation” rights) and extended payment terms to its distributors, with certain sales concessions conveyed either orally, by e-mail or through side agreements.

As a result, Microtune’s product price was not substantially fixed, as required by FAS 48, or determinable at the claimed date of sale.

Are there deviations from internal accounting policies or practices?

Deviations from internal accounting policies do not automatically equate to a violation of GAAP (or the antifraud provisions).

However, for example, where a seller has modified its normal billing and credit terms for a particular buyer, such concessions can evidence a lack of adequate internal controls and may provide evidence of scienter if the deviations also violate GAAP.

The SEC brought a civil action against Symbol Technologies alleging fraudulent practices, including adjusting financial results to match forecasts, artificially reducing operating expenses to create unsupportable reserves, and engaging in channel stuffing practices.

The SEC’s civil complaint described practices that evidenced departures from internal accounting policies (e.g., use of side letters, shipment of wrong product, and backdating of letters).

Allegations such as these show that the SEC will carefully evaluate whether and why an issuer makes an exception to its own policies for purposes of booking a sale.

What disclosure obligations exist under Regulation S-K? The recognition of revenue from sales derived from channel stuffing programs may also create disclosure obligations under Items 101(c)(1)(i) (“Description of Business”) and 303 (“Management Discussion and Analysis”) of Regulation S-K.

See e.g., In re Cypress Biosciences Inc. Consequently, issuers should carefully consider whether disclosures related to the recognition of material amounts of

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accelerated sales revenue are required, including disclosures related to the corresponding financial implications of such practices for future fiscal periods.

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The SEC closely reviews issuer financial statements and disclosures as part of its oversight functions.

Where the agency uncovers evidence of improper revenue recognition, the SEC frequently will impose stiff sanctions against issuers, their officers and directors, and other gatekeepers (such as accountants and lawyers).

Accordingly, financial reporting professionals should remain vigilant in these difficult economic times and observe these core principles, including the careful assessment of the economic realities of the transaction, when making revenue recognition judgments.

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