Revenue Recognition Challenges and Financial Statement Reporting

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Abstract

Revenue is the life wire of every business and a company's results will vary considerably, depending on when it chooses to recognize revenue. This article therefore examines the concept and the emerging issues relating to revenue recognition. The methodology adopted is that of library research because of the expository nature of the study. The study revealed that IAS Nos. 11 and 18 were not robust enough in framework regarding the observance of standards in revenue recognition even though it had laid the necessary foundations. The study revealed also the existence of a proposed new standards on revenue recognition which will be effective by the end of 2012 or early 2013. It was also revealed in this study that the financial reporting objectives of an enterprise will determine the choice of revenue

recognition policy to be taken. The study equally revealed some subtle manipulations that can vitiate the true position of financial statements hence the revenue to be recognised by a business enterprise can be adversely affected if not effectively checked. It was recommended that the Financial Reporting Council of Nigeria should step up its oversight functions through external auditors on the activities of business organisations in Nigeria regarding their published financial statements. Secondly, it was recommended that auditor's independence could be enhanced by granting social security and insurance to the external auditors.

Introduction

Revenue recognition is of great concern to many managers, financial regulators and Auditors. Naturally, managers are and should be more concerned than other parties. This is mainly because selecting the wrong accounting methods or one that may be challenged or lead to falling stock prices will attract shareholders' litigation, which may consequently affect management's reputation and credibility.

International accounting standards No 18 (IAS 18) defines Revenue as the gross inflow of economic benefits during the period or arising in the ordinary course of business activities and resulting in increases in equity other than contributions by equity participants. Simply put, Revenue is the inflow of economic benefits that is derived from activities in the ordinary course of business. According to Abdullahi (2012) "revenue is one of the most important line items and commonly the largest item in the financial statements". He said that to find the appropriate model to apply in recognizing revenue can be a challenge even for the most seasoned accounting professional. A company's reported results will vary considerably depending on when it chooses to recognize revenue. Policies for recognizing revenue are critical and contentious, this is partly because the timing of revenue recognition is especially complex simply because business activities which are used in generating revenue are also complex especially in today's world where multiple and cross boundary transactions are common.

Generally, the current credit crisis that is pervading the markets has been fueled to a large extent by suspicion regarding the value of assets that lending institutions normally use to secure loans. As the housing market is collapsing, so also were the complex securities that were based on mortgages and other debts (Rao and Lambert , 2009). Since these assets have become very

difficult to value, they are being rejected as collaterals for short – term borrowing that keeps many businesses afloat. The current climate of uncertainty is not limited to financial institutions since the importance of being able to "trust number" applies to all public companies, especially on how they report revenues and income which are basis to assessing short – term results and long term financial viability.

The Statement of Problem

The speed of change in the marketplace is creating stress on companies to respond quickly and effectively. Some companies intentionally distort its financial results and as such they disregard the standards in order to overcome their operational problems. The main objective of every accounting manipulation is either:

a) to inflate current / period earning by overstating revenues and gains or understating expenses or

b) to reduce current period earnings by understating revenues or overstating expenses, through this strategy, a company can shift earnings to a later period when they might be needed.

IAS No.18 identifies four financial manipulation strategies:-

1. The recording of questionable revenue or recording revenue prematurely, this can occur by:

    - Recording revenues for services that are yet to be performed.
    - Recording revenues for items which the customer is not required to pay.
    - Engaging in quid pro quo transactions with customers.

2. The Recording of fictitious Revenue

3. The Recording of one – time gains to boost income

4. The Shifting of revenues to future periods

Unusual transactions such as sales of assets outside the ordinary course of business or unusual period-end revenues, introduction of new period-end sales promotion programs, and disposal of a segment of a business might cause reporting problems. This is because such transactions and adjustments

that occur outside the company's ordinary course of business may not be subject to the checks and balances imposed by the internal control system.

Purpose of the Study

In this study, the researcher will ascertain the causes of revenue manipulations in the financial statements. The various ways in which financial statements could be manipulated are to be examined. Again, the study will examine the principles underlying the concept of revenue recognition.

Theoretical Framework in Revenue Recognition and Financial Statement Reporting

The primary purpose of accounting is to provide the necessary information for sound economic decision making to take place. A key piece of that information is the calculation of net income. (i.e. revenues less expenses). The growth and size of the net income informs decision makers about the sustainability, financial strength and growth capacity of the business. Growth can only be determined by comparing net income results over a series of accounting periods made up of similar durations (i.e. monthly, quarterly or yearly). So, identifying when revenue can be legitimately recorded into the books of the business and the accounting period that it should be recorded against are important considerations for accountants and decision makers alike. The revenue recognition principle provides guidance on how the revenue timing issues should be managed and treated in the financial statements.

The basic revenue recognition principle is that revenue should only be recorded in the books of a business when payment is assured (realizable), measurable and revenue has been actually earned (final delivery and completion of work). These rules must be adhered to before an event can be recorded as revenue in the bookkeeping system of a business.

The guidelines for accounting for revenue are simply stated as, "Revenues are not recognized until they're earned.*"* More specifically, "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" (Krishnan, S. (2002)).

There is no established Revenue recognition standard in former Nigeria statement of accounting standards (SAS), so to adopt IFRS in regards to 1AS No.18 and/or the proposed new revenue standards from contracts with customers in Nigeria would not be a problem but this not the case of US where we have revenue recognition standards embedded in the SEC staff Accounting Bulletin (SAR) No 104 which stipulates criteria for Revenue recognition in the US. The SAR No 104 is not very different from IFRS on IAS No.18. The IAS No.18 is explicit on what should constitute revenue. The issue is not what constitute revenue but when and how to recognize revenue. For instance, in IAS No.18, Royalty is recognised on accrual basis while Dividend is on Dividend declaration date.

Revenue is recognized on IAS No.18 on sale of goods if

A. Significant risks and rewards of ownership of the goods are transferred to the buyer.

B. The entity retains neither continuing managerial involvement of ownership nor effective control over goods sold.

C. The amount of revenue can be measured reliably.

D. It is probable that the economic benefits of the transaction will flow to the entity.

E. The costs of the transaction can be measured reliably.

Also revenue recognition on services rendered takes place if:

A. The outcome of transaction can be estimated reliably, costs and revenue are recognized according to the stage of completion at the statement of financial position date.

B. When the outcome of the transaction cannot be estimated reliably, recoverable contract costs will determine the extent of revenue recognition. Generally, revenue is recognized when it is (1) earned and (2) when realized or realizable (delivery or realizable with passage of time).

In IAS N0.18, the following are not Revenues;

a. Amount collected on behalf of third parties (e.g. value – added tax)

b.   Lease income

c.   Equity method investments

d.   Insurance contracts

e.   Changes in fair value of financial assets and liabilities.

f.   Initial recognition and changes in fair value on biological assets.

Choosing a Revenue Recognition Policy

Revenue recognition is the most pervasive and most difficult single accounting policy choice that many companies must face. Although there are many theoretical alternatives, the choice of policy is not a free game of luck. The revenue recognition policy is, first and foremost, a function of the revenue generating activity of the enterprise. When there is more than one revenue-generating activity, then there may be a different policy for each. For example, a retail company that engages in straight forward sales activity for cash or credit will probably recognize sales revenue at the point of delivery, while for interest revenue on its outstanding credit balances the company will likely recognize interest revenue as time elapses.

A chosen revenue recognition policy must satisfy the general recognition criteria of measurability and probability. Revenue must be measurable with reasonable assurance, and its eventual realization (in cash) must be highly probable. One should note that the act of revenue recognition increases the net assets of a company.

The increase may be through an increase in cash, accounts receivable, or inventories, but ultimately the amount must be realizable in cash.

Often, there are several different points in a single revenue-generating activity at which revenue can be recognized. This is especially true if the activity involves a sustained effort to earn the revenue or to collect it. The choice of revenue recognition policies depends very heavily on the financial reporting objectives of the company and on the motivations of its managers. An objective of income tax minimization will lead to a much different revenue recognition policy than will an objective of maximizing net income. In Nigeria, it is more likely that non quoted companies would prefer completed contract method to defer payments of tax whereas quoted one may likely adopt the percentage of completion method to defend their market

price position in the stock exchange. Revenue recognition policy is, very often, the supreme test of an accountant's professional judgment.

The Earning Process

At the conceptual level, a firm earns revenue as it engages in activities that increases the value (or utility in economic terms) of an item or service. Revenue generation may not be instantaneous, for instance, when an automobile parts manufacturer increases the value of sheet metal by carrying out or undertakes activities to cut, shape and wield the sheet metal into automobile fenders. Transporting completed fenders to a regional wholesale warehouse also adds value because it is now readily available for purchase by automobile repair shops. The earning process is fully completed when the fenders are sold and delivered to a customer in return for cash or a promise to pay cash. All of these activities and many more are part of the earning process. The earning process in sale of goods is as simple as in the above statement on what constitutes revenue on sale of goods. Revenue earning process in contract project is not as simple as in the above but in stages, for instance, percentage of completion and completion methods.

Challenges to Reporting Revenue in Financial Statements

Although IAS No.18 and IAS No.11 seem to be comprehensive in approach and standards, it has some pecuniary issues that needed to be resolved, for instance, time value of money and non- cash consideration in determining transaction price, sale of a product with a right of return and product warranties. The new proposed IFRS on revenue from contracts with customers may take care of them but much still depends not just on the standard setters (FRC in the case of Nigeria) for surveillance but also on the integrity of the auditors and tone of management. This is because despite the significant models by IFRS to improve the overall accuracy of financial reporting, there is no doubt that improper revenue recognition may continue to be a challenge especially in this present day economic climate, why?, because a tough economy makes it even harder for companies to meet earnings expectations and the pressure to achieve such a target creates an environment that induce improper revenue recognition practices. The scope of the current recession and stiff competition among businesses is broad and unfathomable so that the range of revenue recognition problems is high and diverse. That is why some companies chose to use subtle revenue manipulating techniques, for instance, the use of 'channel stuffing,'

miscounting 'bill – and hold transaction' and 'side agreements.' According to American Institute of Certified Public Accountants (AICPA), channel stuffing is a marketing practice that helps suppliers to sometimes boost sales by inducing distributors to buy substantially more inventory than they can promptly resell. This is likely to occur near the end of a reporting period in order to "book tomorrow's revenue today with the effect of window – dressing the financial statement." They explained bill and hold transaction arrangement as a process whereby sales are invoiced to customers prior to the delivery of the goods and often delivery does not occur until the customer specifically request for it. This type of arrangement is susceptible to premature revenue recognition innocently or intentionally. Side arrangements has equally been explained as a process whereby some companies create favourable terms unknown to the company's auditors and board of directors that induce customers to accept the delivery of goods or services without assuming all the risks of ownership, if the risks of ownership do not fully pass to the customer, then revenue cannot be properly recognized.

Findings

The findings in this article showed that IAS No.18 has made some fundamental improvements in the observance of standards in revenue recognition but the proposed new standard on revenue from contracts with customers that is due to be released at the end of 2012 or early next year may totally revise or replace both IAS No. 18 and IAS No.11 because they are not robust in framework. We noticed that the integrity, competence and auditors independence including the tone of management affects observance of standards of revenue recognition of any organization. The study revealed some subtle manipulations of revenue recognition that can still take place despite the standards set in the IAS No.18. Examples of such subtle manipulations include; (a) channel stuffing (b) bill – and – hold transaction arrangements (c) side arrangements. The study also revealed that the financial reporting objectives of an enterprise will determine the choice of revenue recognition policy that will be taken.

Conclusion

Revenue is the most important and largest item in the financial statement. Revenue recognition has been and is still a challenge to standard setters, financial regulators and stakeholders of business organizations. The international financial reporting standard (IFRS) is poised to revise and

replace IAS No.18 and IAS No.11 as the official standard guide on revenue recognition by the end 2012. The degree of integrity, competence and auditors independence including the tone of management have a very significance impact on the standard of revenue recognition of any organization. And to restore investors' confidence on the financial statement prepared by many companies in Nigeria, the Financial reporting council of Nigeria (FRC) need not only adopt the proposed revised standard on revenue recognition but institute a high degree of surveillance on the activities of audit firms in Nigeria.

Recommendations

To minimize or avoid high rate of misstatements or spurious figures in the financial statements, the following steps could be adopted:

1) Standard setters – for instance in the case of Nigeria, financial reporting council (FRC) should ensure that a good tone of management exists that will be interested in accurate revenue recognition formula. This could be achieved by ensuring that there exist a good number of independent members on the board of directors of companies.

2) There should be a close eye on every fast growing company by the FRC to ensure that the companies are actually generating commensurate revenue for their growth and that they are not window – dressing their financial statements.

3) There should be a social security and insurance for external auditors of certain sensitive companies.

4) The financial reporting council of Nigeria in collaboration with the professional accounting bodies should restore confidence in the financial markets by exposing every aspect of corporate culture of fraud and deception in the financial institutions, quoted and unquoted companies in Nigeria.

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