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Recognition Position Paper

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No matter what a person does, be it an entrepreneur, a manager, or a clerk, accounting has an impact on his/her life. Many do not think of balancing a home checking account as a form of accounting, but it is. Not all people are skilled in accounting methods, however. When faced with making business decisions, a savvy business person will call upon others with expertise that is different from their own. Our M & M consulting firm is just such an entity. As consultants to the CEO of a manufacturing firm, we have been tasked with making recommendations regarding recognition of revenues and expenses. In addition to the recommendations, we also will give reasons why we have or have not chosen the various methods available.

Revenue is recognized when two basic criteria are met. First, revenue must be earned, that is, the earning process in either completed or virtually completed. Second, revenue must be realizable, that is, cash is received or the amount to be received can be measured. Failure to meet one of these criteria results in the deferral of revenue.

Judging whether the two criteria are met can be straightforward or present major challenges. For example, retailers recognize revenue at the time of the sale. However, for the service and high-tech industries, establishing when revenue is earned can present difficulties in situations where complex contracts are concluded with customers. Return and upgrade clauses, continuous services, and conditional payments make it difficult to apply realization criteria.

There are three methods that are used to help recognize revenue. These methods are the percentage of completion, the completed contract method, and the installment payment method. The percentage of completion method is most common with construction companies, such as those that build bridges or aircraft that take years to deliver the product to the customer. In this

case, the company responsible for building the product wants to be able to show its shareholders that it is generating revenue and profits even though the project itself is not yet complete. As a result, it will use the percentage of completion method for revenue recognition if two conditions are met: 1.) there is a long-term legally enforceable contract and 2.) it is possible to estimate the percentage of the project complete, revenues and costs.

Next, there is the completed contract method. This is the method that probably makes the most sense to investors. Under this method, revenue is recognized at the time of sale or at the completion of a project. On a sales basis the sale can be for cash or credit. This means that revenue is not recognized even if cash is received before the transaction is complete.

Finally, there is the installment payment method. This method is similar to percentage-of-completion in that the product has not passed to the buyer. While the amount of revenue recognized and paid using the percentage completion method can change from one month to the next, the installment method has a set amount to be collected each billing period.

Because our client is a manufacturer of food products that do not take much time to make, we are recommending the completed contract method of revenue recognition. The turn around time between receiving raw materials and shipping the product is short. The company will be able to recognize the revenue at the time of shipment, since their shipping terms are FOB shipping point. This method will enable the company to recognize revenues as they ship product and also recognize costs at the same time. The percentage completion method would prove to be quite cumbersome, since the product is leaving the manufacturing process so quickly. The installment method would also be time-consuming, unless the company had a long-term contract with a customer. The completed contract method would also streamline expense recognition.

Walther stated (Walther, 2005) expense recognition will typically follow one of three approaches, depending on cost:

Associating cause and effect

Systematic and rational allocation

Immediate recognition

Many costs are linked to revenue produced. For example, sales commission owed to an employee is based on the sale. Therefore, "the cost of inventory delivered to a customer should be expensed when the sale is recognized. This is what is meant by "associating cause and effect" (Walther, 2005, p.1). In the lack of a connection in cost and revenue, other expense recognition methods can be utilized. "In such cases, accountants may use a systematic and rational allocation scheme to spread a portion of the total cost to each period of use, through a process known as depreciation"(Walther, 2005, p.1). Lastly, immediate recognition occurs when costs cannot be linked to any revenue production, and do not benefit future interval as well. For example, "severance pay to a fired employee, which would be expensed when the employee is terminated" (Walther, 2005, p.1).

In the case of our manufacturer, costs would be recognized at the time of shipment, using the completed contract method. The same reasoning for costs exists as it did with revenue recognition. The percentage completion method would be too cumbersome as the manufacturing process enables a fast turnaround. Costs and revenue are therefore more quickly recognized with the completed contract method.

The post-Enron era companies now record an expense when options are awarded. There seems to be a couple of issues surrounding recording of an expense when an option is given.

Will the expensing provide a level playing field in accounting for management compensation? In addition, by recording an expense when an option is given will it improve corporate governance?

In 1991, the Financial Accounting Standards Board (FASB) floated a draft of a proposed new accounting standard. FASB indicated that a level playing field did not exist in the reporting of management incentive compensation. Companies that rewarded management with cash bonuses were required to report a compensation expense for the bonus paid, thereby reducing net income. In contrast, FASB stated, companies that rewarded management with stock options did not have a comparable reduction in net income. FASB's proposal was that, at the time a company awarded a stock option to an employee, it would record an expense for the "fair value of the option".

Pros

From what I have read if you use expensing options then you will provide a level playing field so that companies who use cash bonuses and companies that use stock options each have an expense on the income statement.

It will improve corporate governance by reducing or eliminating incentives to inflate income and earnings per share.

Cons

The playing field is already level. A company using cash bonuses as management incentive compensation has a reduction in net income and a resultant reduction in earnings per share. When a stock option is given and the strike price is in the money, the additional shares become outstanding for purposes of calculating earnings per share. Remember, your earnings per

share will be calculated by dividing net income by weighted average shares outstanding, as the shares outstanding increase, the earnings per share decrease. If you require a company to record an expense for the option, and subsequently increase the shares outstanding then this becomes a double hit to earnings per share.

Regarding improved corporate governance, it is difficult to believe that the management or the Board of Directors of Enron would have limited the number of options simply because of the requirement to record an expense. Management is concerned strictly about personal gain and not about the company's income statement.

During recent years, each time that earnings management is scrutinized, analysts regularly state, "follow the cash." Ignore entries that are purely accounting and have no cash impact. Such is the nature of recording an expense when an option is given. This is an accounting entry with no cash impact. It is very likely that analysts will remove the option expense from the income statement to obtain a clear view of the company's performance. This would likely lead to companies including a pro forma income statement which excluded the option expense.

As a footnote to the "follow the cash" guideline, it is interesting to note that, not only is there no cash affect from the expense option, there is positive cash flow to the company. At the time the option is used, the employee must pay for the shares received.

Based on the information found in my research the original position of FASB appears to be no reason to make the proposed change in order to provide a level playing field.

As to the improved corporate governance argument for the change, the Securities and Exchange Commission certainly has just cause to seek improvements in corporate governance. However, there are ways of accomplishing this without creating controversial accounting

requirements and penalizing employees below the top level of management. There are more effective ways to accomplish this than the FASB proposal on expensing options.

Two suggested methods of dealing with options that could improve corporate governance are:

The SEC could place a limit on the percentage of a company's options are issued to the top three people in the company.

The SEC could require that the top three people in the company issued stock options on restricted stock (often called "letter stock" or Rule 141 stocks). This stock must be held for two years before it can be sold.

In summary, the financial reporting practices of businesses, especially their revenue reporting policies, are coming under increased scrutiny. Many recent scandals, splashed across the front pages of newspapers, have resulted from artificial inflation and overstatement of revenues, reporting of gains on sales of assets as revenue, backdating of sales contracts, improperly created cookie jar reserves, and questionable reporting methods. Whether misstatement of revenue occurs by intent, in response to pressure to perform, or simply because of improper understanding of the rules, businesses and their advisors must be alert to the signs of faulty policy. They need to be absolutely certain their policies are appropriate and legal.

Reference

Walther, L. M. (2005). 3. In (Ed.), *Income statement: principles of accounting* (pp.). : .